Draft law released on proposed integrity rules for stapled structure arrangements

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In brief

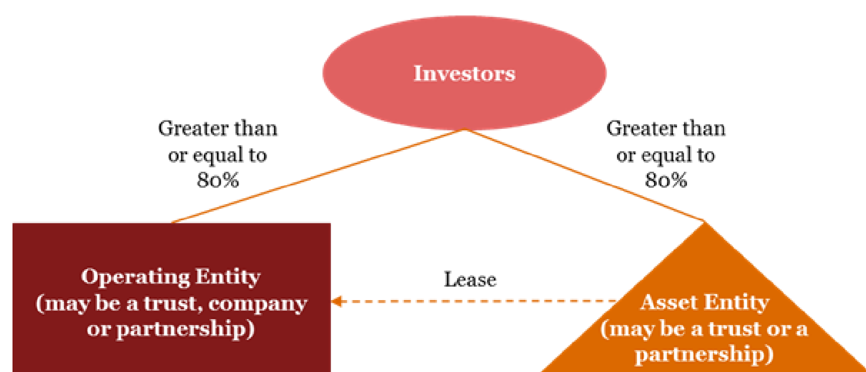
On 17 May 2018, Treasury released for public consultation the first stage of exposure draft legislation and explanatory material giving effect to most of the proposed integrity measures for stapled structures that was previously announced on 27 March 2018. The draft legislation seeks to 'address the sustainability and tax integrity risks posed by stapled structures and limit the concessions currently available to foreign investors for passive income'.

This exposure draft legislation contains the first four measures proposed by the package, including subjecting foreign investors to the corporate tax rate in respect of income derived by a Managed Investment Trust (**MIT**) that is part of a stapled structure, preventing double gearing, limiting concessions available to foreign pension funds and limiting the application of the established principle of sovereign immunity. Draft legislation to deal with the agricultural MIT changes and the conditions that stapled entities must comply with in order to access the infrastructure concession and/or transitional arrangements will be released in due course.

The draft legislation is open for comment until 31 May 2018. Whilst the consultation period on the draft legislation is remarkably short, the release of this draft legislation follows Treasury consultations on the future of stapled structures which commenced in March 2017. The Government appears to be aiming to have the measures introduced into Parliament in the current Winter sittings.

Although the majority of the law changes have transitional rules for existing arrangements held as at 27 March 2018, the changes proposed to be made to the thin capitalisation rules apply as early as 1 July 2018.

Simplified illustration of a typical cross staple arrangement



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Considerations for infrastructure and real estate investors

These proposed law changes will particularly impact the after-tax outcomes that apply to foreign investors in many Australian infrastructure and real estate investments, and not just those who invest in stapled arrangements. Broadly, a *cross staple arrangement* is an arrangement where the same investors hold 80 per cent common ownership in two or more entities (whether or not the ownership interests in these entities are bound together by a formal legal arrangement).

Although the transitional rules for existing arrangements may mean there is no immediate need for foreign investors to revisit existing structures, other than for those who have 'double gearing' in their upstream structures, many could suffer negative impacts on their investment values.

The changes to the foreign pension fund and sovereign immunity exemptions however, are likely to impact rates of return, which may mean that certain foreign investors will sell down their investments during the transitional period. For these investors, the exit timeline and strategy may need to be considered in the coming months.

In addition, all proposed new investments will need to factor in the new rules when it comes to assessing the financial impact for investors. Foreign investors in new investments (other than in nationally significant infrastructure) will find competing with domestic Australian institutional investors more challenging.

As expected, the draft law is positive news for traditional stapled real estate investment trusts (**REITs**) in the commercial and retail property sectors with little to no cross-staple lease arrangements, confirming that they should not be materially impacted by the proposed changes.

Unfortunately, other real estate stapled structures with cross-staple leases (i.e. typically found in hotel and student housing structures) which are not generally considered a single unified business may still be adversely impacted. Although the so-called 'flow-through' rent exception may apply to some cross staple arrangements (see below).

This draft legislation provides the much needed detail required to assess the financial impact for investors. However, there are also a number of additional questions as to the application of the proposed new law. We outline below some observations in relation to the proposed new law:

- The effect of the draft law in relation to stapled structures is to subject fund payments paid by MITs that are sourced from cross staple arrangements (other than interest on loans) to the top corporate tax rate (referred to as non-concessional MIT income). Importantly, capital gains derived by a MIT should continue to be subject to the 15 per cent MIT withholding rate.
- The draft law also provides that MITs holding a direct or indirect interest in a trading trust (even if non-controlling) will not be eligible for the 15 percent MIT withholding tax rate in respect of their proportionate share of the net income of the trading trust. Further, the draft law applies to an interest held by a MIT in a partnership or a trust (that is not a unit trust) that would have each been classified as a trading trust had it been a unit trust. Transitional rules should apply for existing investments.
- Interestingly, the draft law does not specifically address the application of the general anti-avoidance rules (**GAAR**) to staple structures (including staple structures that involve an asset trust that is not a MIT), which could, for example, apply to deny deductions to the operating entity on the cross staple arrangement. However, there is protection for the duration of the transitional period on the deductibility of rent paid by operating entities within economic infrastructure staples and existing staples which qualify for the transitional rules (this is subject to seeing the details of the integrity provisions). Taxpayers will need to consider the GAAR if they are not eligible for the transitional rules, or use staple structures in periods before or after the applicable transitional period.
- To lower compliance costs, a carve out is proposed to shelter MITs from the higher MIT withholding tax rate under a de-minimis rule which applies where the non-concessional MIT income does not exceed five per cent of the assessable income of the MIT (excluding capital gains) for the previous year. This rule is helpful, for example, where stapled groups lease head office premises. However, whilst the intention of the law to create a de-minimis rule that provides a safe-harbour for non-concessional MIT income that does not exceed five per cent of the assessable income, the devil is in the detail in the application of this rule. As such, taxpayers will need to carefully work through these rules in order to determine the application to their specific circumstances and, in particular, the entity to which the de-minimus applies.

- Although the draft law provides some comfort that cross-staple payments which are sourced from underlying rental income by the operating entity should not attract the higher withholding tax rate, the draft law refers only to rent and therefore, this exception is not overly helpful to structures where the operating entity is deriving income from third parties for the use of space that may technically not be rent (i.e. flexible working arrangements, some data centres, student housing and hotel operators). However, this exception could be helpful for landlord ports structured as a staple, as external rent received by the operating entity can be passed through to the asset trust and arguably may be subject to the 15 per cent MIT withholding tax rate.
- The transitional arrangements are somewhat complex and care will need to be taken to check eligibility in respect of proposed stapled structures where the 'asset' was not actually acquired before 27 March 2018, but may have been committed to. Furthermore, eligibility for the transitional period is determined on an asset by asset basis. *Asset* is not defined however, the context in which the term *asset* appears in the transitional provisions and in the definition of economic infrastructure asset, each suggest that *asset* should be read as referring collectively to the broad piece of infrastructure (e.g. the network) rather than each smaller working part (e.g. the substations, poles, wires). Examples provided in the draft explanatory material specifically state that expansion of an electricity network to a newly constructed suburb, or the addition of new levels to an existing building, would in each case constitute an improvement of an existing asset rather than investment in a new asset. Accordingly where an existing asset is eligible for transitional treatment and is improved, the transitional treatment should extend to improvements as well.
- It should also be noted that stapled entities must make an irrevocable choice in writing at the relevant time for the transitional provisions to apply.
- An entity will only be eligible for the foreign pension fund withholding tax exemption and sovereign immunity exemption where it controls ownership interests which constitute less than 10 per cent of an entity's ownership interest *and* it does not, broadly, influence an entity's key decision making (which includes membership of an advisory committee). This is a two part test, which is a higher threshold for taxpayers than has historically been the case, and may require taxpayers who are currently relying on these concessions to revisit their availability.
- In addition, the sovereign immunity exemption appears to only apply to distributions from trusts which are MITs. Distributions from trusts which are not MITs appear to not be covered by the exemption. The 10 per cent threshold test must also be aggregated with other sovereign entities from the same foreign country. This is a clear change in approach and in practice, which can be problematic as, in our experience, sovereign entities do not share information with one another, even where they are from the same foreign country. In welcome news however, existing investments that would not qualify for sovereign immunity under the proposed new law will have their cost base reset to market value at the end of the transitional period. It should be noted however, that if an entity qualifies for sovereign immunity and later ceases to qualify, this will not result in a cost base reset.
- Renewable energy assets may be allowed to access the 15 year concession for economic infrastructure (as energy infrastructure), where the electricity generated by the renewable energy asset is for use by the public. This will require a case-by-case consideration of the supply arrangements in place with respect to the renewable project (which may not be reliably predictable prior to completion of the project). For completeness, this is also a consideration for other economic infrastructure assets.

In detail

The draft legislation addresses the following four previously announced measures:

- subjecting foreign investors to the corporate tax rate in respect of income derived by a Managed Investment Trust (**MIT**) that is part of a stapled structure;
- preventing double gearing through thin capitalisation changes;
- limiting concessions available to foreign pension funds; and
- limiting the application of the established principle of sovereign immunity.

However, this current package of draft law does not include the proposed measures to prevent agricultural MITs from accessing the lower 15 per cent concessional tax rate or the integrity measures, which are yet to come.

The majority of the proposed law changes have transitional provisions for pre-existing arrangements as at the date of the announcement (being 27 March 2018). Although, the stapled entities must make an irrevocable choice in writing at the relevant time for these transitional provisions to apply. However, the thin capitalisation changes are proposed to apply with effect from income years commencing on or after 1 July 2018.

We outline below the key issues raised by the proposed law changes.

1. Increase in MIT withholding tax rate on non-concessional MIT income

Under the draft legislation, fund payments made by a MIT to a foreign investor are subject to MIT withholding tax at the top corporate tax rate (currently 30 per cent) to the extent that they are attributable to non-concessional MIT income. Non-concessional MIT income is broadly income that is sourced from cross staple arrangements (other than interest on loans, and that is attributable to third party rental derived from the operating entity).

Non-concessional MIT income also includes amounts that are attributable to the net income of trading trusts even where the MIT has a non-controlling interest (i.e. vertical trust structures), which would otherwise have been subject to the MIT withholding tax rate of 15 per cent. This also includes net income from an interest in a partnership and net income from a trust (that is not a unit trust) that would have been classified as a trading trust on the assumption it were a unit trust.

The MIT withholding tax provisions are therefore modified so that, to the extent that a fund payment reflects amounts of income derived by a MIT that is non-concessional MIT income, the amounts are subject to withholding tax at the top corporate tax rate, rather than 15 per cent.

Practically, this means that two MIT withholding tax rates could apply to fund payments. This dual rate approach will be welcomed by taxpayers as the inclusion of non-concessional MIT income will not taint the concessional treatment of income other than non-concessional MIT income, as was initially feared may be the case when a review of stapled structures was initially announced.

However, there will be an increase in the overall tax payable on a MIT fund payment to a blended rate that is higher than the traditional 15 per cent. This dual rate outcome will also lead to a focus on expense allocation between different income types.

Perhaps more interestingly, if this dual rate approach is embraced more broadly, it could provide a policy solution to the disproportionate outcomes that exist under Division 6C of the *Income Tax Assessment Act 1936*. That is, the Government could choose for all temporary 'bad income' to be taxed at this higher rate, rather than putting the whole flow-through status of a trust at risk.

2. Significant complexity applying the key principles

Whilst the drafting intent to tax non-concessional MIT income at the top corporate tax rate is clear, there is significant complexity regarding the key principles of the proposed new law. This complexity is largely driven by the introduction of a number of new legislative terms such as *asset entity*, *operating entity*, *cross staple arrangement* and *stapled entity*.

Broadly, an *asset entity*, in relation to an income year, is a trust or a partnership (if it were treated as a trust and presumably owned by an MIT) that is not a trading trust; does not carry on a trading business; or does not directly or indirectly control another person who carries on a trading business. Whereas an *operating entity* is broadly a trust, partnership or company (if treated as a trust) that carries on one of these three trading activities. Furthermore, each of the entities that have entered into the cross staple arrangement is a stapled entity.

However, the definition of *cross staple arrangement,* which is core to many of these measures, is particularly complex and may yield surprising results to structures where there is differential ownership of entities. According to the draft legislation, a cross staple arrangement is an arrangement that is entered into by two or more entities (arrangement entities) where at least one is an asset entity, at least one is an operating entity, and external entities (i.e. entities that are not a party to the arrangement, such as a unitholder, shareholder, investor, etc.) have a total participation interest of at least 80 per cent or more in each arrangement entity. For the purpose of working out the total participation interests that an investor has in another entity, the amount of the test entity's total participation interest is equal to the lowest participation amount.

The fact that this definition is mechanical rather than purpose based or subjective is welcome.

Taxpayers will need to carefully work through the above definitions in order to determine the application of the proposed new rules to their existing and proposed arrangements.

3. Exceptions to the treatment of income as non-concessional

The draft law provides the following three circumstances in which an amount that is attributable to a cross staple arrangement will not be non-concessional MIT income of a MIT and therefore, will continue to attract the 15 per cent fund payment withholding rate:

- the **'flow-through rent' exception** - the amount derived, received or made by an operating entity is rent from an unrelated party that, directly or indirectly, flows through to a MIT as part of a cross staple payment.
- the ***de minimis exception*** - the non-concessional MIT income of the MIT in the previous year and the non-concessional MIT income that was attributable to a payment made by another trust (including another MIT) did not exceed five per cent of the total assessable income (disregarding any net capital gains) of the MIT for that previous income year.
- the ***approved economic infrastructure asset exception*** - the amount is rent from an approved infrastructure asset. An approved infrastructure asset is an asset that has the current approval of the Treasurer (see below for details of the criteria to be considered by the Treasurer). Notably, this exception is available for a time that is no later than the end of the period of 15 years beginning on the day that the asset is first put to use.

4. Concession for new nationally significant infrastructure

As noted above and previously announced, a 15-year exemption may be available in respect of *new* infrastructure projects so as to encourage the construction of *nationally significant infrastructure* approved by the Treasurer. The 15 year period commences on the day that the relevant asset is first put to use.

This exemption will allow approved infrastructure assets held in a stapled structure to enjoy the 15 per cent MIT withholding tax rate on cross-staple rental income for the exemption period (provided they satisfy the other conditions for this concession).

The draft legislation provides the much needed detail on what constitutes nationally significant infrastructure that was missing in the previous announcement. Specifically, the draft law provides that the Treasurer may approve the asset if satisfied that the following criteria are met:

- the asset is an economic infrastructure asset (being transport, energy, communications or water infrastructure for public purposes);
- the estimated capital expenditure on the asset is $500 million or more;
- the asset is yet to be constructed, or the asset is an existing asset that will be substantially improved;
- the asset will significantly enhance the long-term productive capacity of the economy; and
- approving the asset is in the national interest.

The guidance provided by the draft legislation will be welcomed by the infrastructure industry.

Foreign investors will note that engagement with Treasury in respect of future infrastructure investments may be required for both approval to invest in Australian assets (i.e. the Foreign Investment Review Board approval process), as well as to access the MIT concession on economic infrastructure assets.

5. Preventing 'double gearing' structures through amending the thin capitalisation rules

The draft legislation reduces the threshold at which a trust (other than a public trading trust) or partnership becomes an 'associate entity' from ownership of 50 per cent or more to 10 per cent or more for the purposes of applying the thin capitalisation rules. The ability for investors with a 10 per cent interest to obtain relevant information in respect of downstream entities so that they can undertake accurate thin capitalisation calculations means many investments may need to be wholly equity funded.

In response to the above change, the draft law also deals with investors who may have attempted to 'double gear' by calculating a thin capitalisation arm's length debt amount. Specifically, the draft law also introduces amendments to clarify that, for the purposes of determining the arm's length debt amount, the debt to equity

ratios of any entities in which the entity has a direct or indirect interest is a factor that must also be taken into account.

The thin capitalisation measure will apply to income years commencing on or after 1 July 2018, with no transitional period.

6. Codifying sovereign immunity

The draft legislation provides a framework for determining sovereign immunity, which broadly exempts sovereign entities only where they hold less than 10 per cent of an entity's ownership interest and do not influence an entity's key decision making. In addition, the 10 per cent threshold test must also be aggregated with other sovereign entities from the same foreign country.

Interestingly, a sovereign entity is taken to hold an interest of 10 per cent of an entity where the interest it holds confers a right in a second entity to vote at a meeting of its Board of Directors (or other governing body); to participate in making its financial, operating and policy decisions; or to deal with its assets.

In addition, the sovereign immunity exemption appears to only apply to trusts that are MITs. Whilst this is in line with the Government's initial announcement to preclude active income (including where it is converted to rent) this appears to be much narrower in scope than what was previously expected (i.e. passive income from non-MITs appears to be excluded from the exemption).

These changes will take effect from 1 July 2019. Investments in existence at 27 March 2018 have access to a seven-year transitional period (unless a tax ruling is in place which extends beyond the seven-year period).

7. Limiting the foreign pension fund exemption

The draft law limits the foreign pension fund withholding tax exemption for interest and dividends to portfolio investments (i.e. where a foreign pension fund investor holds ownership interests of less than 10 per cent, and does not have influence over the entity's key decision-making). This measure will take effect from 1 July 2019. Arrangements in existence at 27 March 2018 will have access to a seven-year transitional period.

Summary of the transitional rule for existing arrangements and application to new structures and arrangements

	Start date	Concession?	Concession start date	Concession length	Concession end date
Existing stapled structures					
Existing / 'Committed to' staples (e.g. renewables and social infrastructure)	1 July 2019	Yes	1 July 2019	7 years	30 June 2026*
Agricultural staples**	1 July 2019	Yes	1 July 2019	7 years	30 June 2026
Existing / 'Committed to' economic infrastructure staples	1 July 2019	Yes	1 July 2019	15 years	30 June 2034***
Commercial / retail property and finance staples	*Not intended to be captured by the draft law*				
New stapled structures - post the announcement					
New economic infrastructure and other staples	1 July 2019	No	n/a	n/a	n/a

New nationally significant economic infrastructure staples	1 July 2019	Yes	1 July 2019 (or later)	15 years	15 years from the day the asset is first put to use
New commercial / retail property and finance staples	*Not intended to be captured by the draft law*				
Non-controlling interests held by MITs in trading trusts					
Existing non-controlling MIT interests in a trading trust at 27 March 2018	27 March 2018	Yes	1 July 2019	7 years	30 June 2026
New interests post 27 March 2018 (including increases to existing interests)	27 March 2018	No	n/a	n/a	n/a
Foreign investor measures - existing arrangements					
Removal of foreign pension fund exemption for existing non-portfolio (>= 10%) equity and debt investments	1 July 2019	Yes	1 July 2019	7 years	30 June 2026
Codifying sovereign immunity	1 July 2019	Yes	1 July 2019	7 years^	30 June 2026^
Amendments to thin capitalisation rules	Income years commencing on or after 1 July 2018	No	n/a	n/a	n/a
Foreign investor measures - new arrangements post the announcement					
Removal of foreign pension fund exemption for existing non-portfolio (>= 10%) equity and debt investments	1 July 2019	No	n/a	n/a	n/a
Codifying sovereign immunity	1 July 2019	No	n/a	n/a	n/a

** Or before 1 July 2031, and the later of 1 July 2026 and the end of the 7 year period beginning on the day the asset is first put to use.*
*** Not included in the draft legislation however flagged in the Treasurer's announcements.*
**** Or before 1 July 2039, and the later of 1 July 2035 and the end of the seven year period beginning on the day the asset is first put to use.*
^ Unless a tax ruling is in place extending beyond the seven year period.

Next steps

With a short period of time available for commenting on the draft law, i.e. before 31 May 2018, it is expected that the Government might be aiming to have the measures introduced into Parliament in the current Winter sittings. The efficient drafting and passage of the proposed measures into law will be critical to ensure that taxpayers have certainty in relation to their existing and proposed investments.

Since the thin capitalisation measures apply as early as 1 July 2018 for some taxpayers, the implications of the new rules on the cost of funding should be considered as soon as possible. For existing arrangements or investment mandates, it will be critical to assess the potential application of the transitional rules in the short

term. However, all proposed new investments will need to factor in these new rules when assessing the financial and commercial impact for investors.

Let's talk

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