New integrity measures for stapled structures – impacts for real estate investors

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In brief

On 27 March 2018, the Australian Government released a package of tax measures, '*Stapled Structures - Details of Integrity Package*', that seek to 'address the sustainability and tax integrity risks posed by stapled structures and limit the concessions currently available to foreign investors for passive income'. These measures will particularly impact the after-tax outcomes that apply to investors in many Australian real estate investments, and not just those who invest in stapled arrangements.

The package of tax measures follows consultations which commenced early last year during the course of the Government's review of the tax treatment of stapled structures.

The majority of the announced measures will apply from 1 July 2019 but with transitional rules for existing arrangements as at the date of the announcement. However, changes are proposed to be made to the thin capitalisation rules as early as 1 July 2018.

What real estate investors need to know

Over the past 12 months, investment in Australian real estate, particularly into non-traditional real estate held in stapled structures (such as hotels and student accommodation), has been clouded as a result of the uncertainty arising from the Australian Taxation Office's Taxpayer Alert 2017/1, and the release of the Treasury consultation paper on stapled structures.

The consultation by Treasury was not limited to stapled structures, but also reviewed a number of concessions available to foreign investors. When releasing the current package of reforms, the Treasurer stated in the announcement that these new measures will level the playing field for Australian investors by closing down unintended concessions that were only available to foreign investors.

In brief, the package of proposed changes includes new measures that will subject 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, prevent double gearing through thin capitalisation changes, limit the concessions available to foreign pension funds, limit the application of the established principle of sovereign immunity and prevent agricultural MITs from accessing the lower 15 per cent concessional tax rate.

As expected, the announcement is accompanied by 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 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. The Government has however, provided transitional relief for seven years to allow time for these types of investments to be restructured.

The announced package provides some level of guidance on the direction of the proposed rules and certainty for foreign investors. It is also clear that the proposed changes will impact the after-tax outcomes applying to foreign (and potentially domestic) investors more broadly than those who invest in stapled arrangements. However in the absence of draft legislation, the proposals raise a number of additional questions as to the application of the new measures. In particular:

- Although the announcement 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 package notably does not provide further detail or guidance as to the meaning of 'rent'. This question links to the broader question of what constitutes rent, which impacts many in the real estate industry (including flexible working arrangements, shopping centres, student housing and hotel operators) where the operator may not be technically deriving rent, even though the end user is charged for the use of space. Guidance as to the meaning of rent will be welcomed to ensure that this measure operates in the way it has been intended.

- To lower compliance costs, a carve out is proposed to shelter MITs from the higher MIT withholding tax rate where only a 'small proportion' of the gross income of the MIT is derived from cross-staple payments. The proposal appears to be similar in form to the safe harbours afforded to taxpayers in considering whether they are investing in land primarily for the purpose of deriving rent. In the absence of further clarity, the questions remain as to the permissible percentage of cross-staple income, whether the test will need to be considered annually, and whether any calculation of proportion will exclude income from capital gains (similar to the safe harbour for the derivation of rent). Potentially this rule could impact leasing of head office space or stapled groups involving in flexible working businesses.

- Treasury will consult separately on the conditions imposed on stapled entities in order to access the transitional measures, with particular attention drawn to 'aggressive cross-stapling' and the potential introduction of stronger integrity measures in addition to those which already exist (for example, debt/equity integrity rules, thin capitalisation and in particular, the non-arm's length income rule (**NALIR**) which currently governs the arm's length pricing of cross-staple arrangements). It is unclear what further integrity measures will be introduced. No detail was provided in relation to this consultation.

- Although transitional arrangements will be afforded to existing structures at the date of the announcement and also structures that were 'committed to' prior to the announcement, it is unclear to what extent an arrangement will be considered to be 'committed to' (for example, is it sufficient to have simply executed a sale and purchase agreement, executed a joint venture agreement, established entities etc?). This will be particularly relevant for those investors establishing platforms for future investment. It is unclear whether the transitional arrangement will also be available to future investments made into those platforms. It is also unclear how these transitional measure will interact with those previously announced (e.g. the proposed transitional rules for existing build-to-rent investments).

- The limitations to the foreign pension fund withholding tax exemptions and the proposal to codify sovereign immunity is accompanied by the announcement that an investment will only be eligible for these concessions where it constitutes less than 10 per cent of an entity's ownership interest *and* does not influence an entity's key decision making. The announcement indicates a two-prong 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.

- It is unclear whether the proposed amendments to the thin capitalisation regime's definition of 'associate entity equity' and 'associate equity debt' will extend the scope of the thin capitalisation rules by capturing downstream entities as associates of investors that are outward investing entities, or if the extension of the definition will be limited for the purposes of thin capitalisation calculations of upstream investors only. Extending the scope of the rules would add significant complexity to the application of the rules and have a broader impact to taxpayers than was previously anticipated.

- In relation to agriculture MITs, there is no detail in the announcement as to whether the removal of the 15 per cent MIT withholding tax rate will only apply to agricultural land in a stapled structure or whether the proposed measures will also apply to single MIT structures that hold agriculture land and derive rent from third parties.

In detail - overview of the proposed changes

The majority of the announced measures have transitional rules for pre-existing arrangements as at the date of the announcement. However, changes are proposed to be made to the thin capitalisation rules with effect from income years commencing on 1 July 2018.

In summary, the key measures announced under this package are as follows:

1. Increase in MIT withholding tax rate on certain income

It is proposed that the MIT withholding tax rate for certain income derived by a MIT (being cross-staple rental payments and cross-staple payments made under some financial arrangement such as total return swaps) will be increased from 15 per cent to the corporate tax rate (currently 30 per cent). Practically, this means that two MIT withholding tax rates could apply to fund payments. This could increase the overall tax payable by a MIT to a blended rate 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 within 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.

The announcement also comments that MITs receiving distributions from trading trusts will be taxed at the new increased rate. This indicates that income from non-controlled trading trusts will be subject to the increased rate. With no minimum threshold announced, this measure could have wide-reaching implications to existing investments.

Acknowledging the long-term nature of economic infrastructure, the announcement includes a 15-year transitional rule which will be available for existing economic infrastructure. Treasury will consult separately on the conditions which must be complied with in order to obtain a 15 year exemption.

2. Concession for new nationally significant infrastructure

A 15-year exemption may be available in respect of *new* infrastructure projects to encourage the construction of ‘*nationally significant infrastructure*’ approved by the Government to be structured as stapled structures.

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).

There is little detail in the announcement on what constitutes nationally significant infrastructure and when the 15 years would commence (i.e. during construction or post construction).

3. Application of general anti-avoidance rules to stapled structures

The Government’s release indicates that following the implementation of this package and during the transitional period (which starts from 1 July 2019), the general anti-avoidance rule (**GAAR**) should not apply with respect to the choice to use a stapled structure to obtain a deduction in respect of cross-staple rent.

Little detail has been provided with respect to this. However, the announcement is notably silent on the application of the GAAR to these arrangements prior to 1 July 2019. It is hoped that a drafting solution can be found so that the GAAR cannot apply in the gap between announcement and the commencement of the transition period.

It appears that the rules have been specifically designed so that no protection is offered from GAAR for the pre-announcement period.

4. Preventing 'double gearing' structure through the thin capitalisation rules

The thin capitalisation rules will be amended to prevent foreign investors from using multiple layers of flow-through entities (i.e. trusts and partnerships) each issuing debt against the same underlying asset.

The package proposes to reduce the threshold at which an entity 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 10% investors 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 addition, the package will clarify that the thin capitalisation arm's length debt test requires consideration of gearing against the underlying assets of an entity to safeguard against adverse behavioural responses to this measure. No further detail was provided on the nature or extent of this clarification.

These thin capitalisation measures will apply to income years commencing on or after 1 July 2018. The announcement states that there is no transitional period as this measure addresses an unintended legislative outcome.

5. Codifying sovereign immunity

The package proposes to legislate a framework for sovereign immunity, which exempts sovereigns 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. Additionally, the package will preclude active income (including where it is converted to rent) from the exemption (there is no detail on the precise mechanics by which this is achieved).

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

6. Limiting the foreign pension fund exemption

The foreign pension fund withholding tax exemption for interest and dividends will be limited 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 the date of the Government announcement will have access to a seven-year transitional period commencing 1 July 2019.

7. Annihilating agricultural MITs

Under the package, investing in agricultural land for the purpose, or predominantly for the purpose, of deriving rent will no longer qualify as an eligible investment business. This measure seems to exclude rent and capital gains from the MIT regime going forward which is different to the proposed measure noted earlier at item 1 which applies to certain cross-staple payments. This measure will take effect from 1 July 2019. Arrangements in existence at the date of the Government announcement will have access to a seven-year transitional period commencing 1 July 2019.

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	1 July 2019	Yes	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 captured by the package*				
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 infrastructure staples	1 July 2019	Yes	1 July 2019 (or later)	15 years	15 years from the start date
New commercial / retail property and finance staples	*Not captured by the package*				
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

** Unless a tax ruling is in place extending beyond the seven year period.*

The takeaway

The drafting of the proposed measures into law will be critical to ensure that the policy intent is appropriately reflected, and that no unintended consequences arise. It is expected that there will be an opportunity to comment on the details of the measures in due course.

The application of transitional rules for existing arrangements means that there is no immediate need to revisit existing structures, other than to consider the thin capitalisation outcomes. 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

For a deeper discussion of how these issues might affect your business, please contact:

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