Revised exposure draft law on stapled structures and foreign investor tax concessions

31 July 2018

In brief

On 26 July 2018, Treasury released for public consultation the second stage of exposure draft legislation and explanatory material giving effect to the proposed integrity measures for stapled structures that were previously announced on 27 March 2018.

The revised exposure draft reflects feedback from public consultation on the first tranche of draft legislation which was released on 17 May 2018. It also includes draft legislation to prevent foreign investors from accessing concessional Managed Investment Trust (**MIT**) tax rates on agricultural land and changes to the treatment of residential housing held in a MIT announced as part of the affordable housing measures.

The revised draft legislation is open for comment until 10 August 2018. The consultation period on the revised draft legislation is again very short indicating that the Government appears to be aiming to have the measures introduced into Parliament in the upcoming Spring sittings.

In detail

The revised draft legislation includes the following measures:

- subjecting converted trading income to MIT withholding at the corporate tax rate;
- preventing double gearing through thin capitalisation changes;
- limiting the foreign pension fund withholding tax exemption for interest and dividends to portfolio investments;
- creating a legislative framework for the sovereign immunity exemption; and
- ensuring investments in agricultural land and residential property (other than affordable housing) are subject to MIT withholding at the corporate tax rate.

This draft of the legislation does not include the conditions that stapled entities must comply with in order to access the infrastructure concession and/or transitional arrangements. These conditions were discussed in the proposal paper released by Treasury on 28 June 2018 (and for which the consultation period closed on 12 July 2018).

A number of changes have been made to the proposed law since the first tranche of draft legislation was released in May 2018 (as discussed in our previous TaxTalk Alert which was published on 18 May 2018).

What's changed and what's new?

Stapled structures

1. Four categories of non-concessional MIT income

The revised draft legislation creates four categories of non-concessional MIT income:

- MIT cross staple arrangement income
- MIT trading trust income
- MIT agricultural income, and
- MIT residential housing income.

The first two categories are largely unchanged from the concepts used in the original draft legislation (including transitional measures - if applicable). However, the agricultural income and residential housing income provisions were not included in the original draft.

MIT cross staple arrangement income

In relation to MIT cross staple arrangement income, it is worth noting that:

- The revised draft legislation introduces the concept of 'rent from land investment' which aligns the concept of rent to the definition of 'eligible investment business' in Division 6C of *the Income Tax Assessment Act 1936* (Cth), i.e. it includes rent from moveable property which section 102MB expressly includes as 'investing in land'.
- The infrastructure concession and transitional provisions for economic infrastructure are now stated to apply to an 'economic infrastructure facility' (rather than an 'asset'). This term is intended to assist in clarifying the position with respect to assets that constitute an augmentation or enhancement to a facility, and is supported by a number of examples in the explanatory memorandum.
- Capital gains arising as a result of the disposal of an asset by the asset entity to the operating entity (where both are stapled entities) are specifically excluded from being MIT cross staple arrangement income.

MIT trading trust income

There have been no changes to the concept of MIT trading trust income (other than the name). That is, MITs holding any direct or indirect interest in a trading trust (or 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) will not be eligible for the 15 per cent MIT withholding tax rate in respect of their proportionate share of the net income of the trading trust.

MIT agricultural income

Treasury's policy announcement on 27 March 2018 proposed that investing in agricultural land for the purpose, or predominantly for the purpose, of deriving rent will no longer qualify as an eligible investment business. Based on the provisions included in the revised draft legislation, it appears that the Government's concerns in relation to agricultural land will now be dealt with by imposing MIT withholding at the top corporate tax rate (after the transitional period - if applicable) to the relevant income rather than amending the definition of eligible investment business.

The revised draft legislation includes MIT agricultural income in the definition of non-concessional MIT income. MIT agricultural income is defined as amounts of assessable income of a MIT that are attributable to an asset (whether or not held by the MIT) that is Australian agricultural land for rent. Importantly, this means that capital gains (derived directly or indirectly) are also included as MIT agricultural income.

'Australian agricultural land for rent' is defined as an asset that is real property (including a lease of land) situated in Australia if the asset:

- is used, or could reasonably be used, for carrying on a primary production business; and
- is held primarily for the purposes of deriving or receiving rent.

The definition is based on the definition of land contained within the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (the 'FIRB Act') with the extended requirement of also being held primarily for the purpose of deriving rent. The 'could reasonably be used' aspect of this definition means that these measures could apply to investors beyond the agricultural sector. Arguably, any large scale user of rural land could potentially be caught even where the land is not currently being used for a primary production business.

This means that if Australian agricultural land is sold while vacant, any gain made on the disposal will be regarded as MIT agricultural income and may be taxed at the corporate tax rate (if no other exceptions apply), even if the purchaser intends to use the land for a non-primary production business. This outcome is specifically intended and is included as an example in the explanatory memorandum.

The application of the rules to capital gains is specifically extended to capture gains from CGT events in relation to a membership interest in an entity where the membership entity passes the 'principal asset test' because its value is principally (more than 50 per cent) attributable to 'Australian agricultural land for rent'. Importantly, this is an 'all or nothing' test where 100 per cent of a capital gain relating to membership interests will be taxed at the non-concessional withholding tax rate if the principal asset test is passed, even if only 51 per cent of the value of the underlying assets relates to agricultural land.

The transitional rules for these measures generally operate so that income or gains relating to assets acquired before 27 March 2018, and derived before 1 July 2026, will be taxed at the concessional 15 per cent withholding rate. This is consistent with most other measures within the staples integrity package.

However, it is important to note that where MITs receive income or gains attributable to agricultural land held by another entity, the MIT will only be entitled to transitional relief if the MIT held **100 per cent** of the other entity throughout the period. That is, based on current drafting, MITs investing into joint ventures will **not** be eligible for the reduced withholding rate during the transitional period and will instead have a 30 per cent withholding from 1 July 2019 onwards. Given this measure appears to be punitive and penalises foreign investors that have invested in joint ventures with Australian partners relative to those which have invested with 100 per cent foreign ownership, we expect this may be a topic of submissions.

Another aspect of the transitional rules that is important to note is that capital gains attributable to Australian agricultural land will be fully taxable at the non-concessional rate from 1 July 2026 onwards notwithstanding that some component of the gain would have accrued during the transitional period or before. In this case, the legislation differs from other changes to the taxation of capital gains (e.g. such as Division 149 of the *Income Tax Assessment Act 1997* (Cth)) which generally provides some form of transitional relief to the taxation of capital gains (e.g. attributing unrealised gains to an earlier period entitled to concessional taxation). If this position is not amended through the consultation process, it is likely that this aspect of the transitional measures would distort the market with transactions in the first half of 2026 significantly advantaged relative to transactions in the second half of the year.

MIT residential housing income

MIT residential housing income is defined as any assessable income of a MIT (whether received directly or indirectly) to the extent it is attributable to an asset that is:

- a dwelling;
- taxable Australian real property; and
- residential premises but not commercial residential premises.

The terms 'residential premises' and 'commercial residential premises' take their meaning from the GST law (i.e. section 195-1 of the *A New Tax System (Goods and Services) Act 1999* (Cth)).

The draft explanatory memorandum notes that MIT residential housing income includes all amounts of assessable income of a MIT attributable to such assets (such as rent, capital gains and licence fees).

There is a specific carve-out in respect of amounts of income attributable to an asset to the extent that the income is referable to the use of the asset to provide affordable housing. The circumstances in which a dwelling is used to provide affordable housing are set out in the *Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018* which is currently before Parliament.

Capital gains in respect of dwellings used to provide affordable housing will also be excluded from MIT residential housing income if the dwelling has been used to provide affordable housing for at least 3,650 days. The days must occur after 1 July 2017 but before the CGT event, and do not need to be consecutive.

2. De minimis exception

The original draft legislation included a de minimis exception which applied if the non-concessional MIT income of a MIT (including amounts received from another trust) in the previous income year did not exceed five per cent of the total assessable income (disregarding net capital gains) of the MIT for the previous income year.

The revised draft legislation applies the de minimis exception to 'MIT cross staple arrangement income'. It also applies the de minimis exception separately to amounts of MIT cross staple arrangement income which a MIT receives indirectly through a lower tier trust - in these circumstances, the de minimis test will apply to the lower tier trust as if it were a MIT.

In addition, it allows a trust that was not a MIT in the previous income year (because it did not exist or was a trust that was not a MIT) to work out whether the de minimis exception applies based on reasonable estimates of MIT cross staple arrangement income, assessable income and total assessable income for the current income year.

3. Specific deduction for cross staple rent

The revised draft legislation introduces a new provision (i.e. new section 25-115 in the *Income Tax Assessment Act 1997*) which provides a specific deduction to an operating entity that has entered into a cross staple lease in respect of an approved infrastructure facility for rent it pays to the asset entity for the duration of the concession period, provided certain conditions are met.

Relevantly, new section 25-115 will require each stapled entity that is a party to the cross staple arrangement to make a choice to apply the section. The irrevocable choice must be made in the approved form before the start of the income year in which the asset is first put to use (or such later time as is allowed by the Commissioner), and must be given to the Commissioner within 60 days.

Thin capitalisation changes

The revised draft legislation introduces an additional integrity measure to the thin capitalisation changes that deals with split holdings. Broadly, the measure provides that an entity is taken to hold an associate interest of 10 per cent or more in the other entity where it is reasonable to conclude that an entity created this circumstance for the principal purpose of, or for more than one principal purpose that included the purpose of, ensuring that the first entity would not be an associate entity of the other entity.

The thin capitalisation changes have also been expanded to ensure the rules will apply where a trust (other than a public trading trust) is a partner in a partnership - specifically, for these purposes, an entity that benefits under the trust is treated as a partner in the partnership.

Foreign superannuation fund dividend and interest withholding tax exemption

In the original draft legislation, the foreign superannuation fund withholding tax exemption was limited to portfolio investments, i.e. total participation interests of less than 10 per cent in the entity that pays the interest/dividend, and with no influence over the entity's key decision making.

The influence test has been amended in the revised draft legislation which now provides that a superannuation fund has the requisite influence in relation to the paying entity if:

- the superannuation fund, acting alone or in concert with others, is directly or indirectly able to determine the identity of at least one of the persons who make (or might reasonably be expected to make) the decisions that comprise the control and direction of the paying entity's operations; and/or

- at least one of those persons is accustomed or obliged to act, or might reasonably be expected to act, in accordance with the directions, instructions or wishes of the foreign superannuation fund (whether expressed directly or indirectly, or through the superannuation fund acting in concert with others).

In addition, the revised draft legislation modifies the application of the total participation interest test to ensure that non share equity interests are taken into account in determining whether the test is satisfied.

Finally, in the case of an interposed entity such as a trust, the withholding tax exemption is also only available where the interest held by a foreign superannuation fund in the interposed entity is below 10 per cent. This is the case even if the relevant interposed trust does not hold any equity interest in the ultimate payer, or holds a minority interest below 10 per cent.

Sovereign immunity

The revised draft legislation clarifies the definition of sovereign entity, introduces the concept of a sovereign entity group (discussed below), and adopts the influence test as described above that applies to foreign superannuation funds, for the purposes of determining whether a sovereign entity qualifies for the sovereign immunity exemption.

The original draft legislation required the grouping of investments made by sovereign entities from the same country for the purposes of applying the portfolio interest test. In response to concerns around the grouping, the revised draft legislation applies the portfolio interest test and the influence test to a 'sovereign entity group', which distinguishes between a foreign government and a part of a foreign government.

According to the explanatory memorandum, this should mean that for countries with different levels of government (such as federal and state governments, or federal, state and provincial governments), the grouping of the sovereign entities occurs at:

- the federal level for federal entities; and
- the state or provincial level respectively for entities that are part of the state or provincial level government.

The transitional rules contained in the proposed legislation now deem the sovereign investor to have acquired the asset at the higher of its market value or its cost base where a deemed disposal occurs after the end of the transitional period on 1 July 2026.

Considerations for infrastructure and real estate investors

Infrastructure

- The infrastructure concession and transitional provisions for economic infrastructure are now stated to apply to an 'economic infrastructure facility' (rather than an 'asset'). This term is intended to assist in clarifying the position with respect to assets that constitute an augmentation or enhancement to a facility, and is supported by a number of examples in the explanatory memorandum. This will be relevant to existing facilities in stapled structures (e.g. ports, airports, roads, electricity distribution networks etc.) that have significant capital expenditure programs / asset expansions during the transition period and the substantial improvements do not qualify for the approved economic infrastructure asset exception.
- The definition of 'economic infrastructure asset' in the original draft referred to transport infrastructure, energy infrastructure, communications infrastructure and water infrastructure that are used for a 'public purpose'. In addition to now being referred to as an 'economic infrastructure facility', the revised draft now removes the requirement for economic infrastructure to be used for a public purpose.
- The introduction of a specific choice to obtain a deduction for cross staple rent (i.e. new section 25-115) is intended to interact with the specific Part IVA exclusion in relation to elections being made as provided for under the tax law. However, the exclusion in that provision will only apply where the scheme was not entered into or carried out for the purpose of creating any circumstance or state of affairs to enable such an election to be made.

Real estate

- The inclusion of MIT residential housing income as non-concessional MIT income reaffirms the Government's position in relation to foreign investors accessing the lower MIT withholding rate for residential assets (other than affordable housing assets). This is disappointing as it will create an additional barrier or disincentive for foreign institutional investors to invest in large scale 'build to rent' residential real estate projects that are required to increase housing supply in Australia. Note that the transitional rule does allow existing MITs that currently access the 15 per cent MIT withholding rate to continue to apply that rate until 1 October 2027.
- The draft law does however simplify structures that may contain a residential element, say for example mixed use developments that contain commercial and residential components which can now be held in a single MIT structure. Critically though, both the commercial and residential components will still need to be held by a MIT primarily for the purpose of deriving rent in order to not be considered a trading trust and maintain MIT status. Taxpayers should consider the 'primarily for the purpose of deriving rent' test carefully to ensure MIT status is maintained.
- As mentioned in our previous TaxTalk Alert, to lower compliance costs, a carve out is proposed to shelter MITs from the higher MIT withholding 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, 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-minimis applies as the rule appears to apply on an entity-by-entity basis and not on a consolidated basis. That is, there is likely to be a better chance of satisfying the de minimis rule where the cross staple arrangement is entered into by the head trust of a group (given the considerable income it would derive) as compared to a single property owning sub trust.

Agriculture

The agricultural measures have broad application and punitive consequences for foreign investors in agricultural land. The broad definition of 'agricultural land' and the extension of these measures to indirect investments increases the potential scope of these measures - perhaps beyond what was expected.

The transitional rules are currently onerous particularly as they relate to capital gains and indirect investments. Investors affected by these provisions may wish to consider making a submission on these points.

The takeaway

Given the short period of time available for commenting on the draft law, i.e. before 10 August 2018, it is expected that the Government will aim to have the measures introduced into Parliament in the upcoming Spring sittings. On that basis, this may be the final opportunity that stakeholders will have to comment on this part of the draft legislation. Note that draft legislation for the conditions that stapled entities must comply with in order to access the infrastructure concession and/or transitional arrangements is yet to be released.

Affected taxpayers should now start turning their minds to the compliance and administrative impacts that arise as a result of the law change. We expect that taxpayers will need to work closely with the Australian Taxation Office to seek guidance and agree an approach for the implementation of these changes.

Let's talk

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

Kirsten Arblaster, Melbourne
+61 (3) 8603 6120
kirsten.arblaster@pwc.com

Joshua Cardwell, Sydney
+61 (2) 8266 0532
josh.cardwell@pwc.com

Trinh Hua, Sydney
+61 (2) 8266 3045
trinh.hua@pwc.com

Mike Davidson, Sydney
+61 (2) 8266 8803
m.davidson@pwc.com

Luke Bugden, Sydney
+61 (2) 8266 4797
luke.bugden@pwc.com

Steve Ford, Sydney
+61 (2) 8266 3433
steve.ford@pwc.com

Glenn O'Connell, Sydney
+61 (2) 8266 0574
glenn.oconnell@pwc.com

Vaughan Lindfield, Perth
+61 (8) 9238 3660
vaughan.lindfield@pwc.com

Christian Holle, Sydney
+61 (2) 8266 5697
christian.holle@pwc.com

Abhi Aggarwal, Brisbane
+61 (7) 3257 5193
abhi.aggarwal@pwc.com

Stuart Landsberg, Brisbane
+61 (7) 3257 5136
stuart.landsberg@pwc.com

Mark Edmonds, Sydney
+61 (2) 8266 1339
mark.edmonds@pwc.com

© 2018 PricewaterhouseCoopers. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers a partnership formed in Australia, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity. This publication is a general summary. It is not legal or tax advice. Readers should not act on the basis of this publication before obtaining professional advice. PricewaterhouseCoopers is not licensed to provide financial product advice under the Corporations Act 2001 (Cth). Taxation is only one of the matters that you need to consider when making a decision on a financial product. You should consider taking advice from the holder of an Australian Financial Services License before making a decision on a financial product.

Liability limited by a scheme approved under Professional Standards Legislation.
WL127057726