The future of stapled structures

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In brief

As the government reviews its policy on stapled structures, Australia's investment landscape is clouded by uncertainty. The government must now deliver timely, yet considered, legislative action.

The Australian Government has actively supported foreign investment into Australian real property assets through tax policy for over 10 years. This policy manifests itself in the taxation of trusts on a 'flow-through' basis and the managed investment trust (MIT) regime introduced in 2007. These policies have facilitated a substantial amount of foreign direct investment into a range of asset classes, including listed and unlisted real estate, privatised government assets and infrastructure, renewable energy and agriculture.

In January 2017, the Australian Taxation Office (ATO) released TA 2017/1, highlighting the proliferation of stapled structures in the market and their inappropriate use to 'fragment' a business or 'recharacterise' its trading income into a character that is subject to concessional taxation. This alert was the catalyst to the release of the Treasury consultation paper on 24 March 2017 which outlined potential policy options to address the concerns raised by the ATO.

In the consultation paper, Treasury confirmed that it is ready to undertake a holistic examination of the taxation of investment income derived using stapled structures, and they are seeking to understand the following from taxpayers to help them respond to the issue:

(1) What is the right policy to deal with existing integrity concerns?
(2) What asset classes should benefit from tax incentives offered to foreign institutions?
(3) What is the right framework to deliver these incentives (i.e. 'stapled structures' or an alternative)?

PwC submitted a response to the consultation paper highlighting that any significant policy change will inevitably have immediate consequences by reducing investor confidence and market capitalisation of Australian institutions. The potential for a significant shift in tax policy will impact a large number of stakeholders, including state and territory governments, a range of foreign institutional investors, Australian superannuation funds and Australian Securities Exchange (ASX) listed entities including real estate investment trusts (REITs). In this article, we set out the approach to consultation and reform as recommended in the PwC stapled structures submission (the submission). What follows is a summary of the key messages in the submission.

In detail

Re-affirm the policy objectives

The submission encouraged the government to reiterate its commitment to policy objectives that have underpinned confidence and growth in Australia's property, infrastructure and agri-business industries. The particular commitments which the government should affirm include:

- a commitment to continue to tax passive income derived from real property (including REITs and instances where a common observable market exists), privatised assets and certain 'included infrastructure' on a flow-through basis,
- a commitment to continue to provide a level playing field for foreign institutions making passive investments in eligible Australian assets — with passive income from these structures, such as rent, subject to a 15 per cent withholding tax rate, and active trading income, such as sales and services income, subject to a 30 per cent corporate income tax or withholding tax rate, and
- in the event fundamental change is legislated, implement comprehensive transitional rules to ensure that existing structures are not adversely impacted and planned projects are not delayed or curtailed, as this could increase the perceived sovereign risk associated with Australian investments.

Restore the integrity of the tax system

The submission encouraged the government to take effective action to restore the integrity of Australia's taxation rules and protect the corporate tax base by addressing the ATO's concerns with respect to the 'recharacterisation' of trading income through the use of contrived royalty and synthetic stapled structures. As an alternative to the three broad policy options set out in the Treasury consultation paper,[1] any amendment to the taxation laws to address these integrity issues should be effected through the withholding regime in the *Income Tax Assessment Act 1936* (Cth) and the *Taxation Administration Act 1953* (Cth), rather than entity level taxation. That is, the amendments should require the trustee of a trust in receipt of royalty or synthetic income derived under arrangements entered into post the announcement in the 2017-18 Federal Budget to withhold and remit amounts to the ATO at Australia's corporate tax rate. This approach should ensure effective collection of taxes and administrative action until any changes to the current tax policy have been finalised. It should also limit the potential for an adverse impact on the broader taxation system and stakeholder community in the short term. The potential adverse impacts of Treasury's broad policy options flagged in the submission include:

- operating company becoming a franking trap (impacting both resident and non-resident investors),
- operating company could become insolvent (impacting directors, ability to operate, creditors etc),
- banking covenants breached (leading to a potential default on third party debts), and
- loss of foreign tax credits for foreign investors (due to effective Australian company taxation).

These issues will need to be carefully considered before implementing the options in the Treasury paper.

Better targeting the tax concessions to foreign capital

The submission encouraged the government to undertake a fulsome consultation and engagement process with stakeholders before any significant changes are implemented to the existing framework. The principles for any review should be clearly laid out and may include, among other things, to:

- constrain the eligibility of the tax concessions to the intended asset classes;
- protect existing investors in stapled structures from adverse change; and

[1] Treasury, Stapled structures, consultation paper, March 2017, p 14.

- enhance the effectiveness of Australia's taxation regime and concessions.

The submission advanced four transaction classes that should be permitted in a stapled structure to encourage passive investment, particularly from foreign institutions. These classes were:

(1) Australian REITs, including the incorporation of a broader definition of 'rent' to include amounts paid for the use of physical space (e.g. student accommodation, hotels etc.),
(2) privatisations, comprising government asset privatisations that include some of the largest transactions in Australia (e.g. toll-roads operating under concessions, ports, airports, utilities etc),
(3) 'included infrastructure', being key infrastructure facilities such as roads, tunnels, bridges, airports, ports, electricity generation (including renewables), gas pipeline assets, water supply assets, sewage etc., and
(4) other real property where an observable third party rental market exists (e.g. agricultural land).

In conjunction with this fulsome consultation process into stapled structures, a suggestion was made for the government to commission a review into the use of transparent vehicles and concessions used by other developed countries to attract foreign investment into 'included infrastructure' — the focus being not the type of entity used, but the nature of its activities and income.

Comprehensive carve-out, transitional and grandfathering rules

The submission encouraged government to introduce comprehensive transitional measures to protect existing investors should major changes be made to the eligibility of existing investments beyond the synthetic and royalty stapled structures. This recommendation was made to prevent one or more of the following adverse outcomes for investors:

- a breach of debt covenants in existing financing arrangements,
- the inability to extract cash from the project entities due to dividend traps,
- the loss of flow-through taxation treatment and impost of higher Australian withholding tax rates, and/or
- the inability to claim foreign tax credits in their home jurisdiction.

Such transitional measures were considered necessary to reduce the financial impact on existing investments and minimise the impact on Australia's sovereign risk. The scope and nature of any transitional provisions will necessarily depend on how comprehensive the law changes are, but consideration should be given to:

- affirming that REITs, privatised assets, included infrastructure and assets where a third party rental market exists (refer to the examples given earlier) will not be affected by any changes or new rules,
- grandfathering assets that are currently eligible to be in stapled structures but would be excluded as a result of any change in policy. Unless a specific carve-out is provided (as per the above), any grandfathering should at least include REITs, privatised assets, included infrastructure and assets where a third party rental market exists. The rationale for grandfathering these assets is that they typically have high restructure costs, complex banking arrangements, support the federal government's asset recycling program and many have received explicit and implicit regulatory approval from the ATO. Grandfathering is also necessary to recognise that some investors have based the purchase price paid to state and territory governments for these assets on the basis of agreed taxation subject to MITs (or for subsequent purchasers) through stapled structures, and have entered into 99-year tax deeds which are intended to provide certainty to investors over the term of the project; and
- an extended transitional period for structures that become subject to a higher rate of trustee withholding tax on distributions to foreign investors, or loss of flow-through taxation treatment. Such a transitional period would need to be a minimum of five years to allow existing structures

to minimise the financial impact and restructure debt arrangements where required. This would apply to arrangements that do not fall into a carve-out or are grandfathered per above.

Additionally, a commitment from the government on policy and approach to carve-outs, grandfathering and transitional rules in a timely manner was also encouraged to reduce the uncertainty for transactions that are being delayed or curtailed as a result of the existing uncertainty.

Real estate investment trusts continue to be flow-through vehicles

Real estate investment trusts (both listed and unlisted) are typically regarded as the aggregation of businesses, not the fragmentation of groups or re-characterisation of income. The 'aggregation' of businesses creates economic efficiency and allows best use of assets. It also allows stapled groups scale for funds management capacity to attract new investment. The current tax outcomes under this model are appropriate as passive income is taxed on a flow-through basis at the investor's rate of tax or withholding tax, and the active income is taxed at the entity level at Australia's corporate income tax rate. Additionally, integrity concerns with cross-staple dealings in a REIT context are adequately addressed through the non-arm's length income rule in Subdiv 275-L of the *Income Tax Assessment Act 1997* (Cth).

The submission encouraged the government to mitigate any adverse impact on REITs by the carve-out of any changes, or grandfathering REITs operating as aggregation 'staples'. Prospectively, Treasury should focus on the potential enhancements to the existing Div 6C of the *Income Tax Assessment Act 1936* (Cth) to:

(1) expand the term 'rent' to more appropriately include payments for the 'use of physical space', and
(2) increase safe harbour thresholds. This may allow more REITs to be operated through a single trust structure. An enhancement of this nature could negate the need for stapled structures for aggregation by REITs going forward.

Media release from the Treasurer

On 2 May 2017, the government released a statement confirming its commitment to this issue, but also stated that, in "[r]ecognising the economic significance of stapled structures in the Australian economy and that this is a complex and sensitive issue, the Government will not be responding to the issue in the Budget".

Given that the Treasurer did not commit in the media release to certain policy objectives or protected asset classes, there will remain, at least for the time being, a degree of uncertainty as to the future policy direction and tax treatment of stapled structures. This uncertainty is something that all stakeholders will have to work through in the short to medium term. However, given the high priority of this issue, the authors expect timely and targeted consultation to occur in the months to come — with the consultation period now extended until July 2017.

Let's talk

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

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