



Australian Government

STAPLED STRUCTURES

CONSULTATION PAPER

MARCH 2017

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CONTENTS

CONSULTATION PROCESS	IV
Request for feedback and comments	iv
OVERVIEW	1
What this paper is about	1
Paper outline	2
BACKGROUND	3
Stapled structures	3
History of stapled structures	4
Importance of stapled structures	4
Use of staples in infrastructure in Australia	5
Tax advantages of stapled structures	5
Other commercial reasons for stapled structures	6
INTEGRITY RISKS	7
Background	7
Recent responses to integrity concerns	7
Difficulties under current tax settings	7
INTERNATIONAL COMPARISONS	9
International approaches to stapled structures	9
International comparisons for REIT regimes	10
International treatment of infrastructure	10
POLICY CONSIDERATIONS	11
Revenue considerations	11
International competitiveness	11
Economic efficiency	12
Simplicity	12
Transparency	13
BROAD POLICY OPTIONS	14
Dealings between stapled entities	14
Excluded structures	14
Specific REIT regime	15
Other specific industry concessions	16
IMPACTS OF POLICY OPTIONS	17
Tax revenue	17
Investment	17
IMPLEMENTATION AND TRANSITIONAL ISSUES	19
APPENDIX 1 - FEATURES OF REIT REGIMES IN SELECTED JURISDICTIONS	20

CONSULTATION PROCESS

REQUEST FOR FEEDBACK AND COMMENTS

Providing a confidential response

All information (including name and address details) contained in formal submissions will be made available to the public on the Australian Treasury website, unless it is indicated that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain confidential should provide this information marked in a separate document.

A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Next steps

The information obtained through this process may inform the Government's future approach to removing tax distortions that may be identified from the use of stapled structures and re-characterising trading income. Once the public consultation process is concluded, further targeted consultation may be necessary to clarify any issues or questions which arise from initial consultations.

CLOSING DATE FOR SUBMISSIONS: THURSDAY, 20 APRIL 2017

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OVERVIEW

WHAT THIS PAPER IS ABOUT

This consultation paper seeks stakeholder views on potential policy options in relation to stapled structures, the taxation of real property investments and the re-characterisation of trading income.

Australia's general framework for the taxation of non-resident investment seeks to balance a desire to ensure that non-residents pay an appropriate amount of tax on Australian sourced income while not unduly affecting the cost and level of foreign investment in Australia.

Over recent years, there has been growth of arrangements to re-characterise trading income into more favourably taxed passive income which can have the effect of reducing the Australian tax applicable to that income in the hands of non-resident investors. The use of these arrangements, most commonly in the form of transactions within stapled structures, has grown significantly and expanded into new sectors, beyond their traditional use in the property and infrastructure sectors. Further, these structures may provide a greater scope for trading income to be re-characterised than is possible in most other countries. This may distort investment decisions and lead to reduced economic efficiency.

This consultation paper is not limited to specific integrity or compliance issues highlighted by the Australian Taxation Office (ATO).¹ Rather the Government seeks to undertake a holistic examination of the taxation of investment income derived using these structures, including the dichotomy between trading and passive income. We seek to better understand how Australia's taxation regime may have contributed to the use of stapled structures and other arrangements to re-characterise trading income, including a comparison to the relevant tax systems in other key countries.

This consultation will be carried out with a view to examining policy options to modernise Australia's taxation regime so as to remove the tax distortions that may be identified from the use of stapled structures. Administrative action alone would be inadequate to address these issues, and can lead to uncertainty for investors. Therefore, the Government is keen to discuss policy options with stakeholders, and develop a process for the transition of existing arrangements to any modified tax rules over an appropriate time period.

The Government is committed to ensuring that Australia is an internationally competitive location for foreign investment — this is particularly important in an increasingly integrated global market. This consultation will examine policy options for specific sectors, such as real estate investment trusts (REITs) and investment in critical infrastructure assets if the tax advantages for stapled entities are removed.

¹ See Taxpayer Alert TA 2017/1 and the ATO's draft guidance in the document entitled "*Privatisation and Infrastructure — Australian Federal Tax Framework*", released on 31 January 2017.

PAPER OUTLINE

Part 1 (Background): briefly describes the history of stapled structures and the applicable non-resident withholding tax regimes, provides some commentary on the sector and highlights past policy initiatives.

Part 2 (Integrity Risks): outlines the integrity issues that may arise from stapled structures and other arrangements to re-characterising trading income.

Part 3 (International Comparisons): looks at international approaches taken to stapled structures, REITs and infrastructure.

Part 4 (Policy considerations): sets out the key framework for considering the policy issues.

Part 5 (Broad Policy Options): sets out some broad policy options to address these problems that could be considered.

Part 6 (Impacts of Policy Options): sets out the potential impacts of the proposed policy direction on the Australian economy.

Part 7 (Implementation and Transitional Issues): sets out how stapled arrangements already in existence could be treated.

BACKGROUND

STAPLED STRUCTURES

Stapled structures are created when two or more securities are contractually bound together, such that they are not able to be bought or sold separately. Stapled structures may be listed or unlisted.

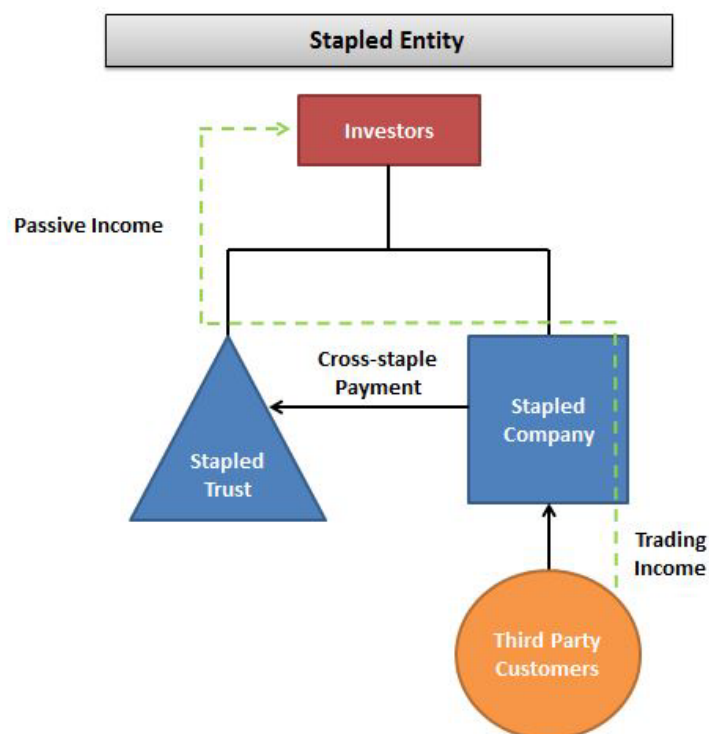
Stapled structures in their simplest form involve stapling together units in an asset-owning trust with shares in a trading company. The core characteristics of a simple stapled structure are that:

- investors own shares in the company and units in the trust, neither of which can be traded separately;
- the trust, frequently set up as a managed investment trust (MIT), typically holds the assets and receives rental or finance income, while the company carries out trading operations; and
- transactions may or may not take place between the stapled trust and company.

Stapled structures may also occur with three securities stapled together (triple staples) or with debt instruments stapled to equity instruments. Units in a non-passive unit trust (taxed like a company) may also be stapled with units in a flow-through unit trust.

Stapled structures may take different legal forms. Some may be contractually stapled using a stapling deed (typically used for listed staples), while others could be created through other types of contractual arrangements ensuring investors only deal with the securities together or are structurally stapled through common ownership or control of a company and related trust.

FIGURE 1: STAPLED ENTITY



HISTORY OF STAPLED STRUCTURES

In the mid-1980s, there were concerns about an accelerating trend for new trading businesses to be set up as public unit trusts. This allowed trading businesses to avoid company taxation through the use of the flow-through trust, with income being taxed in the hands of the unit holders.

In response to these concerns, Division 6C of the *Income Tax Assessment Act 1936* was enacted in 1985. Division 6C sought to tax public unit trusts as companies where the trust was conducting a trading business (broadly, any business that was deriving income other than rental or finance income). In effect, Division 6C ensured that the tax advantages conferred by trusts would be limited to certain categories of passive investment, such as investments in property, equities or securities.

Not long after the introduction of Division 6C, the first stapled structures began to appear in the property sector, involving a stapled trust deriving rental income from unrelated third-party tenants, and a stapled company carrying on a trading business.²

Following the introduction of dividend imputation in 1987, a key tax advantage offered by these structures was removed — corporate profits were no longer subject to double taxation. The ability to flow-through accelerated depreciation deductions as tax deferred distributions became the primary tax benefit of these structures.

In the 1990s, privatisation activities increased, involving the sale by state governments of a range of assets, including ports and electricity assets, to private sector investors. The nature of these investments, often with an operating component, led to further development of stapled arrangements with cross staple transactions (such as the operating company leasing the property assets from the stapled trust or cross-staple financing transactions).

Since that time, the stapled security market has grown significantly and developed beyond property and infrastructure, with an increasing range of stapled transactions being utilised in different industry sectors. There were six listed staples in 2000; this has grown to over 60 listed staples now as well as a range of unlisted staples.

IMPORTANCE OF STAPLED STRUCTURES

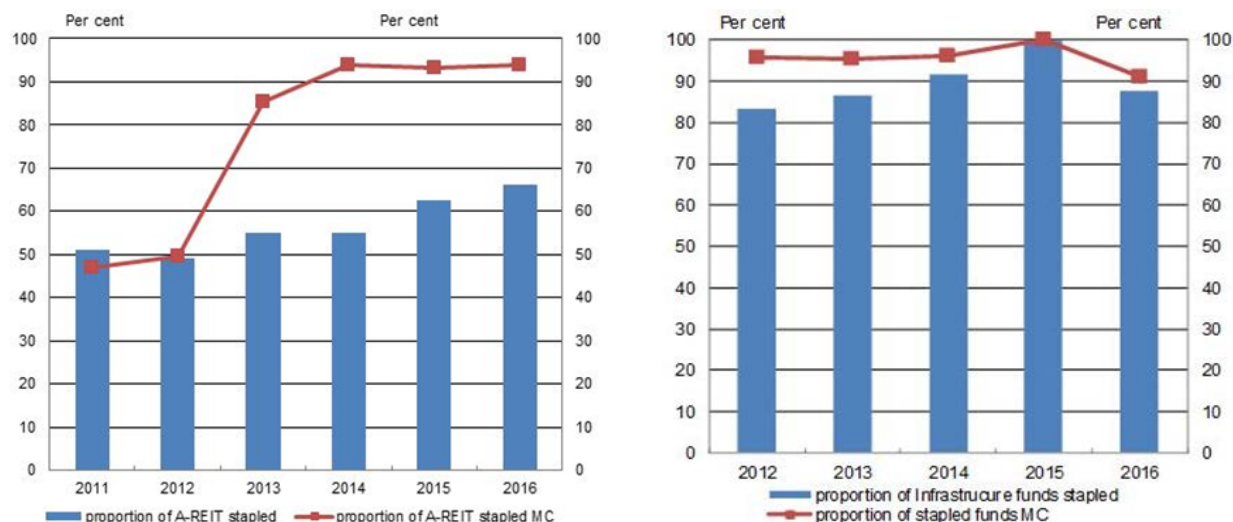
The market capitalisation of listed staples in the infrastructure and property sectors has grown over recent years. As at December 2016, these listed staples accounted for approximately \$199 billion of Australian stock exchange (ASX) market capitalisation, which is approximately 10 per cent of total ASX market capitalisation, up from around \$149 billion two years earlier. Australian REITS and infrastructure funds, by value and number, are largely stapled. Stapled structures are used by almost 90 per cent of infrastructure funds. There are also non-listed staples in use.

Privatisations of state and territory assets have grown significantly. In 2015-16, almost \$60 billion in assets by value were privatised, well above the \$20 billion privatised in 2014-15.

2 The first stapled security in Australia was Stockland Group, following a restructure of their operations in 1988.

Traditionally, staples were only used in the infrastructure and property trust sectors, however, their use has significantly expanded in recent years, including to different industries, such as agriculture and mining, and this is likely to continue with further privatisations and foreign investment applications.

FIGURE 2: PROPORTION OF LISTED A-REITS AND INFRASTRUCTURE STAPLED ENTITIES



MC = market capitalisation

Source: ASX Managed Funds Statistics.

USE OF STAPLES IN INFRASTRUCTURE IN AUSTRALIA

As discussed below, stapled structures mean that investors can receive returns from the start of an investment even though accounting and tax profits may not accrue until later. This is particularly important for infrastructure as projects typically have very long time periods before they generate profit.

Infrastructure assets that deliver regular returns may be especially attractive to pension funds which require long-term, inflation-linked cash flows to meet their pension liabilities. This means that stapled infrastructure assets make it easier to attract investment for infrastructure from other countries.

TAX ADVANTAGES OF STAPLED STRUCTURES

The use of a stapled structure can give rise to various tax advantages to investors compared to investing in the same type of business in a company structure.

- Stapled structures enable investors in property or financial assets to earn additional income from related operating activities, such as management fees, property development or car park revenue, in a separate company, without jeopardising the flow-through tax status of the trust.

- The receipt of tax deferred distributions (cash distributions that are not taxable income because of factors such as accelerated depreciation) from the trust in the stapled structure, typically at the earlier stages of a property or infrastructure project. In contrast, property and infrastructure businesses held in companies may face restrictions on distributing cash to investors. For some domestic investors, this may be a timing benefit only, as resultant cost base adjustments mean the amount is factored into future capital gains or reduced capital losses. However, the full value of capital gains is not always taxed, as certain resident investors may obtain a permanent benefit or non-residents an exemption in some circumstances.
- Foreign investors can access concessional withholding tax rates on distributions under Australia's managed investment trust and royalty or interest withholding tax rules. Under these rules, taxable payments are typically subject to a final withholding rate of 15 per cent or less.³

OTHER COMMERCIAL REASONS FOR STAPLED STRUCTURES

Some have argued stapled structures may:

- lower the cost of capital and increase levels of investment by potentially making it easier to attract greater third party finance (as finance for trust assets may be determined on a pre-tax basis) and by lowering the overall tax burden of investors;
- generate efficiencies or deliver synergies (shared expertise and knowledge) by horizontally integrating several businesses;
- be preferred by investors who more highly value stapled securities than a similar unstapled structure; and
- obtain security price benefits from a higher market capitalisation. The ASX market capitalisation is calculated as the total value of the stapled securities on issue.

QUESTIONS

1. How important are the non-tax reasons for using stapled structures? Please explain your view.
2. What impact would the loss of an ability to make cash distributions at the early stages of a project have on the attractiveness of long-term infrastructure investment for investors? Are there alternative ways to address this problem, such as used in other countries?

³ In the case of a managed investment trust fund payment — if the fund payment is made to an entity that is not resident in an information exchange country the withholding rate is 30%.

INTEGRITY RISKS

BACKGROUND

As noted above, the use of stapled structures has evolved over time, both as a response to Australia's restrictions around flow-through taxation for trusts and due to concessional withholding tax rates introduced for MITs in 2012.

RECENT RESPONSES TO INTEGRITY CONCERNS

Concerns have been raised that there is a growing trend towards structures that involve the fragmentation of an integrated business in order to separate trading income and more concessional tax passive income into different entities. This may also include the conversion of trading income into passive income. It has been identified as a growing trend not only for stapled securities, but also other structures (such as vertical structures or entities under common ownership).

As part of the attribution MIT reforms enacted in 2016, an arm's length rule was introduced to reduce the scope for stapled entities to artificially shift income between stapled entities. The rule can result in tax at the corporate tax rate of 30 per cent on excess non-arm's length income earned by a MIT. A two year transitional period was provided for existing arrangements. Although this rule went some way towards ensuring appropriate arm's length pricing for cross staple transactions, there are limitations in its ability to deal with the broader integrity concerns around fragmentation of business structures.

In response to these broader integrity concerns, the ATO released a Taxpayer Alert, TA 2017/1 '*Re-characterisation of Income from Trading Businesses*' in early 2017. The types of structured arrangements identified by the ATO in their Taxpayer Alert include finance, rental, royalty and synthetic equity staples. Concerns have also been raised about passive income flows structured as cross-staple transactions rather than direct offshore transactions, which may have different transfer pricing or thin capitalisation outcomes.

DIFFICULTIES UNDER CURRENT TAX SETTINGS

There is a wide spectrum of structures which separate trading and passive income flows, ranging from structures that fall well within the original policy intention of Division 6C and the MIT withholding rules, such as A-REIT staples that derive largely all of their income as rental from third party tenants; to highly structured fragmenting of trading businesses, which arguably go well beyond the original policy intention. There are a number of industries within the middle of that spectrum which have an integrated or partially integrated mix of property and services income, such as student accommodation, aged care and certain infrastructure projects.

There are a number of commercial reasons why an entity may choose to sell and lease back an asset to a third party, or carry on a trading business whilst renting premises or licencing an asset from a third party. However, when such a transaction occurs within a framework where the same owners continue to bear the same economic risks and benefits from the fragmented business (either via a stapled structure or otherwise), this gives rise to a question as to the predominant driver of the fragmentation.

It can then become a fine distinction between businesses that are fragmented to ensure that Division 6C is not triggered (for example, a property investment business with some peripheral operating activities) or fragmented predominately to convert trading income into passive income, to take advantage of the concessional tax treatment offered by the MIT regime or other advantageous tax outcomes.

With the wide spectrum of structures and industries affected, difficulties can arise in identifying where the line should be drawn as to what should be considered acceptable or not acceptable within the current legislative framework. This can create uncertainty from both the perspective of the tax administrator and an investor in identifying which side of the line a particular transaction or structure may fall.

To the extent some sectors avail themselves of structures to artificially re-characterise active trading income as a passive income flow to reduce their overall tax liability this can distort investment decisions and resource allocation across the economy. Similarly, organisations who take a more conservative approach can be at a cost disadvantage if their competitors within a sector take a more aggressive approach to structuring their tax affairs.

More broadly, the re-characterising of trading income into a lower taxed passive income flow reduces overall tax revenue and presents a risk to the integrity of the corporate tax base. This undermines the ability of the Government to fund its activities and deliver services to the community.

For these reasons, the Government is revisiting the underlying policy basis and settings around the taxation of REITs and other passive income investments on a more holistic basis in order to modernise the regimes, ensure Australia's tax settings to attract global capital are appropriately targeted and provide greater certainty to investors seeking to manage integrity concerns.

INTERNATIONAL COMPARISONS

INTERNATIONAL APPROACHES TO STAPLED STRUCTURES

With the exception of a few listed staples in Singapore and Hong Kong, the use of stapled structures outside of Australia is uncommon.

Several jurisdictions have rules that remove the tax advantages arising from stapled structures.

United States

Due to growing concerns about the use of stapled structures to avoid tax, in 1984, the United States enacted laws which removed the tax advantages of stapled structures, effectively ending their use.

These laws deemed stapled REIT structures to be a single entity (such that the trading activities of the stapled entity would disqualify the combined entity from having REIT tax status). However, REIT rules do allow for up to 25 per cent of the value of assets of the REIT to be in securities of a taxable REIT subsidiary.

United Kingdom

The United Kingdom's REIT legislation includes provisions which in practice serve to restrict potential REITs from transacting with a 'group company', which include, among other things, a stapled entity. Additionally, stapled entities are treated as a single entity for the purposes of the UK's thin capitalisation provisions.

Canada

Prior to 2006, there were few restrictions on the types of income that could be derived by income trusts. The Canadian Government became increasingly concerned about a growing trend toward the use of income trusts when top Canadian companies converted or announcing an intention to convert to an income trust structure which allowed for more favourable tax treatment due to their flow-through status.⁴

In response to this, the 'specified investment flow-through' (SIFT) legislation was enacted in 2006. The effect of the SIFT legislation was to tax publicly-traded flow-through entities meeting certain conditions more like corporations, unless they qualified as a real estate investment trust.

However, after the enactment of this legislation, a new type of structure emerged similar to the stapled structures described above. In response to this, further amendments were made in 2013 (effective from Canada's announcement in 2011) to deny deductions for payments made in certain circumstances between the members of stapled groups.

4 Department of Finance Canada release 2003-061 — Canada's New Government Announces Tax Fairness Plan.

INTERNATIONAL COMPARISONS FOR REIT REGIMES

Most comparable jurisdictions contain some form of concessionary income taxation treatment for investment in real property. In many cases specific legislation applies to REITs to provide for effective flow-through taxation. Whilst there are many similarities in the way REITs are regulated and taxed globally, there are also significant differences. REIT regulations typically govern the type of structure permitted, the types of assets that may be held, the percentage of income that must be derived from certain asset classes, minimum distribution requirements, gearing restrictions and specific withholding tax rates.

A basic summary of these features in selected overseas jurisdictions is contained in the table in Appendix 1. Key differences from the Australian system are the percentage of income that can be derived from non-rental activities and whether management and other non-rental activities can be conducted by the REIT or subsidiary entities. The more restrictive thresholds in the Australian regime may have contributed to the use of stapled structures in Australia in the property investment market to prevent the application of Division 6C.

INTERNATIONAL TREATMENT OF INFRASTRUCTURE

Whilst many comparable jurisdictions have REIT regimes described above, specific infrastructure taxation regimes or concessions do not appear to be common. There is recognition of the highly geared nature of certain critical infrastructure projects in the OECD's work on thin capitalisation and in the United Kingdom's recently announced changes to their thin capitalisation rules. These, however, also contain a number of restrictions.⁵

India offers investment incentives aimed at channelling capital into investments which establish new industries and encourage investment in infrastructure in undeveloped areas. These incentives include specific 'infrastructure investment trusts' which provide flow-through treatment and reduced withholding tax rates.

QUESTIONS

3. Are there other countries where the use of stapled structures is common? If so, please provide details, including an outline of the tax rules applicable to stapled structures.
4. Are there other countries which provide specific tax concessions or a separate regime for infrastructure investments? If so, please provide details of the concessions or regimes.

⁵ 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 — 2016 Update', OECD, 22 December 2016 and HM Revenue and Customs draft Finance Bill 2017 contains the Corporate Interest Restriction provisions in Schedule 1.

POLICY CONSIDERATIONS

Determining the appropriate tax settings that should apply to business and passive income raises a number of policy issues.

REVENUE CONSIDERATIONS

Australia's tax system raises the revenue required to fund Government activities and services to the community such as defence, education, health and welfare spending. The Australian tax system should raise revenue in a way that minimises the overall cost to the economy. In terms of corporate taxation, it is important that entities pay the right amount of tax in Australia when they do business in Australia.

To the extent that trading income (generally taxed at the 30 per cent corporate rate) is being re-characterised into more favourably taxed passive income (generally taxed at the rate of 15 per cent or less for non-resident investors), tax revenue will be lower than would have otherwise been the case.

Australian resident investors effectively pay tax at their marginal tax rate through the personal income tax system on amounts distributed or attributed, regardless of whether it is received from a company or trust.

INTERNATIONAL COMPETITIVENESS

Australia needs to be internationally competitive to attract and retain investment given that investors can choose the level of investment and where to invest. Investment is important in a small capital-importing country, such as Australia, as it increases productivity, real wages and living standards.

As well as tax settings, international competitiveness of a country is determined by a range of factors, such as political stability, financial sector development, the quality of physical infrastructure and human capital.

It is generally accepted that having a competitive tax regime is critical in attracting mobile capital. Taxes on income from inbound investment, such as the corporate tax rate and non-resident withholding rates, affect the cost of capital and investment decisions.

Australia also shares taxing rights with other countries as part of international tax agreements to avoid double taxation or double non-taxation. As part of international tax norms, typically, active income, such as returns from running a business, is taxed in the country where the business activity takes place. Passive income, such as interest and dividends, is taxed primarily in the investor's country of residence, although limited source country taxing rights apply to some categories of passive income.

In taxing non-residents, it is generally considered appropriate to tax 'passive' income more lightly in the source country than 'active' business income, as 'passive' investments are more internationally mobile. In Australia, this is achieved through passive income being subject to reduced withholding tax rates through a managed investment trust compared to active business income. Business income is generally taxed at the corporate tax rate, with franked dividends to non-residents not subject to withholding tax as it has already been subject to the 30 per cent rate.

The distinction between active and passive investment is an inherent feature of the international tax framework. To be internationally competitive, Australia's overall approach needs to be broadly comparable with the approaches taken by our key international competitors.

However, it is also important that there is integrity around the distinction between active and passive income to ensure that less mobile active income cannot be re-characterised to gain the tax advantages of passive income.

Hence, it is important for Australia to be able to separately identify 'passive' and 'active' income, for the integrity of the corporate tax base and the competitiveness of our tax system.

ECONOMIC EFFICIENCY

To achieve efficient outcomes and drive economic growth, businesses should base their decisions on where their resources are most productive or receive the highest rate of return rather than where they obtain the best tax benefit. The tax system should not distort decisions about resource allocation across sectors or between firms within sectors.

Some organisations that do not re-characterise income will be at a competitive disadvantage compared to those that do. This means that businesses are not competing on a level playing field — which has equity concerns.

It is also important for there to be certainty to encourage investment. Administrative action alone can lead to uncertainty for investors.

SIMPLICITY

The tax system should not impose unnecessary complexity and compliance costs.

If the tax system drives decisions about how businesses structure themselves, given the opportunities to reduce or avoid tax, it diverts resources away from productive uses into unproductive tax planning.

The use of complicated tax structures, such as staples, also imposes costs on investors that may not fully understand the risks, fees or payments to managers.

In addition, the cost of keeping records and managing their tax affairs for investors in stapled entities may be higher than for a single entity. While stapled securities trade as one investment, investors are generally treated as having separate assets for each of the stapled entities for income tax purposes.

TRANSPARENCY

Finally, it is important that any tax concessions that are available to particular investments are clear and transparent. This ensures that the Government and the public are aware of how the tax system is operating and can make informed decisions about the appropriateness and effectiveness of tax policy settings.

QUESTIONS

5. How important is tax in determining the international competitiveness of Australia as a foreign investment location for assets and activities typically placed in stapled structures?

BROAD POLICY OPTIONS

The focus of this paper is to examine the tax and economic efficiency implications of stapled structures. This section outlines broad policy options for consultation to address the integrity risk to the corporate tax base from the use of stapled structures.

DEALINGS BETWEEN STAPLED ENTITIES

The Government is considering measures which remove the tax advantages of stapled arrangements. Transitional rules are considered in the next part of this paper.

Some options to remove these tax advantages could include:

- Disallowing certain deductions for cross-staple payments by companies or Division 6C trusts (including rentals, interest, royalties and synthetic equity payments) to Division 6 trusts (potentially treating the income as non-assessable non-exempt for the trust);
- Taxing the recipient of such payments (either the trustee or foreign investors) at a rate equivalent to the Australian company tax rate⁶; or
- Deeming stapled entities to be consolidated for tax purposes.

Some of these options are similar to the approaches adopted by other countries that have addressed the tax advantages of staples, as outlined in the section above on International Comparisons.

EXCLUDED STRUCTURES

It is important to determine what types of stapled arrangements would be affected by these options (for example, whether limited to contractual stapled structures or broadened to other types of common ownership).

If the above options cover other types of common ownership, this would focus on dealings which:

- give rise to interest or royalty income of non-residents;
- facilitate the application of the MIT withholding rules; or
- ensure the non-application of Division 6C.

These options are not intended to apply to small business or discretionary trust dealings.

⁶ Subject to double tax treaty considerations.

QUESTIONS

6. What would be an appropriate mechanism to remove the tax advantages of stapled arrangements?
7. Are there any international models for removing such advantages that could work in the Australian context?
8. What types of structures or arrangements, if any, should be excluded?

SPECIFIC REIT REGIME

This paper previously noted that most jurisdictions contain some form of concessionary taxation treatment for investment in property through specific REIT regimes. In many cases these regimes appear to be more generous in allowing a higher percentage of permitted trading income than the rules contained in Division 6C (which currently permits only 2 per cent of gross income of a publicly listed trust to be non-passive in nature if 'flow-through' taxation is to be preserved). However, in contrast to Australia, most jurisdictions do not allow the benefits of stapled structures.

It is consistent with Australia's tax policy setting for REITs that derive most of their income as rental from third party tenants to receive flow-through taxation treatment. If an option to remove the tax advantages of stapled structures were to be introduced, current restrictions around the permitted levels of trading income in trust structures may need to be considered to ensure Australia's ability to attract global real estate capital is internationally competitive.

Board of Tax report

As part of its 2009 report on MITs, the Board of Tax considered whether a separate taxing regime for REITs would be appropriate. In recommending against a separate REIT regime, the Board noted that a separate REIT regime would add cost, complexity and administrative difficulties that would not be outweighed by the potential benefits.

In addition, the Board recommended a 10 per cent safe harbour for income from non-eligible investment business to improve the international competitiveness of Australia's REITs.

QUESTIONS

9. If the tax advantages of stapled arrangements are removed, does Australia need a specific REIT regime to provide clarity for flow through tax treatment for real estate investments? If so:
 - a. What might be an appropriate measure and threshold for a designated maximum threshold for associated trading activities (e.g. percentage of profits, income or assets)?
 - b. Are there any global 'best practice' models for REIT regimes that should be considered?
10. If Australia did not introduce a specific REIT regime, what are some alternatives for providing greater clarity to taxpayers to distinguish between acceptable and non-acceptable fragmented structures with common economic owners?

OTHER SPECIFIC INDUSTRY CONCESSIONS

The Government acknowledges that if it determines tax law changes are appropriate to effectively remove the tax advantages of stapled arrangements, some arrangements in respect of critical infrastructure may be especially adversely affected. This may also deter future investment in critical infrastructure assets.

In this context, consideration could be given to other more targeted measures to support investment in critical infrastructure. For example, Australia introduced certain tax loss concessions for infrastructure investments as part of the 2011-12 Budget applicable to designated infrastructure projects (determined by Infrastructure Australia). However, very limited use has been made of the tax loss incentive so far.

QUESTIONS

11. If the tax advantages of stapled arrangements are removed, does Australia need specific concessions for critical infrastructure investment?
12. If Australia does need such concessions for critical infrastructure investment, what should be the form of those concessions?

IMPACTS OF POLICY OPTIONS

Given the tax system may be a factor in decisions about how to structure particular businesses, it will be important to consider what effect any policy options to reduce the scope to re-characterise income will have on tax revenue and the Australian economy.

TAX REVENUE

As the policy options under consideration would reduce the scope to convert active business income into passive income, they should increase tax revenue and the capacity of the Government to fund infrastructure and public services. In addition, any changes may increase public confidence in the integrity of the tax system by ensuring more taxpayers pay an appropriate amount of tax.

INVESTMENT

Removing these tax advantages may increase the cost of capital for particular arrangements relying on the current tax advantage to improve the after-tax rate of return to investors.

The options should however reduce distortions to investment decisions and improve competitive neutrality. Hence, entities and sectors which have not been able to benefit from the re-characterisation of active income, may be better able to compete on price.

If these policy options reduce the use of structures, such as stapled entities, investors may make more informed investment decisions, better understand fees or payments to managers and better price the associated risks. Establishment and ongoing compliance costs may also reduce with a simpler model.

Depending on the options chosen, entities may incur some additional compliance costs, such as legal fees, restructuring costs and stamp duties, in adjusting to any changes in the tax treatment of stapled arrangements. Transitional arrangements (discussed below) could provide existing entities with time to complete or restructure their current arrangements, such as loans, to minimise unnecessary commercial disruption and costs.

The impact of these policy options may differ between taxpayers and across sectors given the extent of income re-characterisation occurring currently and any differences in the sensitivity of investment to tax.

In addition, if a specific REIT regime is provided then the impact on this sector may be more limited.

QUESTIONS

13. If tax laws are amended to remove the tax advantages of stapled arrangements, what impact do you consider this would have on the Australian economy, including the cost of capital, level of investment and price of assets? Please include any supporting evidence.
14. To what extent would alternative measures, such as a higher percentage of trading business permitted to be carried out by Division 6 trusts ameliorate these impacts?
15. Are there any specific sectoral impacts that should be considered?
16. Would the impact be different for new and existing investment and entities? If so, how?

IMPLEMENTATION AND TRANSITIONAL ISSUES

Where modifications to tax laws are proposed to eliminate tax distortions arising from the use of stapled structures, the treatment of stapled arrangements already in existence must be considered.

Experience internationally strongly suggests that any permanent grandfathering of existing structures would encourage the inappropriate use of those grandfathered structures to acquire new investments which would introduce significant competitive distortions into the market. It would create equity issues, as grandfathered structures would be at an advantage when undertaking new investment, assisted by tax advantages not available to new structures.

An alternative to grandfathering is to introduce transitional arrangements to bring all stapled arrangements under the new laws over an appropriate period of time. The enactment of the Canadian SIFT legislation was accompanied by a 5 year grace period and rollover relief, to allow stapled structures time to restructure their affairs. Further, the Canadian approach included rules under which the existing structures were prohibited from growing beyond a certain size.

In Australia, when Division 6C was introduced, there was a 3 year transitional period. Similarly, the arm's length rules for MITs included a 2 year transitional period.

QUESTIONS

17. What is the typical term of external third party finance for stapled groups?
18. Should pre-existing structures and instruments issued prior to any new taxation laws be grandfathered?
19. What is an appropriate transition period and transitional arrangements for existing staples?
20. What would be the types of compliance and other transaction costs (such as stamp duty) of undertaking such a restructure? Should specific tax relief be provided to facilitate a restructure?

APPENDIX 1 - FEATURES OF REIT REGIMES IN SELECTED JURISDICTIONS

Country	Structure	Activity restrictions	Asset requirement	Income requirement	Distribution requirement	Taxation
USA	Companies, trusts or associations. No listing requirement. 100 or more persons.	Real estate for rents Financial securities.	75% of total value of assets must be real estate assets and government securities. Up to 25% assets can be securities in taxable REIT subsidiaries (TRS), reducing to 20% from 2018.	75% of gross taxable income must be from real estate related income (including rent from TRS subject to conditions). 95% must be from that real property and other passive income. Exceptions for lodging and health care facilities.	Must distribute 90% of ordinary taxable income each year.	REIT — only taxed on undistributed income. Investors — residents- taxed at normal rates and non-residents subject to 35% FIRPTA WHT on capital gain dividends and 30% on other dividends (DTAs may reduce the rate).
UK	Company (or group of companies). Listed and widely held. Penalties if corporate shareholder owns >10%.	Property rental activities (concessionally taxed). Other activities attracting normal company tax.	75% of total value of group assets must relate to the property rental business Must be more than 3 properties with no single property > 40% of portfolio.	75% of group profits must relate to the property rental business.	Must distribute 90% of rental profits.	REIT — scheduler approach — exempt on rental income and capital gains, company tax applies to the 'other activities'. Shareholders — withholding tax of 20% to resident individuals or non-residents if out of exempt rental income or gains (DTAs may reduce to 15%).

Country	Structure	Activity restrictions	Asset requirement	Income requirement	Distribution requirement	Taxation
Canada	Mutual fund trust. Listed, at least 150 unit holders.	Real or immovable property situated in Canada (excluding depreciable property except buildings). (Foreign property investment exempt from SIFT). Subsidiary entities, including internal management company.	95% of total fair market value of assets must be Canadian real or moveable property or certain financial instruments. 75% of REIT's equity value must be real property and certain other assets. 10% safe harbour for non-qualifying REIT property.	75% of REIT revenue must be attributable to rents or property capital gains. 90% of gross REIT revenues must be from rent or other gains from property and other passive income.	No minimum distribution (but to avoid tax at REIT level all of its income must be distributed).	REIT not taxed on distributed income. Residents — at normal rates. Non-resident unit holders — 25% withholding tax (DTAs may reduce to 15%).
Germany	Company. Listed. At least 15% shares must be publicly listed, and no shareholder can hold more than 10%.	Real estate in Germany and abroad. Wholly owned service corporation.	75% of assets must relate to real estate assets. Wholly owned service corporation assets must not exceed 20% of total assets.	75% of earnings must relate to real estate assets. Wholly owned service corporation earnings must not exceed 20% of total earnings.	Must distribute 90% of profits.	G-REIT company — exempt. G-REIT subsidiaries — taxable. 26.4% withholding tax on dividends (final tax for resident individuals, corporate taxpayers claim a credit). (DTAs may reduce to 15% for non-residents).
Hong Kong	Unit Trusts. Listed. No minimum investors.	Real estate (not vacant land or property development). Special purpose vehicles may be used for hotels, recreation parks, or serviced apartments.	75% of assets must be income generating properties.		Must distribute 90% of audited annual net income after tax.	REIT — exempt, except subject to property tax on rentals. Investors — not subject to any Hong Kong tax.

Stapled Structures

Country	Structure	Activity restrictions	Asset requirement	Income requirement	Distribution requirement	Taxation
Singapore	Unit Trusts. Listed. 25% units must be held by a minimum of 500 public unit holders.	Real estate (not vacant land or property development). Limited financial securities.	75% of assets must be income producing real estate.	No more than 10% of revenue can be from sources other than rent and passive income from financial securities.	Must distribute 90% of taxable income to be tax transparent.	Undistributed income — trustee taxed at corporate tax rate (currently 17%). Distributed to corporate — at corporate tax rate (currently 17%). Distributed to individuals generally tax-exempt. Withholding tax for non-residents — 10% to non-individuals, 17% to others.

