Australian Government

STAPLED STRUCTURES

DETAILS OF INTEGRITY PACKAGE

March 2018

OVERVIEW

1. A stapled structure is an arrangement where two or more entities that are commonly owned (at least one of which is a trust) are bound together, such that they cannot be bought or sold separately. Staples have been used in Australia by the property sector since the 1980s. Prior to the introduction of the Managed Investment Trust (MIT) regime in 2008, stapled entities bore a similar level of Australian tax as if they had been operated as companies. Domestic and foreign direct investors were taxed in Australia at their marginal tax rates on business income (although they enjoyed some timing benefits). Generally, foreign institutional investors in managed funds (that typically invest using a foreign company) would have paid tax at the corporate tax rate.

2. The MIT regime was aimed at increasing the attractiveness of Australia's fund management industry (especially commercial and retail property funds) to mobile foreign investment. It did this by lowering the withholding taxes on certain distributions to foreign investors, particularly rental income. In recent years, the withholding tax rate has generally been 15 per cent.

3. As a result of the MIT regime, foreign investors in stapled businesses were no longer effectively subject to tax at the corporate tax rate. If the trust side of the staple was a MIT, tax was generally withheld on rental income at 15 per cent.

4. For traditional staples in the commercial and retail property sectors that earned rental income, the introduction of the MIT regime did not raise significant integrity issues. The trust side of traditional property staples generally held portfolios of property assets that derived passive rental income from independent third party tenants. A lower tax rate on this income was an intended outcome of the MIT regime. Trading activities (for example, commercial and retail property development) were undertaken by the company side of the staple, which continued to pay corporate tax. There was no conversion of active income into passive income.

5. Over time, the tax rate differential encouraged an increase in the use of stapled structures to convert active business income into passive rental income. For example, a single business would be split between a MIT and an operating company. The land assets necessary for use in the business would be held in a MIT but leased to an operating company. The taxable income of the operating company would be reduced by rental payments to the MIT. The rental payments would obtain access to the 15 per cent MIT withholding tax rate when distributed to foreign investors. In this way, the active income of a trading business was converted into concessionally taxed rental income.

6. Increasingly, businesses in a broad range of sectors are seeking to access the MIT concession by using stapled structures. In some cases, these arrangements have no clear commercial justification and appear to be solely a tax driven strategy to reduce effective tax rates for foreign investors.

7. Meanwhile, globally, the pool of funds invested by sovereign wealth funds and pension funds has grown rapidly. As these types of investors have access to a range of additional tax

concessions, effective tax rates on distributions from stapled businesses for these investors can be between 0 and 15 per cent.

8. In effect, stapled structures have resulted in the unintended emergence of a dual corporate tax system that taxes foreign institutional investors in land-rich industries at rates anywhere between 0 and 15 per cent. Meanwhile, other large businesses remain subject to the 30 per cent corporate tax rate. This creates a tax bias in investment decisions, potentially attracting capital towards land-rich businesses rather than businesses that are capital intensive, knowledge based and/or research and development intensive.

9. The Government is committed to ensuring Australia has a tax system that is both fair and competitive for domestic and foreign investors. So while the Government is committed to cutting the corporate tax rate for all businesses as part of its Enterprise Tax Plan, it also considers it necessary to address the use of stapled structures in order to protect the integrity of Australia's tax system. A clear set of rules in this area will also provide more certainty for investors and a fairer and more predictable investment environment in the future.

10. In choosing to address the use of stapled structures, the Government has balanced the following objectives:

- removing the tax benefits associated with converting active business income into passive income so as to protect revenue and assist in the sustainability of the tax base;
- ensuring Australia retains globally competitive tax settings, particularly for nationally significant infrastructure projects;
- providing a more level playing field between domestic and foreign investors; and
- increasing certainty for businesses and investors.

11. A package of policy measures has been designed to address the tax integrity risks posed by stapled structures and other tax concessions, consistent with these objectives. This package seeks to neutralise the tax benefits delivered by staples without requiring investors to restructure their existing arrangements.

12. The development of this package has drawn heavily on stakeholder feedback provided to Treasury throughout 2017 during extensive consultation on policy principles and options in the course of its review of the tax treatment of stapled structures.

DETAIL OF MEASURES

Element A: Preventing active business income from accessing the 15 per cent MIT rate

13. This measure neutralises the tax benefits of stapled structures by preventing foreign investors from accessing the 15 per cent MIT rate on active business income. Instead, this income will be subject to withholding tax at the company tax rate. Specifically, the higher MIT withholding tax rate will apply to MIT fund payments derived from cross staple rental

payments, cross staple payments made under some financial arrangements such as total return swaps, or where the MIT receives a distribution from a trading trust.

14. The higher withholding tax will not apply where the stapled operating entity receives rent from third parties and this is merely passed through as rent to the trust. These staples do not convert active business income – the cross staple payment doesn't change the character of the rental income. Requiring these staples to restructure in order for the trust to receive these third party rents directly would create compliance costs, without raising revenue.

15. The higher withholding tax will also not apply where only a small proportion of the gross income of the trust relates to cross staple payments. This will lower compliance costs for entities that have some cross staple arrangements but where the conversion of active business income is not central to the structure.

16. The Government will also introduce a concession for certain infrastructure projects to encourage the construction of nationally significant infrastructure. To achieve this, a time-limited exemption from this measure will be available for new investment in economic infrastructure assets approved by the Government. 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). At the end of the exemption period of 15 years, the MIT withholding tax rate on this income will increase to align with the company tax rate. This exemption will facilitate investment in productivity enhancing projects.

17. Treasury will consult separately on the conditions stapled entities must comply with to access the infrastructure concession (for example, stronger integrity rules may be needed to protect against aggressive cross staple pricing).

Element B: Preventing double gearing structures through the thin capitalisation rules

18. Stapled structures are often very heavily geared with debt. Gearing in the form of investor debt from foreign investors reduces the amount of tax that is paid in Australia in respect of the project as interest payments are generally deductible and subject to withholding tax at rates of 10 per cent or lower when the interest is paid offshore. Australia's thin capitalisation rules put limits on the amount of interest that foreign-controlled Australian entities can deduct.

19. Some investors are able to gear at levels greater than the intended thin capitalisation limits by using 'double gearing' structures. These structures involve the use of multiple layers of entities that are 'flow-through' for tax purposes (for example, trusts and partnerships), each issuing debt against the same underlying asset. This strategy is often employed in conjunction with a stapled structure to achieve very low effective tax rates as investors can provide excessive amounts of their capital as concessionally taxed investor debt.

20. There are provisions which are intended to prevent this 'double gearing', by grouping 'associate entities' when working out the thin capitalisation limits. Entities are generally considered to be associate entities where there is an ownership interest of 50 per cent or

more. However, investors do not require full control of an entity to influence its financing arrangements to achieve double gearing.

21. This measure will lower the thin capitalisation associate entity test (for the purposes of determining associate entity equity and associate entity debt) from 50 per cent or more to 10 per cent or more for interests in flow-through entities. This will help prevent tax avoidance using double gearing structures. To safeguard against adverse behavioural responses, this measure will also clarify that the thin capitalisation arm's length debt test requires consideration of gearing against the underlying assets for interests in any entity.

Element C: Limiting the foreign pension fund withholding tax exemptions

22. Australia currently provides broad unilateral exemptions from dividend and interest withholding tax for both government and private sector foreign pension funds that are exempt from tax in their home country. Most other countries do not provide such broad exemptions meaning that Australian superannuation funds do not generally receive reciprocal treatment when investing offshore.

23. The exemption from interest withholding tax makes it very attractive for foreign pension funds to gear their Australian equity investments using investor debt to lower their overall Australian tax on the investment. Combined with a stapled structure, this exemption can result in foreign pension funds paying little Australian tax on their investments in Australian businesses.

24. To address this, the measure will limit the withholding tax exemptions for foreign pension funds to interest and dividend income derived from an entity in which the fund has a portfolio-like interest (holds an ownership interest of less than 10 per cent and does not have influence over the entity's key decision-making).

Element D: Limiting the sovereign immunity tax exemption

25. The ATO provides an administrative concession to foreign government ('sovereign') investors on income from 'non-commercial' investments. No exemption exists in legislation – it is based on longstanding ATO practice.

26. The ATO generally exempts a sovereign investor from tax where the investor is not acting in a commercial capacity and cannot influence the decision-making of an entity. In some instances, this can mean a sovereign investor with an ownership interest of more than 10 per cent can be exempt from interest and dividend withholding taxes, capital gains tax and tax on trust distributions (there is no exemption from company tax). In a stapled structure, this means sovereign investors that meet the ATO's conditions for sovereign immunity pay no MIT withholding tax and get a tax exemption for income earned by a trading trust which can achieve tax rates of close to 0 per cent on active business income.

27. Most countries do not provide reciprocity through such broad tax concessions for sovereign investors. This means that foreign sovereign investors generally receive a much greater benefit when they invest in Australia than we receive when our sovereign wealth funds invest in other countries.

28. This measure will create a legislative framework for the sovereign immunity tax exemption and limit it to situations where sovereign investors have an ownership interest of less than 10 per cent and do not have influence over the entity's key decision-making.

29. To ensure foreign sovereign investors are subject to tax on active business income earned through a trust, the exemption will not extend to distributions of active business income from trusts (including where the active income has been converted to rent through cross staple payments).

Element E: Preventing agricultural MITs

30. Foreign investors can currently access the 15 per cent MIT rate on rent and capital gains derived by a MIT from agricultural land. This means that foreign investors enjoy lower tax rates on rent and capital gains from agricultural land compared to most domestic investors. This provides foreigners with a competitive advantage over domestic investors when purchasing Australian agricultural land. To level the playing field, this measure will prevent rent from agricultural land from qualifying as eligible investment business income.

Timing and transition

31. Elements A, C, D and E will commence on 1 July 2019 but arrangements in existence at the date of government announcement of this package will have access to a seven year transition period. For arrangements qualifying for transitional relief, the earliest these tax changes (other than the thin capitalisation changes) will apply is 1 July 2026. Given the long life of infrastructure assets, a 15 year transition period for existing economic infrastructure staples will be given with respect to Element A.

32. During these transition periods, qualifying foreign investors can still access the MIT concession on converted active business income and the foreign pension fund and sovereign immunity exemptions. During the transition period, concessional tax rates will only apply in relation to investments made or, in the case of Element A, committed to at the date of announcement. Sovereign investors that have a ruling from the ATO on sovereign immunity for a particular investment extending beyond the seven year period will be able to access the transition period on that investment until the expiry of the ruling.

33. In Taxpayer Alert 2017/01, the ATO warned that some stapled structures might attract the operation of the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936*. Following the implementation of this policy package, the general anti-avoidance rule will not apply with respect to the choice of a stapled structure to obtain a deduction in respect of cross staple rent during the transition period. Consistent with the ATO's taxpayer alert, the Government also expects that Part IVA will apply to egregious tax-driven arrangements such as royalty staples.

34. Treasury will consult separately on the conditions stapled entities must comply with to access the transitional arrangements available under Element A (for example, stronger integrity rules may be needed to protect against aggressive cross staple pricing).

35. Element B will apply to income years commencing on or after 1 July 2018 (with no transitional period as it addresses an unintended legislative outcome).