GREENWOODS
+HERBERT
SMITH
FREEHILLS

Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

31 May 2018

By Email

stapledstructures@treasury.gov.au

Dear Sir/Ms

Improving the Integrity of Stapled Structures

Thank you for the opportunity to comment on the provisions of the Exposure Draft Bill, *Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018* ('**the ED**') released on 17 May 2018.

Our submission addresses a number of substantive and technical issues that arise under the ED. The critical items that we consider should be addressed in the final legislation relate to:

- expanding the types of income qualifying for the exclusion from non-concessional MIT income to include related amounts that would not cause the trust to be a 'trading trust';
- clarifying that capital gains on the disposal of assets from the 'passive' side of a stapled group to the 'active' side of the group are not non-concessional MIT income;
- clarifying that the renewal or extension of a cross-staple lease does not terminate the transitional protection that would otherwise be available;
- clarifying the de minimis test including introducing a de minimis dollar figure as an alternative to the proposed calculation and removing TAP capital gains and cross staple interest from the numerator in the calculation;
- limiting non-concessional MIT income from interests in trading trusts to interests of 10% or more;
- extending the Part IVA carve-out for cross-staple rent to the period beyond the expiry of the Transitional / Exemption period (where the integrity rules continue to be complied with) and to other relevant taxpayers such as the Asset Trust and its resident / non-resident investors;
- clarifying uncertainties in applying the 'less than 10%' test to investors who are exempt foreign superannuation funds and sovereign funds;
- clarifying the 'influence tests' relevant to exempt foreign superannuation funds and sovereign funds, including having regard to veto rights;
- refining the reference to a trust in the sovereign immunity transitional rules to exclude trusts taxed like companies and relaxing the requirement that the only trusts which qualify for the Transitional rules are MITs; and
- expanding the transitional rule as it applies to private rulings to include circumstances where rulings have been issued to group members with

equivalent facts and private rulings issued after 27 March 2018 but which cover periods prior to 27 March 2018.

The detailed elements of the submission are set out in the Appendix.

Yours sincerely

Chris Colley
Director
Greenwoods & Herbert Smith Freehills
[redacted]

Manuel Makas
Director
Greenwoods & Herbert Smith Freehills
[redacted]

Appendix

1 Section 12-440(3)(a)

The exclusion from non-concessional MIT income in s.12-440(3) (rent passing through an operating entity) applies to an amount where:

(a) *the amount is derived, received or made by a *stapled entity in relation to the *cross staple arrangement from an entity that is not a stapled entity in relation to the cross staple arrangement; and*

(b) *the amount mentioned in paragraph (a) is rent.*

The limitation of the exclusion to "rent" (presumably, within its ordinary meaning) creates an inappropriate difference between a structure where:

- the asset entity leases real property directly to a third party, with the operating entity providing separate services to that third party (**Direct Leasing Scenario**); and
- the asset entity leases real property to the operating entity, with the operating entity providing a sublease and additional services to that third party (**Indirect Leasing Scenario**).

In the Direct Leasing Scenario, the definition of rent for the purposes of determining whether a trust has invested in land primarily for the purpose of deriving rent (**Rental Purposes Test**) extends to:

- services that are incidental and relevant to the renting of land and ancillary to the ownership and use of land (s.102MB(3)); and
- other items of income that are incidental and relevant to a leasing business that otherwise satisfies the Rental Purpose Test.

For example, an asset entity could derive amounts in respect of the provision of electricity or licensing of common areas without this being considered to be a trading activity for the purposes of Division 6C / the MIT withholding tax provisions (i.e., the 15% concessional withholding tax rate will apply to distributions to non-residents).

In the Indirect Leasing Scenario, the net income of a MIT attributable to these items of incidental income will be subject to 30% withholding tax. This is an inappropriate outcome and will create unnecessary administration costs from multiple withholding rates where small amounts of non-rent incidental income is passed on by an operating entity to an asset entity.

We appreciate that there is a policy decision to generally exclude amounts that are merely "rent like" (e.g., licence fees for use of a hotel room). However, this policy position does not require a strict limitation to amounts that are rent under general law. We suggest that rent be defined for the purposes of s.12- 440(3) to include:

- amounts treated as rent for the purposes of s.102MB(3); and
- income that is incidental and relevant to the derivation of rent.

2 Section 12-440(2)

The de minimis test is structured such that different tests apply depending upon whether:

- a MIT is an asset trust (i.e., with a direct cross staple arrangement); or
- a MIT holds an interest in a sub-trust that is an asset trust.

It will be common for the head trust of a stapled group to be both an asset trust and hold interests in sub-trusts that are asset trusts. At present, it is not clear how the provisions should be applied in this case as they are structured as an 'either / or' test.

We understand the intention to be that:

- the de minimis test is applied at the level of each sub-trust and, if it is failed by a particular sub-trust, the non-concessional MIT income generated by that trust flows up to the head trust and the ultimate investors with that character; and
- the de minimis test is applied again at the level of the head trust, taking into account both its direct non-concessional MIT income and non-concessional MIT income flowing up from sub-trusts. If the head trust satisfies the de minimis test, only the non-concessional MIT income flowing up from sub-trusts that have failed the de minimis test is subject to the 30% withholding rate.

That is, the mere fact that one sub-trust has failed the de minimis test does not cause all cross staple income within the group to be non-concessional MIT income. We suggest that this be clarified by an example in the Explanatory Memorandum.

3 Section 12-440(2)(c)(ii)

The calculation of the de minimis test for income derived through sub-trusts is inappropriate and produces different outcomes depending upon whether a group is structured with a separate trust for each asset or whether trusts hold multiple assets.

The current structure of the provisions is that:

- if a MIT derives income via a sub-trust, s.12-440(4)(b) provides that the de minimis test is set out in s.12-445(5); and
- s.12-445(4) applies the de minimis test to the relevant sub-trust as if that sub-trust were a MIT.

This means that if, for example, the headquarters of a stapled group were held in a particular sub-trust of a MIT, that sub-trust would likely fail the de minimis test and the rent paid by the operating entity of the stapled group would be subject to 30% withholding tax if distributed to non-residents. By contrast, if the relevant asset were held in the MIT itself, the de minimis test would likely be satisfied.

There is no apparent policy basis for this difference and, as with the previous item, the current arrangement will create unnecessary administration costs by creating small amounts of non-concessional MIT income in circumstances where there is no substantive integrity concern. If the Government is insistent upon the de minimis test being applied at the entity level, there should be a separate de minimis dollar figure (say, $5 million) to prevent small amounts from single asset sub-trusts being picked up.

4 Section 12-440(7)

The extension of the concept of non-concessional MIT income to any income derived through a non-public trading trust was not contained in the March 2018 staples announcement and is clearly too broadly drafted to address the concern to which it is directed.

We understand that this measure is directed towards the 'split control' structures raised in the Discussion Paper released by Treasury in March 2017. These are structures where a number of MITs hold significant, but minority, interests in a trading trust that in aggregate amount to control of the trading trust. A key element of these structures is that the investment by each MIT is sufficiently significant that it has some element of influence over the trading trust.

The provisions dealing with sovereign entities and foreign superannuation funds recognise that there is a substantive difference between portfolio (i.e., less than 10%) and non-portfolio investments and that portfolio investments should generally qualify for concessional treatment. We submit that s.12-440(7) should make a similar distinction and be limited to investments where the MIT has a participation interest of 10% or more.

5 Section 12-445

The calculation of cross staple income as a percentage of total income contains a number of anomalies. For example:

- interest income paid by an operating entity to an asset entity would seem to be included in non-concessional MIT income;
- capital gains from the disposal of taxable Australian property by an asset entity to an operating entity would seem to be included in non-concessional MIT income and excluded from gross assessable income.

We understand that these outcomes are not intended and will be corrected in the final legislation. However, we also understand that there is some concern that a broad-based exclusion of capital gains could somehow permit amounts that would otherwise be non-concessional MIT income to be alienated in a way that delivers a concessionally taxed capital gain to an asset trust. We submit that this is not a valid concern and that an exclusion of all capital gains is appropriate. In this regard, we note that:

- gains from the alienation of income streams would be ordinary income (either under general principles or s.102CA) and so would not qualify for the exclusion; and
- the sale of assets into the 'active' side of a staple means that there is a realisation of any existing gain and all future income and gains from that asset will be taxed at the corporate rate. No group would undertake such a transaction without a clear commercial benefit from doing so.

There would also seem to be a circularity in that:

- the "5% test" operates by reference to "non-concessional MIT income"; but
- if the "5% test" is satisfied, an amount is deemed to not be "non-concessional MIT income".

It would seem that the definition of "non-concessional MIT income" in s12-445 should disregard s.12-440(4).

6 Item 9

The transitional measures set out in Item 9 of the ED require clarification in three important respects.

The first item is in respect of existing cross staple arrangements for non-infrastructure trusts. The transitional rule for infrastructure assets states, relevantly:

> *(1) This item applies if:*
>
> ...
>
> *(b) either:*
>
> *(i) a cross staple arrangement was entered into in relation to the asset before 27 March 2018; or*
>
> *(ii) it is reasonable to conclude that a cross staple arrangement will be entered into in relation to the asset;*

By contrast, the provision for other trusts states:

> *(2) This item also applies if:*
>
> ...
>
> *(b) it is reasonable to conclude that a cross staple arrangement will be entered into in relation to the asset; and*

Read literally, this could suggest that a non-infrastructure trust with an existing cross staple arrangement is not entitled to any transitional relief. We assume that this is not intended and suggest that Item 9(2) be drafted to align with Item 9(1) to achieve the intended result.

The second item is to clarify, by way of an example in the Explanatory Material, that the renewal of the cross-staple lease will not cause transitional relief to cease to apply where it is reasonable to conclude that the renewal will occur. Typically, a cross staple lease will be granted for a term of 3-5 years. This is necessary to ensure that the rent payable under the arrangement can be periodically adjusted to ensure that the operating entity is making an adequate, but not excessive profit.

Given that transitional relief is intended to apply to other future arrangements that are reasonable to conclude will occur (e.g., the grant of a lease on completion of construction of a building, the grant of a lease to an expanded area following the enhancement of an asset), we understand that it is also intended to apply to the renewal of a lease that meets the same test. In this regard, for assets that had yet to produce assessable income as at 27 March 2018, Item 9(5) makes it clear that seven years of transitional protection is available regardless of whether the asset is leased to the operating entity under one lease or a series of leases.

To ensure that there is no doubt in respect of this matter, we suggest the following example be added to the Explanatory Material:

> ***Example 1.8: Renewal of a lease***
>
> *Hotel Asset Trust is party to a cross staple arrangement that includes Hotel Operating Co. Hotel Asset Trust owns a single building that has operated as a hotel for many years. Hotel Operating Co has leased the building under a series of three year leases since its acquisition by Hotel Asset Trust.*
>
> *The lease that was in place at 27 March 2018 expires on 30 June 2019. It is reasonable to conclude that the lease would be renewed for further three year periods commencing 1 July 2019, 1 July 2022 and 1 July 2025, subject to adjustment of the rent payable by Hotel Operating Co and other minor changes in the terms of the lease.*
>
> *The asset is eligible for a seven year transitional period, commencing on 1 July 2019 and ending on 1 July 2026. Because it was reasonable to conclude that the lease to Hotel Operating Co would be renewed, the rent charged under the additional lease terms will not be treated as non-concessional MIT income until 1 July 2026.*

The third item is the preservation of deductions for cross staple payments during the transitional period. As with s.12-440(3)(a), this benefit is limited to payments of "rent". This means that it will not extend to payments for services and other incidental and relevant income amounts that would normally be acceptable under Division 6C / MIT provisions. We suggest that Item 9(4) (and s.12-453 for infrastructure arrangements) be extended to payments "of rent and other amounts in respect of an asset".

7 Section 880-55(2)(b)

One of the requirements to qualify for the sovereign immunity concession is that the entity is a "foreign resident".

The Commissioner of Taxation has noted that a trust is not capable of being a foreign resident (ATO ID 2009/77) as it is not a "person", as defined. We understand that this outcome is not intended and suggest that s.880-55(2)(b) refer to a "*foreign resident or non-resident trust estate*".

8 Section 880-105(1)(f)

The requirements for an amount to be non-assessable, non-exempt income of a sovereign entity are set out in s.880-105(1). One of these requirements (which are cumulative) is that:

> *(1) An amount of *ordinary income or *statutory income of a *sovereign entity is not assessable income and is not *exempt income if:*
>
> ..
>
> *(f) the amount of ordinary income or statutory income is not attributable to a *fund payment made by a managed investment trust, to the extent that the fund payment is attributable to *non-concessional MIT income (as worked out in accordance with section 12-435 in Schedule 1 to the Tax Administration Act 1953)*

The grammatical construction of this provision is difficult to follow. If it is intended to exclude amounts that are non-concessional MIT income, it should state:

> *(1) An amount of *ordinary income or *statutory income of a *sovereign entity is not assessable income and is not *exempt income if:*
>
> ..
>
> *(f) where the amount of ordinary income or statutory income is ~~not~~ attributable to a *fund payment made by a managed investment trust, ~~to the extent~~ that the fund payment is not attributable to *non-concessional MIT income (as worked out in accordance with section 12-435 in Schedule 1 to the Tax Administration Act 1953)*

9 Part IVA carve-out

The inclusion of and scope of the Part IVA carve-out in proposed s. 12-453 and item 9(4) creates uncertainty as to whether Part IVA could apply after the end of the exemption / transitional period (even where the specific integrity rules yet to be announced are complied with) and does not address the potential application of Part IVA to other taxpayers, being the relevant Asset Trust and investors.

We submit that the Part IVA carve-out should not be constrained by the exemption / transitional period and should also include complementary provisions to the effect that Part IVA will not be applied in respect of the flowthrough nature of the relevant Asset Trust (for resident and non-resident investors) and the application of the MIT withholding regime to foreign investors. Supporting examples should be included in the EM.

10 Applying the 'less than 10%' test for the foreign superannuation funds withholding tax exemption

The requirement in s.128B(3CA) that the interest of the foreign superannuation fund in 'the entity from which the superannuation fund derived the income' is less than 10% is unclear. For example, where the foreign superannuation fund derives the income through one or more trusts such that s.128A(3) applies, it is unclear whether the 10% interest test should be applied by reference to the downstream entity that originally paid the relevant amount, or by reference to the trust through which the foreign superannuation fund derived the relevant amount. We submit that the former would be appropriate.

It would be useful if the EM could include the following examples and attendant solutions:

- the foreign superannuation fund held a 25% interest in a trust and the trust held a 30% interest in a company that pays unfranked dividends;
- the foreign superannuation fund held a 9% interest in a trust and the trust held a 100% interest in a company that pays unfranked dividends; and
- the foreign superannuation fund held a 100% interest in a trust and the trust held a 9% interest in a company that pays unfranked dividends.

The uncertainty is also apparent in s.128B(3CB), where it is unclear whether an investment made by a foreign superannuation fund through one or more trusts requires an analysis of the rights held by the superannuation fund in the trust, or the rights held by the trust in the entity that pays the interest, dividend or royalty, or both.

11 Clarifying the 'influence test' – foreign superannuation fund exemption and sovereign fund provisions

There is very little guidance in the EM which explains when an entity will have a right 'to participate in making financial, operating and policy decisions' in respect of another entity for the purposes of the proposed s.128B(3CB)(b)(ii) and s.880-105(2)(b)(ii).

For example, if the issue of significant equity or debt (arguably a financial decision) requires approval by a vote of investors, does the right to cast a vote at an investor meeting constitute a right to participate in the making of that decision, even if the votes

able to be cast by the superannuation fund / sovereign entity are not sufficient to pass the resolution?

In addition, is it possible to be conferred rights under the agreements, elect not to exercise them while the interests are held by a sovereign entity but have them enlivened again if the interest is sold by the sovereign entity to a third party which is not a sovereign entity?

Further, what would be the outcome if the investor has a right of veto of financial, operating and policy decisions'? And what if the rights only applied to one discrete type of decision (as compared to a blanket right)?

In relation to veto rights, it is important to recognise that veto rights are provided to protect minority investors in non-public entities for bona fide commercial reasons. These are the very type of investors which would hold a less than 10% interest. It is submitted that a right of veto should be carved out from the rights described in s.128B(3CB)(b)(ii) and s.880-105(2)(b)(ii).

Greenwoods are aware that the ATO has taken an extremely broad view in the context of sovereign immunity rulings that being a member of an investor advisory board dealing with matters which relate to investor protection, such as resolving managerial conflicts of interest, extension of the investment period or reviewing valuation methodologies, are sufficient to categorise the investor as carrying on commercial dealings and therefore deny sovereign immunity. If Treasury considers that being one member on such an advisory board constitutes participating 'in making financial, operating and policy decisions', then this language should be more explicit and precise.

12 Proposed paragraph 880-105(1)(b)

In the case of a payment / distribution by a Trust, proposed paragraph 880-105(1)(b) as drafted has the effect of limiting the sovereign fund concession to those trusts which are a MIT.

We are not sure of the policy intent as to why an investment in a MIT is favoured over a regular flow-through trust which does not carry on a trading business, and we submit that the provision should be amended to substitute the MIT requirement with a requirement that the paying trust not be a 'trading trust'.

There is a clear intention in proposed subsection 880-105(1) that the limitations which apply to paying entities which are trusts do not apply to paying entities which are companies. It should follow then that if the trust is a public trading trust, that it be treated as if it were a company such that the requirement in paragraph 880-105(1)(b) does not need to be satisfied for the attendant payment to be treated as NANE income in the hands of the sovereign fund.

13 Transitional rule – sovereign wealth funds - private rulings

As currently drafted, the transitional rule is only available where the particular sovereign entity obtained a private ruling on or before 27 March 2018 in respect of an asset acquired on or before that time, and the ruling applied on that day.

The transitional rule would not apply if, for example, the sovereign fund had a ruling but it lapsed on 26 March 2018 and the ATO had not got around to refreshing the ruling despite an application having been lodged.

We submit that at a minimum, transitional relief under the private ruling limb should apply to a sovereign entity which holds a private ruling which applies for a period including 27 March 2018, irrespective of when the ruling was issued. This would enable the sovereign fund to later obtain the ruling based on the law that applied on 27 March 2018.

Given the administrative effort in obtaining a private ruling, if is often the case that a subsidiary entity of a sovereign fund would obtain one private ruling and rely on that ruling for equivalent investments by it or a 100% related entity. This approach reduces the workload of the sovereign fund and the ATO. We further submit that the transitional ruling provisions should apply in such cases, that is, to similar investments held by the

same sovereign entity or similar investments made by a 100% related entity of that sovereign entity to which the private ruling was issued.