INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

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RE: SUBMISSION ON THE STAPLED STRUCTURES INTEGRITY MEASURES PROPOSAL PAPER

Infrastructure Partnerships Australia (IPA) welcomes the opportunity to provide comments on the Stapled Structures Integrity Measures Proposal Paper (the Paper).

As discussed during the consultation meeting between Infrastructure Partnerships Australia's Tax Taskforce and The Treasury on 4 July, there are a number of comments and observations with respect to the proposal paper, which we have discussed below.

1. Introduction of the proposed integrity measures

The Paper proposes that the suggested integrity measures for staples eligible for the 15-year transition concession will be effective from 27 March 2018, when the original measures were announced (transition date). This is not withstanding the fact that the Paper was not released until 28 June 2018. In the interim, relevant taxpayers (who, either directly or indirectly, owned or invested in stapled economic infrastructure assets) were required, at significant expense and effort, to either implement or ensure that relevant transactions complied with the non-arm's length income rule (NALIR) set out in section 275-610 of the *Income Tax Assessment Act* (1997).

In many cases, this has included briefing boards of directors and trustees about the proposed changes that the NALIR could require, as well as obtaining approval to implement the required changes to ensure the relevant entities were compliant with NALIR requirements. For such taxpayers, the NALIR became relevant from 1 July 2018 due to the transitional provisions that were introduced when the NALIR came into effect.

Bringing in a two-tier test for "good" rental income risks undoing the significant work that was undertaken by taxpayers. We suggest that such a test is unnecessary and could be of further detriment to non-resident investors in affected staples (for example, where the existing arrangements were below a market value rental amount).

We acknowledge that it was foreshadowed that there would be "integrity provisions" associated with the transitional provisions. We note the following two comments:

- The Treasurer's media release, "*Levelling the playing field for Australian investors: Taxation of Stapled Structures*", dated 27 March 2018

  To balance concerns over the impact on existing arrangements, transitional arrangements of seven years (ordinary business staples) and 15 years (for infrastructure assets) have been included for the majority of the package. The transitional arrangements will minimise the impact of the package on existing investments.

  The 15-year exemption for new, Government-approved infrastructure assets will ensure continued support for the development of nationally significant infrastructure assets that enhance the productive capacity of the economy and drive long term economic growth.

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

- Paragraph 34, "*Stapled Structures – Details of Integrity Package*", dated 27 March 2018

  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).

The comments above did not indicate the introduction of the measures proposed in the Paper. To the contrary, these comments suggested that the integrity measures would be directed towards rental income that was above an arm's length amount (i.e. aggressive cross-staple pricing). It is difficult to see how a market value rental, which is supported by external advice and which follows an acceptable methodology, could be seen as "aggressive".

We note that the ATO in LCR 2015/15 (Managed Investment Trusts: the non-arm's length income rule in sections 275-605, 275-610 and 275-615 of the *Income Tax Assessment Act 1997*) provided guidance on an appropriate pricing methodology for assets such as a stapled economic infrastructure asset. Additionally, it should be noted that LCR 2015/15 provides very useful guidance on the practical application of the NALIR, including guidance on comparables, examples and documentation requirements. We submit that this should be referenced in the exposure draft legislation for the integrity measures and the accompanying explanatory memorandum.

Consequently, this would suggest that staples that are eligible for the 15-year transition concession only need to satisfy the NALIR and that any income above that be subject to the 30 per cent tax, as currently set out in Division 275. This would ensure simplicity in the legislation, reduce the compliance burden and ensure all investors are treated equally, given that the non-concessional MIT income (NCMI) only affects non-residents.

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If this approach is not acceptable, any affected taxpayer who rebalanced their cross-staple rent between 27 March 2018 and 28 June 2018 (or 30 June 2018) in order to satisfy the NALIR requirements, should be allowed to retain that revised rental without any of it being considered to be NCMI. In addition, we believe it should be recognised that these taxpayers may not be able to implement these changes until a market rent review event occurs under the relevant lease agreement which could take place beyond 1 July 2018.

In practice, it is expected that taxpayers will take the next rent review opportunity provided for under the lease agreements to adjust the amount in line with the NALI amounts. Relevantly, we submit that any adjustments to rental amounts are subject to approval by boards of directors of both parties to the agreement. Additionally, changes to rental agreements can require Government partner and financier consents, and adherence to broader project documentation. These necessary steps require time to implement any rental reviews or adjustments.

Accordingly, we recommend consideration should be given to allowing taxpayers that have determined a NALIR rent amount prior to 1 July 2018 a period in which to implement that NALIR rent. We recommend this period should be 12 months to 1 July 2019. This will ensure that taxpayers are not adversely impacted, as the extended period would allow taxpayers to have finalised their NALI work by 1 July 2018 and to be able to implement the changes at the next available rent review date within the following 12 months.

More generally, there should be some allowance for or acknowledgement that taxpayers my need some time and flexibility to amend and update trust deeds to address the practical application of the integrity rules.

2. The methodology for the "Concessional Cross-Staple Rent Cap" on existing cross-staple rental arrangements

The proposed integrity measures allow existing economic infrastructure staples, which are eligible for the 15-year concession, to continue to charge cross-staple rent based on the calculation methodology that existed before the transition date for the period of transition and still access the 15 per cent MIT rate. If during the transition period a different method of calculating rent is adopted, that causes the cross-staple rent to increase above the rent charged under the methodology applied before the transitional period (the cap), any rent amount that exceeds the cap will not be able to access the concessionary treatment and will be subject to a withholding tax (WHT) of 30 per cent. Therefore, it is important that Treasury confirms that market rent reviews included in rental agreements, and which are a common feature of rental agreements, are not precluded, provided that they have regard to consistent and objective criteria.

Additionally, illustrative industry examples provided below highlight the need for guidance to clarify:

i. The term 'methodology' encompasses annual rent reviews performed by reference to a formula;
ii. Where a non-mandatory formula is detailed in an agreement, the requirement for an objective methodology for the calculation of rent be satisfied;
iii. Where an agreement prescribes more than one methodology (for example, as at the transition phase), either methodology be applied thereafter; and

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iv. The impact of features such as 'floors' and 'ceilings'.

Illustrative examples

We submit that guidance should clarify access to the 15 per cent MIT rate is maintained for the concessional period where rent is determined under contractual arrangements including the following contractual terms:

Example 1
Sub Lease prescribes a methodology comprising five factors to which regard may be had in annual rent reviews. Rent has always been calculated as XX per cent of gross revenue, pursuant to the Sub Lease (i.e., no annual rent reviews undertaken).

Assessment - There was (a) an executed lease agreement, and (b) objective methodology for the calculation of rent in place as of the time of the Transition Deed, and therefore the proposed requirements with respect to the Concessional Cross-Staple Rent Cap should be satisfied.

Example 2
The Sub Lease provides for annual market rent reviews, prescribing five factors to which the Sub-Lessor and Sub-Lessee must have regard. The FY17 notice of market base rent reassessment demonstrates how the sum of these factors is calculated analogous to a formula.

Assessment - There was (a) an executed lease agreement, and (b) objective methodology for the calculation of rent in place as of the time of the Transition Deed, and therefore the proposed requirements with respect to the Concessional Cross-Staple Rent Cap should be satisfied.

Example 3
The Sub-Lease provides for periodic (every five years) rental reviews to be undertaken by the Manager and Lessee together, but doesn't prescribe how that assessment must be undertaken, or the factors to which regard must be had. Where parties cannot agree, the valuation must be referred to a qualified Valuer. Rent is subject to a floor (i.e., can't be less than the rent immediately before review) as well as a ceiling of 15 per cent per annum compounding, and an absolute ceiling of $5 million at any time during the concession period.

Assessment - There was an executed lease agreement in place as of the Transition Date and the prescribed methodology should be able to be relied upon under the proposed measures, even though it is not prescriptive, and features what could be viewed as non-commercial terms (i.e., floors and ceilings). It should be noted that Rental agreements cannot be varied without consents from State and financiers.

Example 4
Pursuant to the Sub-Leases, rent is subject to annual CPI adjustments. Every two years, rent is subject to a market review, but the agreement does not specify which particular factors need to be considered to determine market rent. An annual market increase of 4 per cent has been applied historically.

Assessment - There was an executed lease agreement in place as of the Transition Deed and the prescribed methodology should be able to be relied upon, even though it is not prescriptive. It should be noted that Rental agreements cannot be varied without consents from State and financiers.

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Expense allocation ordering rule

We suggest that a worked example is included in the explanatory memorandum to illustrate the 'expense allocation ordering rule', which is intended to ensure that expenses are first allocated to the rental income that can access the 15 per cent MIT rate.

In particular, this example should illustrate that the WHT is based on the relevant proportion of the non-concessional amount.

We suggest that a worked **example** based on an equitable approach be included.

A suggested exampled is shown below.

1. Determine taxable income

	Income	Expenses	(1) Taxable income
Interest	100	35	65
Rent	120	25	**95**
Total	**220**	**60**	**160**

2. Allocate expenses first to the concessional rent

3. Determine proportion of concessional and non-concessional rent to total rent.

	Income	(2) Expenses	Taxable income	(3) Proportion of total rent
Rent - Concessional	100	25	75	78.95%
Rent - Non-Concessional	20	0	20	21.05%
	120	25	95	1

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4. Calculate the WHT amount for non-residents

	Distribution	Resident	Non-Resident	(4) WHT	Calculation of WHT
		70%	30%		
Interest	65	45.5	19.5	1.95	19.5 * 10%
Rent - Concessional	75	52.5	22.5	3.375	(Non-resident proportion of concessional rent * 15%)
Rent - Non Concessional	20	14	6	1.8	(Non-resident proportion of non-concessional rent*30%)
Total	160	112	48	5.175	

The above example allocates concessional and non-concessional rental income to residents and non-resident investors based on their ownership percentages. In our view, it is unlikely that the trustee would be able to allocate non-concessional rent to non-residents only.

3. Methodology for calculating the rental cap for new assets

We suggest that the method for calculating the “combined taxable income” of the operating entity and asset entity for new assets be clarified as to whether it involves the aggregation of the standalone taxable income or loss of each entity or the calculation of the combined income or loss on a consolidated basis.

We believe that the combined taxable income of the operating entity and asset entity should be calculated by reference to the sum of the taxable income or loss for each entity. To calculate the rental cap on the basis of a consolidated approach would likely result in a number of incongruous outcomes (particularly in the case of a cross staple asset transfer or other cases where there is not a symmetrical tax treatment of cross staple income or expenses).

In this regard, we note the following:

- The NALIR rule does not apply on the basis of a consolidated income calculation. Rather, it applies in respect of the taxable income or loss of the asset trust.
- Investors are subject to tax on their respective shares of the taxable income calculated for an asset trust and operator trust on a standalone basis and are already accustomed to the fact that any tax losses are carried forward within the trust.

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4. Technical amendments to the NALIR

We submit that a de minimis exemption to the application of the NALIR apply in circumstances where upstream investor MITs or AMITs hold an interest in the downstream entity of less than 10 per cent (on an associate inclusive basis). This exemption is justified on the basis that such investors struggle to get the relevant information to monitor the impact of the NALIR and do not influence the cross-staple pricing of the downstream entities.

We also submit that local and foreign investors receive a tax credit for any trustee tax imposed under the NALIR that could be used either as a credit against income tax payable or any excess refunded (for example, in a similar manner as applies currently for tax paid by a trustee for non-resident beneficiaries under section 98 of the *Income Tax Assessment Act 1936*). By way of example, local complying superannuation funds are currently subject to an effective tax rate of 30 per cent in respect of income that is subject to a determination by the Commissioner under the NALIR, whereas they are generally subject to income tax at the rate of 15 per cent on all their income.

Conclusion

We trust the above comments and suggestions provide useful feedback to Treasury's current drafting of legislation on the integrity measures. We would be happy to provide further details on the above and additional comments on the broader package, if required.

If you have any questions in relation to the above, please contact Varsha Maharaj on or .

Sincerely,

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