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Our ref KPMG Submission to Stapled Structures ED 3005AM (002)

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Dear Sir

Stapled structures - KPMG submission to exposure draft

Thank you for the opportunity to provide comments on the Exposure Draft and Explanatory Memorandum to the *Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018* to give effect to the Government's announcements to improve the integrity of stapled structures (**the Bill** and **the EM**).

Uncertainty as to the historic tax outcomes and future treatment of stapled structures has been a significant concern in the infrastructure and property sectors, and we welcome the increased certainty that the Government has sought to create through its recent policy announcements and the Bill.

We acknowledge that the Government's policy position on these structures is now clear, and in this submission we have sought to highlight opportunities for the Bill to provide greater clarity in its application to give best effect to this intent and to provide ongoing certainty to investors into these asset classes. We have not sought to comment on the underlying policy.

Summary of recommendations

The key recommendations raised in our submission are as follows:

- An amendment should be made to explicitly state that Part IVA will not apply to a stapled structure that qualifies for concessional relief during the transitional period.
- Where a stapled structure will qualify for transitional relief and to the extent it was in compliance with the integrity provisions, the Bill should include an amendment to Part IVA to confirm that the general anti-avoidance provisions should not retrospectively apply to that structure.
- The Bill should include an amendment to make clear that Part IVA will not apply after the concessional period to a project that qualified for transitional relief and remains in compliance with the integrity measures.

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- Section 102M of the ITAA36 should be amended to confirm that income derived by the asset trust on the cross-staple lease should be eligible investment income to the extent that the integrity measures are satisfied.
- To ensure that Australia's tax law appropriately responds to modern 'rent-like' arrangements that may not be structured as a traditional lease for commercial and legal reasons, the definition of eligible investment income at section 102M should be expanded to cover both rent and rent-like income.
- Additional examples should be included at item 1.75 of the Explanatory Memorandum to address multi-stage developments in the property sector.
- To prevent inappropriate aggregation of independent funds from a single jurisdiction, the Bill should include additional requirements that must be satisfied before Sovereign interests are aggregated by subsection 880-105(1)(d).
- Sovereign investors should continue to be able to invest through a wholly owned Australian trust without compromising their ability to access the Sovereign Immunity concession.
- Cross-staple payments for the transfer of an asset should be excluded from the definition of non-concessional MIT income both for the purposes of calculating the higher fund payment amount, as well as numerator in the de minimis calculation.
- The 5% de minimis threshold should apply at a group level rather than at an individual entity level.

Part IVA

Transitional period

In the Stapled Structures – Details of Integrity Package document that was released by Treasury on 27 March 2018 (**the Policy Paper**), it is stated explicitly at paragraph 33 that the general anti-avoidance provisions contained in Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 36**) will not apply to the choice of a stapled structure to obtain a deduction for cross-staple rent.

The Bill does not contain any explicit reference to the non-application of Part IVA.

As the Bill requires a choice to be made to access the transitional measures, it could be implied that Part IVA cannot apply on the basis that the choice exception from Part IVA would apply (ref. subsection 177C(2)). However, there remain concerns that Part IVA could still have application in respect to the initial choice to adopt a stapled structure.

To provide greater certainty that Part IVA does not apply during the transitional period, the final legislation should include an amendment to explicitly state that Part IVA will

not apply for that period. We envisage that a mechanism similar to that used in the rights to future income legislation transitional measures could apply. For example, where an election has been made for the transitional rules to apply, the treatment adopted by the taxpayer both prior to the transitional measures, during and after (provided consistent with any relevant integrity measures), would not be amended. We set out the rationale for the pre and post periods below.

Not including such an amendment would fail to achieve the purpose articulated in the Policy Paper which explicitly entitle an operating entity to a deduction for rent during the transitional period.

Other periods

Prior to transitional period

The Bill also provides no additional clarity as to whether Part IVA could apply retrospectively to staples. This is particularly relevant for investor certainty given the views expressed by the ATO in Taxpayer Alert 2017/1. Investors are concerned that the ATO could seek to apply Part IVA to, say, infrastructure staples in the period to 30 June 2019 and then only cease to apply these provisions if the project qualifies for transitional relief.

Where a stapled structure will qualify for transitional relief, the Bill should also include an amendment to Part IVA to confirm that the general anti-avoidance provisions should not retrospectively apply to that structure.

From a policy perspective, the Exposure Draft legislation could provide projects that are eligible for transitional relief with protection from the application of Part IVA if an election is made to apply the integrity provisions to the periods prior to 1 July 2019. Any adjustments to taxable income (to the extent that prior year treatments differ from the outcomes prescribed in the integrity provisions) could be made as a one-off adjustment in the year in which the election is made.

After transitional period

Investors into infrastructure and real estate assets are generally long-term owners of the assets with investment horizons of years, if not decades. These investors place a premium on certainty when considering investments, and the Bill as presently drafted leaves it open that Part IVA may apply to a project once the transitional period has concluded.

On conclusion of the transitional period, a stapled structure will arguably not create any enduring tax benefit for non-resident investors, on the basis that the concessional 15% Managed Investment Trust (**MIT**) withholding tax rate will no longer be available. Domestic investors will continue to be taxed at their marginal rate at all relevant times and will similarly not derive a tax benefit.

The Bill is currently silent as to whether, or not, the Part IVA general anti-avoidance provisions can apply to a stapled structure after the transitional period has concluded. In consultations with the ATO since the release of the Exposure Draft legislation, the ATO have indicated that Part IVA is less likely to apply following the end of the transitional period due to the fact that non-resident investors will, effectively, be subject to tax at 30% on the income of both sides of the staple. However, the ATO has still noted that a tax benefit potentially continues to exist – from the conversion of trading income into passive rental income.

Investors continue to have concerns about the potential application of Part IVA following the end of the transitional period. More can be done to provide investors with certainty, particularly in the context of the comments at paragraph 11 of the Policy Paper which highlight that the new provisions should not necessitate the restructure of existing investments.

In the absence of any ongoing tax benefit arising from differentials in the applicable tax rate, the Bill should include an amendment to make clear that Part IVA will not apply after the concession period to a project that qualified for transitional relief and remains in compliance with the integrity measures.

Division 6C

Non-application to eligible stapled structures

The Bill's principal focus is on the integrity of the MIT concessions, and does not address any associated implications for the Division 6C public trading trust provisions. Many of the considerations raised in the context of the integrity of the MIT provisions will be similarly relevant to assessing whether the asset trust in a staple is carrying on a trading business.

From an investor certainty perspective, as debt service and return expectations will have been modelled on pre-tax cashflows, preserving the flow-through nature of the asset trust will be a key commercial issue. Moreover, unlike the MIT concessions this outcome will be of similar importance to both domestic and foreign investors.

The Bill addresses the deduction outcome for the cross-staple transaction, confirming the availability of a deduction under section 8-1 for the rental payment. It is silent however on the characterisation of the payment received by the asset trust, and whether such amount is eligible investment income.

To the extent that the integrity measures are satisfied, income derived by the asset trust on the cross-staple lease should then be eligible investment income for the purposes of section 102M of the ITAA36.

Modernisation of the definition of rent

The concept of passive income for the purposes of the Division 6C trading trust provisions, qualification for the MIT provisions and in respect of the amendments proposed in the Bill is outlined in the definition of Eligible Investment Business within Section 102M of the ITAA36. This definition is increasingly important to the determination of the tax consequences associated with investment structures and proposed investments.

The eligible investment business definition was originally enacted in 1985 and it has become increasingly difficult for taxpayers and the ATO to apply these provisions as property investors become more sophisticated in their use of available space within commercial and retail real estate investments. Consideration should be given to modernising the definition of eligible investment business so that it provides a clearer policy framework to address this innovation, allowing real estate investors to have greater certainty as to how the law will be applied. This is an important current and on-going issue for the property sector, as the use of space within the traditional REIT sector evolves.

It is acknowledged that this is currently outside the scope of the Treasurer's announcement in relation to staples. However, we provide some additional observations below.

In order to derive eligible investment income for the purposes of section 102M, a trust must invest in land for the purpose of deriving rent. As the property sector has evolved and responded to changing dynamics and demands in the market, there are an increasing number of 'rent-like' arrangements that may not be structured as a traditional lease for commercial and legal reasons.

A non-exhaustive list of property investments and transactions that have the potential to be impacted by this strict approach include:

- Licencing of common property within a retail centre to pop up stores and carts;
- Shared workspaces or 'pop-up' shops which may take the form of a licence
- Social and disability housing;
- The provision of rental support by a Vendor of a property to a Purchaser for a limited period whilst vacant space within a building is leased up following sale of the property;
- Aged care or retirement living facilities which involve significant service elements alongside a core rental activity;
- Student accommodation facilities which are often structured as licences; and

- Datacentres where the use of space may be contracted through a service agreement.

In each of these asset classes, the central activity is the provision of 'space' to a tenant, often with the same or substantially similar proprietary rights to those arising under a traditional landlord/tenant relationship. However, as that agreement may not result in the derivation of rent, it may be challenging for these projects to satisfy the current definition of eligible investment income, and by extension to be held within a flow-through trust. This creates structuring complexity and uncertainty, and can act as a disincentive for the development of projects in these sectors.

To ensure that Australia's tax law appropriately responds to these developments in the market, the definition of eligible investment income at section 102M should be expanded to cover both rent and rent-like income.

Transitional measures for existing structures

The transitional provisions at item 9 of Part 3 of the Bill outline certain criteria that must be present in order for a staple involving that project that is not yet in existence to qualify for transitional relief. The application of this measure is relatively clear in the context of a stand-alone project such as a single stage aged care development, but there is some ambiguity as to how the provisions might apply in the context of staged developments and other 'expansion' style opportunities.

Development of land in the property sector often involves development over multiple stages. Investments in the aged care, hotel, student accommodation and data centre sectors are potentially impacted by the staples announcement. To the extent that investments in these sectors are to be developed in stages or are a component of a larger scale property development, there is uncertainty as to whether such staged projects will qualify for transitional relief.

Using an aged care facility as an example, the development involves multiple stages that will be carried on at the same site by the same entity. However, subsequent stages of the project may not have yet received all approvals, or their construction may not have commenced pending future demand. As contracts have been entered into in respect of the creation of the asset (e.g. the land, approvals, etc.), it is reasonable to expect that the transitional provisions should apply, however this result is not expressly confirmed in the Bill or Explanatory Memorandum.

To provide greater certainty in such scenarios, additional examples should be included at item 1.75 of the Explanatory Memorandum to address multi-stage developments in the property sector.

Requirement for a ‘choice’

Sections 12-450 and 12-453 of the Bill require the taxpayer to make a choice in order to become entitled to a deduction under section 8-1 for the payment on the cross-staple lease.

As section 8-1 is a general deduction provision, it application will follow automatically having regard to the characteristics of the underlying transaction, without the need for it to be ‘activated’ by the taxpayer through a positive choice. If Treasury’s intention is that cross-stapled amounts should only be deductible where the relevant choice is made, it may be necessary to include a new specific deduction provision along with expressly providing that such amounts will not be ordinarily deductible.

Sovereign exemption

Aggregation of foreign sovereigns

Subsection 880-105(1)(d) requires that the total participation interests of all sovereigns of a single foreign country must be aggregated when assessing whether the 10% maximum interest threshold has been met.

Satisfying this requirement presents significant practical and policy issues where multiple, unrelated sovereign investors may be resident within a particular foreign country. For example, it is not uncommon in some jurisdictions for separate Federal and State sovereign investment entities to exist.

Given the independence of investment objective, governance and ownership of those funds, it would not be appropriate for interests held by separate sovereign investors in such circumstances to be aggregated. From a practical perspective, it is also unlikely that these independent funds would have access to each other’s proprietary investment information to enable them to assess whether or not this threshold has been breached.

To avoid such situations arising, the Bill should include additional requirements that must be satisfied before Sovereign interests will be aggregated under subsection 880-105(1)(d). These could include:

- Common ownership of funds;
- Commonality of governance; and
- Commonality of investment decision-making

Captive MITs for Sovereigns

Pursuant to the proposed changes to sovereign immunity, sovereign investors will only be entitled to sovereign immunity in relation to less than 10% investments in companies and MITs. This means that such investors would no longer be able to

invest in a wholly owned trust (that itself may be an MIT) into an underlying fund that qualifies as an MIT.

We recommend that sovereign investors continue to be able to invest through a wholly owned trust into a fund. Enabling this would mirror the consequences of direct investment by the Sovereign, as the taxation characteristics of the underlying entity (including its ability to qualify as a MIT) should be determined as a consequence of its own activities and underlying ownership profile.

Under the current provisions of the Exposure Draft legislation, the sovereign investor would lose sovereign immunity (as the interposed trust ceases to be an MIT) and would not be able to access the MIT regime even though it is an eligible investor and the underlying investment is a passive investment (for example, an investment in a commercial building that derives rent from third party investors).

We consider that this is not an intended outcome of the changes in relation to sovereign immunity.

Application of transitional measures

The Sovereign and pension fund transitional exemptions requires that the relevant equity or debt interest must be in place on 27 March 2018 in order to qualify for the exemption during the transition period.

There are concerns that a relatively immaterial change may terminate the transition period. This would be inequitable to investors.

For example, the mere renewal of existing shareholder debt that forms part of the capital structure of an investment during the transition period does not result in a significant difference in the capital structure of the borrower and the debt continues to be an asset of the relevant superannuation fund for foreign residents at all times. In addition, where a debt facility has been provided and the facility was not fully drawn as at 27 March 2018, any further drawdowns in the facility or equivalent actions (including issuance of loan notes pursuant to that facility) during the transitional period should also fall within the transitional rule.

There will also be investments that have been committed to prior to this time, but not yet legally in place at the relevant time the Sovereign and pension fund exemptions should contain a similar transitional measure to that in the MIT provisions (Part 3 para 9 of the Bill). This would ensure that committed but undrawn investments appropriately qualify for relief during the transitional period.

Technical refinements

Cross staple capital gains

Capital gains made from transferring assets across the staple are currently included in the definition of non-concessional MIT income. A payment made in exchange for an asset sale by a REIT is not a recharacterisation of active income into passive income.

Such asset transfers may occur for various reasons, including a rezoning of a commercial or industrial building to residential after the land and building has been rented to third parties for the medium to long term, or the sale of part of a site to the operating entity so that the stapled group can pursue mixed-use opportunities which are not permitted within the trust side of the staple.

The EM reiterates the policy intention that the integrity measure is designed to address situations where active income is being inappropriately converted to passive income. The draft legislation should be amended so as to exclude payments relating to asset transfers so that the integrity measure is consistent with the policy intent. In the absence of such a change, these provisions may result in significantly adverse implications for property stapled groups even though they are not engaged in recharacterisation activities.

To achieve this, cross-staple payments for the transfer of an asset should be excluded from the definition of non-concessional MIT income [section 12-440] both for the purposes of calculating the higher fund payment amount, as well as for the purpose of calculating the numerator in the de minimis calculation.

5% de minimis threshold is overly restrictive

The de minimis threshold is intended to represent a compliance saving measure. The intention of this measure is to reduce compliance costs where only a small proportion of the gross income of the trust relate to cross staple payments. However, the provisions as drafted result in a number of issues that will reduce the effectiveness of this as a compliance savings measure.

Currently the de minimis test in section 12-445 operates such that the concessional de minimis threshold must be passed at both an individual entity level, as well as cumulatively at a group level where fund payments are received which have been identified as non-concessional.

In respect of real estate MITs, property investments can either be held in separate subsidiary unit trusts or all property investments made by the MIT itself. Individual assets may be held in separate vehicles for various reasons including the ability to obtain separate financing, investment and future disposition reasons. These commercial factors may give rise to different outcomes when applying the de minimis test depending upon whether all of the investment property assets are held in the one

vehicle or separate vehicles. Existing common commercial holding structures should not be disadvantaged from the compliance saving measure.

To preserve the purpose of this test as being a compliance saving measure for those who are not actively converting passive to active income, this test should apply at a group level to reflect the incidental nature of these activities to the whole operation rather than at an individual entity level.

Should you wish to discuss KPMG's submission further, please contact Scott Farrell on (02) 9335 7366 or Brendon Lamers on (07) 3434 9148.

Yours faithfully

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