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10 August 2018

To Corporate and International Tax Division
The Treasury
Langton Crescent
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Dear Treasury

Comments on Exposure Draft: Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax and Other Measures) Bill 2018

1 Introduction

King & Wood Mallesons welcomes the opportunity to provide our comments on the second exposure draft legislation *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax and other Measures) Bill 2018* (the "**Second Stage ED**"), released on 26 July 2018.

We appreciate the efforts being made to consult with stakeholders. A number of the concerns we expressed in our earlier submission in respect of the initial ED have been addressed in the Second Stage ED.

We have outlined below some residual observations and recommendations in relation to the Second Stage ED. We would welcome the opportunity to engage with Treasury to discuss these in more detail, and are happy to assist in preparing drafting to give effect to our recommendations.

King & Wood Mallesons acts for a wide range of participants in the types of arrangements and investments that are the subject of the proposed measures. While our experiences with these clients have informed our views, the views expressed in this submission are our own and are not provided on behalf of or in support of any particular client or industry groups.

References in this submission to the 1936 Act and the 1997 Act are to the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997* respectively. References to the EM are references to the Explanatory Memorandum to the Second Stage ED.

2 Executive Summary

2.1 Overview

With the exception of the policy issue identified in section 2.3 below, we have sought to limit our comments in this submission to the technical aspects of the Second Stage ED. The policy concerns relating to the impact of the proposed measures on foreign investment in Australia that were noted in our submission in respect of the initial ED remain relevant.

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2.2 Technical recommendations

In summary, our key concerns with the Second Stage ED are that:

(a) **Switch off Part IVA:** reliance on the interaction between the choice to claim the deduction by the operating entity under section 25-115 and the exemption in subsection 177C(2) to "switch off" Part IVA is insufficient.

The protections from Part IVA should apply broadly to all rent paid by an operating entity to an asset entity. It should not be limited to the payments of rent during the concession period in relation to "*approved economic infrastructure facility*".

(b) **Grandfathering of transitional relief for gains on disposal of agricultural land:** the transitional relief for capital gains in respect of *Australian agricultural land for rent* assets should be grandfathered so that only the portion of the gain referrable to the period after 1 July 2026 is subject to the higher 30% non-concessional MIT rate.

(c) **Portfolio interest should be tested at level of originator of payment:** for the purposes of both the foreign superannuation fund and sovereign immunity measures, the requirement that the foreign investor holds a portfolio interest of 10% or less should apply in respect of the investment in the originator of the payment (as opposed to in respect of the first point of entry into Australia).

(d) **Requirement that sovereign entity invests in MIT:** the requirement in new section 880-105(1)(e) that where the paying entity is a trust, it must be a MIT should be removed.

A further explanation of our concerns, along with our recommendations to address these concerns, are set out in the table in section 3 of this submission.

2.3 Superannuation Fund for foreign residents – policy concern

Based on our understanding of the current interpretation of section 128A(3) adopted by the Australian Taxation Office, the circumstances in which a foreign superannuation fund may obtain the benefit of the withholding tax exemption in subsection 128B(3)(jb) may (except in limited circumstances) be restricted to situations where the foreign superannuation fund directly invests into an Australian fund.

Direct investment into Australia by the foreign superannuation fund is often not possible. For example, the foreign superannuation fund may be required to invest via a separate feeder fund to comply with foreign regulations.

The superannuation fund for foreign resident measures in the Second Stage ED address the integrity concerns with the withholding tax exemption in section 128B(3)(jb). From an integrity perspective, there does not appear to be any basis for limiting this exemption to direct investments only. It would be appropriate for the legislation amending section 128B(3)(jb) to clarify the intended scope of section 128A(3).

3 Recommended technical clarifications

Our residual technical concerns with the Second Stage ED are set out below.

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3.1 Non-concessional MIT Income

	Technical concern	Recommendation
(a)	**Switch off of Part IVA** The Integrity Package stated that the general anti-avoidance rule in Part IVA would 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*". We understand that new section 25-115 has been drafted to achieve this outcome by enabling an operating entity that makes an express choice to claim a specific deduction for rent it pays to an asset entity in respect of an approved infrastructure facility. The EM provides that entities that make the choice under new section 25-115 will be subject to additional integrity rules. As noted in our previous submission on the initial ED, there is significant uncertainty relating to the existing operation of section 177C(2). For certainty in this context, it is important that the integrity rules do not solely rely on the interaction between the choice by the taxpayer and the exemption in subsection 177C(2) to switch off Part IVA. It is extremely important that the reforms provide clear drafting to give effect to the intention to exclude the adoption of a stapled structure from being susceptible to challenge under Part IVA where a choice for the purposes of section 25-115 has been made. This is particularly so given the ATO's public views on the application of Part IVA to stapled structures (see for example Taxpayer Alert 2017/1). The protections from Part IVA should not be limited to the concession period. The new regime set out in the Second Stage ED comprehensively deals with the integrity concerns raised in connection with stapled structures.	Part IVA should be specifically amended to provide that the establishment and use of an Asset Entity and Operating Entity in a cross-staple arrangement the subject of the relevant election, insofar as it relates to cross-staple payments, cannot be subject to a Part IVA determination by the Commissioner. The amendment should apply to arrangements both within and outside the transitional provisions.
(b)	**Grandfathering of transitional relief for gains on disposal of agricultural land** Under the Second Stage ED, MIT agricultural income will include capital gains (derived directly or indirectly by a MIT) from the disposal of *Australian agricultural land for rent*. In certain circumstances, MIT agricultural income will also include a capital gain derived from the disposal of a	The transitional relief for capital gains in respect of *Australian agricultural land for rent* assets should be grandfathered so that only the portion of the gain referrable to the period after 1 July 2026 is subject to the

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	Technical concern	Recommendation
	membership interest in an entity where the value of the entity is principally derived from *Australian agricultural land for rent*. Capital gains relating to *Australian agricultural land for rent* assets that qualify for the transitional treatment and are acquired before 27 March 2018 will be taxed at the concessional 15% MIT withholding tax rate provided that the gain is derived before 1 July 2026. However, if a qualifying agricultural land asset is disposed of after 1 July 2026 the gain will be fully taxed at the higher 30% non-concessional MIT rate. In our view, the application of the higher non-concessional rate to the entire gain (including the portion of the gain that is attributable to the period prior to 1 July 2026) creates a significant risk that we will see, just prior to 1 July 2026, a significant amount of movement in the market that is likely to lead to artificial and inappropriate outcomes in the agricultural sector. This is because foreign resident investors are incentivised to sell prior to 1 July 2026, as under the current formulation they lose all of the transitional benefits, including a 15% tax rate vis-à-vis the corporate tax rate, if they sell even one day after that date. This structure may also lead to the use of artificial structures by entities seeking to capture the full value of the transitional concessions. Introducing less of a "cliff" based ending to the transitional concessions for capital gains should mitigate the above risks.	higher 30% non-concessional MIT rate.

3.2 Superannuation Funds for Foreign residents

	Technical concern	Recommendation
(a)	**Portfolio interest test should be tested at level of originator of dividend or interest payments** New section 128B(3CA) provides that the superannuation funds for foreign residents withholding tax exemption applies only if a portfolio interest test in new section 128B(3CB) is satisfied. Broadly, the portfolio interest test requires that the foreign superannuation fund's investment in the *paying entity* is less than 10%. The drafting of new section 128B(3CA) gives rise to some ambiguity as to whether the *paying*	The *portfolio interest test* set out in new section 128B(3CB) should be tested at the level of the originator of the interest or dividend payment. This could be achieved by testing the entity's participation interest in the "originator" of the payment and not the "paying entity". The drafting in section

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	Technical concern	Recommendation
	entity may be the originator of the payment (i.e., for income that is dividends, the *paying entity* is the company that 'paid' the dividend). However, the EM suggests that the *paying entity* is intended to be the "*first level of [the foreign superannuation fund's] investment into Australia*". The EM states that: *[W]here a superannuation fund for foreign residents invests through an Australian trust, an assessment must be made of the superannuation fund's level of interest in that trust.* As stated in our previous submission in respect of the initial ED, our view is that the portfolio interest should be tested at the level of the entity that originated the payment of the interest or dividend and not at the level of the first entry point into Australia. Applying the test at the first entry point into Australia creates a disincentive for foreign superannuation funds to use Australian asset managers or invest into Australian assets via Australian funds. It may also lead to anomalous outcomes in certain circumstances (refer to further discussion in our previous submission).	128B(3CA) & (3CB) would therefore replace "paying entity" with "originator of the payment". "Originator of the payment" would be defined as "the entity which makes the first payment of the interest or the company which makes the first payment of the dividends or non-share dividends."

3.3 Sovereign wealth funds

	Technical concern	Recommendation
(a)	**Portfolio interest test should be tested at level of originator of dividend or interest payments** Section 880-105(3) is on similar terms to section 128B(3CB). For the same reasons enunciated at 3.2(a) we recommend that the interest be tested at the originator level.	For the purposes of the portfolio interest test in section 880-105(3), the interest should be tested at the level of the originator of the interest or dividend payment.
(b)	**Requirement to be a MIT** If the sovereign invests or derive its income in Australia through a trust, it is unclear why that trust must be a MIT. As we noted in our previous submission, there can be significant additional costs of establishing and maintaining MITs which are not applicable to non-MITs.	Remove the requirement in section 880-105(1)(e) that where the paying entity is a trust, it must be a MIT.

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4 Superannuation Fund for foreign residents – policy concern

4.1 Background

Under section 128B of the 1936 Act, withholding tax is payable, broadly, on interest or dividend income that is derived by a non-resident and paid by an entity that is an Australian resident for tax purposes. However, section 128B(3)(jb) of the 1936 Act provides that withholding tax does not apply to the extent that the relevant income is:

- derived by a non-resident that is a "superannuation fund for foreign residents";
- consists of interest dividends paid by a company that is a resident; and
- is exempt from income tax in the country in which the non-resident resides.

Further, section 128A(3) provides that for the purposes of these provisions, a beneficiary who is presently entitled to a dividend or interest included in the income of a trust estate shall be deemed to have derived income consisting of that dividend or interest at the time when he or she became so entitled.

We understand that the Australian Taxation Office is adopting a narrow interpretation of section 128A(3) such that the exemption in section 128B(3)(jb) may only apply where a foreign superannuation fund holds an Australian investment via a non-resident trust where:

(a) the foreign superannuation fund is presently entitled to the interest or dividend payment immediately at the time it is derived by the interposed trust; and

(b) the foreign superannuation fund is presently entitled to the gross amount of the interest or dividend payment.

4.2 Outline of concern

Practically, the above narrow interpretation of section 128A(3) generally means that a foreign superannuation fund will not be able to access the withholding tax exemption in section 128B(3)(jb) if it holds its investment via an intermediary trust. This will generally be the case even if the foreign superannuation fund has a fixed entitlement to a share of the trust income and/or is the sole beneficiary of the intermediary trust.

This is because, for trust law purposes it is often the case that:

(a) a beneficiary's present entitlement to trust income is determined at the end a distribution period; and

(b) a beneficiary's present entitlement is to a share of net trust income, after covering trust expenses.

Direct investment into Australia by the foreign superannuation fund is often not possible. For example, the foreign superannuation fund may be required to invest via a separate feeder fund to comply with foreign regulatory requirements.

The implications of the above view are that the withholding tax exemption in section 128B(3)(jb) is unavailable in circumstances which squarely fall within the policy intent of the exemption and which do not pose an integrity concern. Furthermore, it could result in situations where the exemption is not

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available where a foreign superannuation fund receives the relevant dividend or interest income through a wholly owned trust.

4.3 Recommendation

We recommend that the legislation introducing the measures contained in the Second Stage ED also clarify the intended scope of section 128A(3).

For example, section 128A(3) could be redrafted so that:

(a) the section applies where:

  (i) a dividend, interest or royalty is included in the income of a trust estate; and

  (ii) a beneficiary has a fixed entitlement to a share of the income of the trust estate for the year; and

(b) where the section applies, the beneficiary shall be deemed to have derived income consisting of that dividend, interest or royalty at the time when it is received by the trust estate.

Concluding comments

We would welcome the opportunity to discuss these matter and our recommendations with Treasury and, in particular, to assist with any drafting to give effect to recommendations.

In the first instance, please contact Scott Heezen on [redacted].

Yours faithfully

King and Wood Mallesons