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

31 May 2018

By email: stapledstructures@treasury.gov.au

Stapled Structures and Other Measures

Dear Brendan

PricewaterhouseCoopers (**PwC**) welcomes the opportunity to make a submission to Treasury in relation to the Exposure Draft (**ED**) legislation and accompanying Explanatory Memorandum (**EM**) (Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018) released for comment on 17 March 2018.

The intention of our submission is not to cover detailed technical points but rather to highlight several key issues. We note that we have already discussed a wide range of technical issues relating to the drafting of the provisions with you and your team at Treasury in recent consultation. We would be happy to discuss any aspect of our submission points with you further.

In addition, we note that the second stage of the ED and EM is expected to be released soon to deal with the agricultural Managed Investment Trust (**MIT**) changes and the conditions that stapled entities must comply with in order to access the nationally significant infrastructure concession and/or the transitional arrangements. We look forward to the opportunity to provide further consultation when this subsequent Exposure Draft is released.

PwC makes the following general submissions on the ED.

PricewaterhouseCoopers, ABN 52 780 433 757
One International Towers Sydney, Watermans Quay, Barangaroo NSW 2000,
GPO BOX 2650 Sydney NSW 2001
T: +61 2 8266 0000, F: +61 2 8266 9999, www.pwc.com.au

1. Submission for timing of introduction of related integrity measures

We understand that it is proposed that the related integrity measures will be introduced into Parliament in a separate bill later this year. Given the 1 July 2019 start date for the "non-concessional MIT income" measure, we would strongly support taking additional time to consult on and refine the legislation in a holistic fashion to ensure it can be a robust measure that prevents mischief, while allowing legitimate activities to continue to be undertaken by stapled groups and taxed at the appropriate 15% rate.

We are concerned that introducing law in a piecemeal manner could lead to further confusion and may result in legislation that does not achieve the desired policy intent, which could have significantly adverse implications for legitimate activities.

Therefore, we would suggest "decoupling" the thin capitalisation measures, which have a start date of 1 July 2018, and only introduce these into Parliament now. That would give Treasury time to address the points raised below and to ensure the legislation is considered as a complete package.

2. Submissions for Non-Concessional MIT Income

Submission 1: Definition of "asset" for the transitional rules

The term "asset" is not defined in Schedule 1, Item 9 of the ED. We suggest that the term asset used in the ED should be clarified to mean an asset in its entirety that operates in an integrated manner and not be left to its generally accepted interpretation of each individual functional asset. This clarification is required because generally the term "asset" is interpreted in other provisions of the *Income Tax Assessment Act 1997 (Cth)* (**ITAA 1997**) on an individual functional asset basis and, in our view, this narrower interpretation of the term "asset" is inconsistent with the intended operation of the provisions.

Our proposition is supported by the examples provided in the EM. Specifically, the examples state that the expansion of an electricity network to a newly constructed suburb, or the addition of new levels to an existing building, would in each case constitute an improvement of an existing asset rather than investment in a new asset. Accordingly, where an existing "asset" is eligible for transitional treatment and is improved, the transitional treatment should extend to improvements as well.

An alternative approach is that the term "asset" is specifically defined for the purposes of these provisions. If this approach is to be taken, we would recommend a definition that clearly encompasses collectively the broader piece of infrastructure, including any future modifications, alterations, enhancements and improvements in relation thereto.

Submission 2: Definition of 'Economic Infrastructure Asset'

The term 'economic infrastructure asset' in subsection 12-450(4) of the ED should be more clearly defined given this is a key definition for the operation of the provisions. In this respect, in the current definition of economic infrastructure asset the words 'transport', 'energy', 'communications' and 'water' need further clarification of what activities are included in each category.

Further, the use of the term 'for public purposes' is not clear in situations where assets although used for or by the public are provided for such use through third party intermediaries rather than the actual infrastructure owner or operator. This should be clarified.

Submission 3: The requirement to have entered into a contract by 27 March 2018

The investments made by investors in projects and assets that are affected by the reforms are significant. The transitional relief afforded to affected investors under sub item 9(2) only applies if an entity entered into a contract before 27 March 2018 in respect of the acquisition and creation of an asset. That is, the transitional relief under this section only applies to legal commitments in place at the time of the announcement.

As noted in our previous submission dated 9 May 2018, there are concerns that capital expenditure which is estimated to be incurred by an "*asset entity*" in future years, and which is included in financial models on which acquisition or investment decisions are based, but is not necessarily contractually committed to as at the date of the announcement, will not be considered an investment to which the transitional period rules apply.

The impact of this approach is that the net rent received by the asset entity for leasing or sub-leasing the property (with fixtures) would need to be apportioned, such that the net rent received with respect to the future capital expenditure would not be afforded the concessional tax rates during the transitional period.

A material assumption on which investment decisions are based is the level of future capital expenditure required in order to maintain, expand and organically grow the existing asset base. We welcome the fact that the ED and associated examples in the EM confirm that life cycle capital expenditure to maintain or enhance the existing asset base should be subject to the transitional rules. However, we submit that expenditure to organically expand the business in the ordinary course should be subject to the transitional period. To take the alternative approach would effectively mean that the transitional period is substantially less than the 7 or 15 years in many cases.

Investors have a range of commercial and financial commitments in their existing Australian portfolios that are fundamental to their investments.

The transitional concessions should apply to arrangements where investors had a commercial commitment to investments or capital expenditure as evidenced in constituent documents or other objective evidence that existed prior to the announcement and not just a legal commitment. Where these commitments are in the form of option agreements, they often cannot be moved to other entities without adverse commercial and stamp duty implications. This will be particularly important if the proposed agricultural land provisions rely on similar definitions as without access to the transitional rules, the asset under option must not be held by the existing trust as it would taint the entire trust.

To address any concerns that the Government may have on this point, we submit that there is legislative precedent available to the Government to set the parameters of any such concession. Specifically:

- In relation to organic growth, a similar concept can be found in the "same business" or "similar" business concepts in the loss integrity rules (e.g. Subdivision 165-E of the ITAA 1997) together with an established jurisprudence and ATO guidance in respect of the application of the rules.

- In relation to commitments, a broader concept was introduced as part of the Capital Gains Tax (**CGT**) measures for roll-overs for corporate restructures enacted as part of the *Tax Laws Amendment (2008 Measures No 6) Act 2009*. Under these rules, where an arrangement did not involve a takeover bid or a scheme of arrangement, the measures will apply to an arrangement ***if a decision*** *to enter into the arrangement was not made before 7.30 pm (legal time in the ACT) on 13 May 2008*. The Explanatory Memorandum for these measures provide that:

  "1.81 It will be a question of fact as to whether a decision to enter into the arrangement was made before 7.30 pm, by legal time in the Australian Capital Territory, on 13 May 2008. However, it is expected that there would be some evidence of the decision in the records of the acquiring entity or the original entity. "

  Under these CGT provisions, a contract does not need to be entered into by the relevant time however a decision to enter into the arrangement will need to be made. We suggest a similar approach is adopted for the transitional provisions. We also recommend that guidance is provided to assist with determining what evidence is sufficient to support that a decision is made by 27 March 2018.

Submission 4: Confirmation that Part IVA does not apply to cross staple arrangements

Schedule 1, sub item 9(4) of the transitional rules for existing assets and section 12-453 for approved economic infrastructure assets confirm that an operating entity should be entitled to a deduction for rent paid to the asset entity under a cross staple arrangement. These current provisions are too narrow as they do not deal with other cross staple payments and are silent on the position before or after the applicable transitional period.

The transitional rule is not sufficient to prevent Part IVA of the *Income Tax Assessment Act 1936 (Cth)* (**ITAA 1936**) from applying to cross staple arrangements that are subject to the transitional provisions as specifying that a deduction is available does not in our view necessarily prevent the Commissioner alleging Part IVA applies.

We submit that it should be made clear that Part IVA of the ITAA 1936 will not apply to the relevant cross staple arrangements that are subject to the transitional provisions and also confirm whether in legislation or ATO guidance that Part IVA should not apply to these arrangements post the transitional period.

Submission 5: Definition of an operating entity

Section 12-455 defines 'operating entity' in order to determine if there is a 'cross staple arrangement'. In defining an operating entity which is a partnership or company, subsection 12-455(3) assumes that the partnership or company is a trust and then applies subsection 275-10(4) to determine whether the partnership or company is a trading trust.

Subsection 275-10(4) contains two different tests, one that applies to unit trusts and one that applies to other trusts. We would recommend that subsection 12-455(3) be clarified such that in applying subsection 275-10(4), partnerships and companies are treated as 'unit trusts'. This will ensure consistency within the provisions (for example with subsection 12-440(7)) and that such partnerships and companies are able to be assessed on the same basis as operating entities that are actually unit trusts.

Submission 6: Gains from the transfer of assets and non-concessional MIT income

The policy intent of the new law is to limit access to tax concessions for income that is attributable to a trading business (refer paragraph 1.14 of the EM).

Under the ED, payments made from transferring assets held by the asset entity to an operating entity are currently captured in the definition of non-concessional MIT income. A payment received in relation to an asset sale is not a re-characterisation of active income into passive income and therefore we are of the view that any gains made in relation to the transfer of assets within a stapled group should not be included in the definition of non-concessional MIT income.

Where the ED is not amended to exclude these payments relating to asset transfers, the integrity measures would capture amounts that are not within policy intent as they do not arise from the re-characterisation of trading income.

We suggest that gains made from the transfer of an asset are excluded from the definition of non-concessional MIT income.

Submission 7: Clarification of meaning of 'Rent'

Where a cross staple payment is attributable to an amount of rent derived by a stapled entity from a third party, that payment will not constitute 'non concessional MIT income'. The term 'rent' is not defined and we suggest that the term should be specifically defined for these provisions. As a minimum, rent should be defined to be rent in accordance with Division 6C of the ITAA 1936. Further, we suggest that the term 'rent' should be extended for the purposes of these provisions to include income from providing usage rights in respect of real property to third parties (i.e. licence fees).

3. Submissions for the superannuation funds for foreign residents withholding tax exemption

Submission 1: Application of Schedule 3, Item 2

Schedule 3, item 2 of the ED broadly states that an exemption from interest and dividend withholding tax for a superannuation fund for foreign residents ("foreign superannuation fund") is only available if the total participation interest of the foreign superannuation fund in the entity from which the foreign superannuation fund derived the income is less than 10%.

Although it is appropriate to test the foreign superannuation fund's level of interest where it derives the interest and dividend income directly, the current drafting of the provision however does not cater for indirect investments by foreign superannuation funds in debt and equity instruments (for example, it is common practice for foreign superannuation funds to invest into an Australian pooling vehicle, such as an Australian trust, and it is this Australian trust that then holds the relevant debt or equity instrument).

In such a scenario, Section 128A(3) of the ITAA 1936 states:

> *"For the purposes of this Division, a beneficiary who is presently entitled to a dividend, to interest or to a royalty included in the income of the trust estate shall be deemed to have derived income consisting of that dividend, interest or royalty at the time when he or she became so entitled."*

Where a foreign superannuation funds hold units in an Australian trust, it is clear that section 128A(3) will deem that the foreign superannuation fund will derive interest and dividend income at the time when it is presently entitled to that income of the trust. Under current drafting of the ED, the level to test the participation interest is in the Australian trust, and not in the underlying entity that is held by the Australian trust that is actually paying the interest or dividend.

The examples in the EM also only relate to a direct interest held by a foreign superannuation fund and do not cover the scenario where a foreign superannuation fund indirectly invests in debt instruments and companies indirectly via a pooling vehicle, such as an Australian trust.

Example 3.1 of the EM confirms that a foreign superannuation fund that holds 8% of the ordinary share capital of Aus Co will be exempt from dividend withholding tax. If the facts were altered to insert an Australian pooling trust between the foreign superannuation fund, so that:

- foreign superannuation fund holds a 100% interest in an Australian trust (the Trust);
- the Trust then holds the 8% of the ordinary share capital of Aus Co;

then based on the current drafting of the ED, dividends paid by Aus Co ultimately to the foreign superannuation fund via the Trust would not be exempt from dividend withholding tax as the foreign superannuation fund has a 10% or greater interest in the Trust (i.e. the entity from which the foreign superannuation fund derived the income). This is the case even though the foreign superannuation fund holds only an 8% indirect interest in Aus Co. We submit that there should be no difference in outcome where a foreign superannuation fund invests in debt and equity instruments directly or indirectly.

This can be achieved by ignoring a trust, or a chain of trusts, for the purpose of testing the participation interest of the foreign superannuation fund in the entity from which the foreign superannuation fund derived the income.

Submission 2: Key decision making for foreign superannuation funds

The ED will limit the interest and dividend withholding tax exemption for foreign superannuation funds to portfolio investments only (i.e. a membership interest of less than 10% interest). In addition, even if a foreign superannuation fund holds a portfolio interest in an entity or a debt interest, the foreign superannuation fund will not be exempt from interest and dividend withholding tax where the foreign superannuation fund has:

- A right to vote at a meeting of the Board of Directors (or other governing body); or
- Rights to participate in making financial, operating and policy decisions relating to the entity that paid the dividends or interest.

The additional requirements imposed on foreign superannuation funds are extremely broad and, in our view, would capture any right held by a foreign superannuation fund as a shareholder or debtholder such that they would not qualify for the dividend and interest withholding tax exemption. This seems to be a much lower threshold than “sufficient influence” which is used throughout the ITAA 1936 and ITAA 1997 to determine whether an entity has influence over the key decision making of an entity.

Given the broad interpretation of this provision, we recommend that further clear guidance is provided on the nature of the rights that can / cannot be held by a foreign superannuation fund.

4. Submissions for sovereign immunity

Submission 1: Definition of 'Sovereign Entity'

The definition of sovereign entity in subsection 880-55(2) seems to be different to that previously adopted by the ATO in practice in providing sovereign immunity rulings. Specifically, we are concerned with:

- the complete exclusion of superannuation funds for foreign residents (refer section 880-55(2)(d); and
- the requirement that all of the investments be funded by public monies (refer section 880-55(2)(c)) and suggest that these matters be reconsidered.

With respect to superannuation funds for foreign residents, there are a number of sovereign entities that may also fall within the definition of superannuation funds for foreign residents and which satisfy all other conditions of a sovereign entity in section 880-55(2). The policy and purpose regarding this exclusion is unclear to us. We therefore suggest further guidance is provided and, absent clear policy objectives, the exemption being extended to foreign government pension funds.

With regard to the requirement for **all** of a sovereign entity's investment to be funded by public money in section 880-55(2)(c), we understand that in its past practice the ATO gave rulings in respect of specific investments on the basis that that investment was wholly funded by public money. Whether or not other investments existed, (which did not rely on the principle of sovereign immunity), did not impact the availability of the principle of sovereign immunity to the specific investment wholly funded by public monies.

We submit that the fact that the sovereign entity may fund other investments e.g. in part with debt, should not impact on the availability of the sovereign immunity exemption in respect of a specific Australian investments which are solely funded by public monies. This is in particular the case given that the requirement in section 880-55(2)(c) appears to have no jurisdictional limits.

Submission 2: Aggregation of interests for sovereign entities in the same foreign country

The ED provides that one of the conditions that must be satisfied to determine whether income derived by a sovereign entity is non assessable non exempt (**NANE**) income, is that a sovereign entity must hold a total participation interest of less than 10% of the relevant entity.

In determining whether the 10% threshold has been exceeded, the ED provides that a sovereign entity's interest in the relevant entity must be aggregated with other sovereign entities from the same foreign country that have an interest in the same entity. We are concerned with the aggregation of interests of sovereign entities from the same foreign country as there are a number of sovereign entities from the same foreign country that operate independently to each other and invest, often without knowledge of each other, in the same Australian entities. This could not only arise where foreign states have sovereign funds that act independently at the federal level but also where sovereign funds operate independently at a federal, state and municipal level.

We submit that the 10% threshold should be determined on an individual entity by entity basis where a sovereign entity is operating independently (i.e. it has a separate Board of Directors responsible for choosing their own investment mandate and therefore the particular deployment of capital for each relevant investment). Where a sovereign entity is operating independently, we submit that there should be no aggregation of the sovereign entity interests from the same foreign country.

In respect to this matter, our experience is that it would be unreasonable to aggregate interests in otherwise independent investment bodies (when determining whether or not the less than 10 percent threshold has been exceeded).

Submission 3: Transitional rules and tax ruling date

The transitional rules apply to a sovereign entity that had a private ruling that applied on 27 March 2018 (Schedule 4, Item 4(2)(c)). We are aware of sovereign entities that lodged tax rulings with the Australian Taxation Office (**ATO**) *prior* to 27 March 2018 and are still in negotiations with the ATO.

We suggest that this provision is updated to ensure that it captures existing investments where sovereign entities had applied for tax rulings prior to 27 March 2018 and were engaged in discussions with the ATO in relation to the application prior to this date and the Commissioner would issue a positive ruling but for these proposed changes. We also recommend that this amendment is reflected in Item 5(1) regarding the deemed sale and purchase concessions.

Submission 4: Deemed cost base for sovereign entities

Where a sovereign entity continues to hold a transitional investment after the transitional period, the ED deems their cost base of their investment to be equal to the market value on the later of 1 July 2026 or the day before their private ruling ceases to apply. We welcome this transitional provision in the ED however we suggest that the deemed cost base should be the higher of the market value and cost base of the asset.

Submission 5: Trading business condition for sovereign entities

Subsection 880-105(1)(e) requires a sovereign entity to assess whether the investments in Australia for which they seek to claim sovereign immunity are acquired in carrying on a *trading business of the sovereign entity*.

We would suggest that this requirement is redundant and creates an unnecessary burden on the sovereign entity. The sovereign entity is only able to obtain the NANE outcomes if it holds a less than 10% interest in the relevant entity and the types of interests for which the treatment is available are limited to financial instruments. As such, the sovereign entity is not in a position to control the entity and the relevant asset is an eligible investment business asset. Hence the need to test whether the sovereign entity is carrying on a trading business is already inherent within the other requirements.

For a sovereign entity to consider its satisfaction of the definition of 'trading business' would potentially also require an assessment of the activities outside of Australia. The definition of trading business within Division 6C is also a very narrow concept and does not include the statutory protections available to other entities who must determine whether they carry on an eligible investment business. As such, if the requirement is to be retained, at a minimum the threshold test should be changed from 'trading business' to 'eligible investment business'.

Finally, to retain this requirement also imposes an additional burden on sovereign entities which is not required for foreign superannuation funds.

Submission 6: Extend the application of sovereign immunity to fixed unit trusts

Subsection 880-105(1)(b) of the ED in respect of sovereign immunity should be extended so that the sovereign immunity exemption is not only applicable to investments in companies or MITs. We consider that the provisions should be extended to investments in fixed unit trusts which are not trading trusts for the purposes of section 102N of ITAA 1936.

In this respect it is submitted that the current provision is too restrictive and impacts on the ability to attract future sovereign investors into fixed unit trusts that are not MITs. Failing that, the current restriction will force entities within structures to qualify as MITs (where possible) and bear the ongoing costs in respect of maintaining MIT status.

Submission 7: Reference to company

The reference in subsection 880-105(1)(a) of the ED that an amount is derived, received or made from a trust or company should be changed such that the word ‘company’ is replaced by ‘corporate tax entity’. This is to ensure that sovereign immunity can appropriately extend to investments in public trading trusts.

* * * * *

We look forward to the opportunity of discussing our submission with you in further detail. In the interim, if you have any questions or comments, please do not hesitate to contact us.

Yours sincerely,

Luke Bugden Partner	Joshua Cardwell Partner	Christian Holle Partner