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BY EMAIL: Stapledstructures@treasury.gov.au

20 April 2017

Dear Sir/Madam,

Submission: Re Stapled Structures Consultation Paper March 2017 (Consultation Paper)

We are pleased to submit this response to the Consultation Paper regarding potential policy options in relation to stapled structures, the taxation of real property investments and the re-characterisation of trading income.

We fully support the Government's desire to investigate the current policy settings for long term capital investment in Australia, and if considered necessary following such a review, the development of a balanced and informed response to the perceived re-characterisation of trading income into more concessional taxed passive income. However, the limited time frame prevents the full and detailed response that the significant complexities raised by the Consultation Paper require.

The diversity of taxpayers potentially affected by any changes to the tax outcomes of stapling arrangements necessitates a comprehensive and detailed examination of the design and impact of any proposed change. Any change must meet the objectives of maintaining a viable, long-term model for capital investment attractive to local and international investors and be in the best interests of the Australian community and the economy. These objectives can only be achieved based on a complete understanding of the current investment landscape for both domestic and international investors, and clear policy direction.

Treasury is aware that stapled structures have been a preferred investment model in Australia for nearly three decades. The Australian Taxation Office (**ATO**) has also been aware of stapled structures over this period. Stapling is well understood by investors in Australia and overseas, it achieves significant cost savings in the delivery of essential infrastructure and is recognised in the income tax legislation.[1] In short, the stapling of

[1] See section 102NA of the *Income Tax Assessment Act 1936;* section 83A-335, section 124-1045, section 235-835 of the *Income Tax Assessment Act 1997*; and, the Review of the Debt and Equity Tax Rules – The

securities has been a part of the architecture of financial and tax structuring in the Australian economy for a significant period of time and should be permitted into the future.

We have included the following as part of our submission:

- Appendix A: Critical concerns
- Appendix B: Summary of other key recommendations
- Appendix C: Deloitte Growth 25 Results Matrix

Due to our broader concerns about the policy directions of the paper as a whole and the complexities involved, we have provided some broader commentary around these concerns rather than necessarily answering the consultation questions as listed in the paper.

We would be pleased to provide further information and detail in the future. Deloitte is committed to making a constructive and balanced contribution to any future development of the policy and law in this area.

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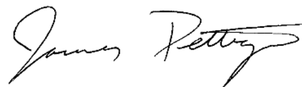
Should you have any questions, please do not hesitate to contact James Pettigrew on 02 9322 5656, Brett Greig on 03 9671 7097, Max Persson on 02 9322 7538 or James Fabijancic on 03 9671 7370.

Yours sincerely,



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Related Scheme and Equity Override Integrity Provisions, A Report to the Government, Board of Taxation, December 2014 and the draft legislation, explanatory material and regulations issued thereto.

Appendix A: Critical concerns

There are significant complexities in understanding the current tax policy settings and alignment with the Government's objective of making Australia an internationally competitive jurisdiction to attract mobile global capital. Given the magnitude of the impact changes in law would have on a range of industries and businesses, a thorough analysis is essential and should be expected to be a lengthy process. Absent strong evidence of the need for amendments, we would recommend no change in law and reliance on existing integrity provisions, ultimately including Part IVA of the *Income Tax Assessment Act 1936 (Cth)* (**Part IVA**) to address perceived revenue risks. If a change in law is considered necessary, this should be in the form of targeted integrity measures in respect of re-characterisation, but only after thorough consultation with all stakeholders, through a co-design process.

We understand that following initial consultation Treasury understands that the use of stapled structures does not *per se* result in a re-characterisation of trading income and that the current Real Estate Investment Trust (**REIT**) regime should be preserved in favour of the implementation of a new REIT regime based on international models. We fully support both conclusions and also strongly support the maintenance of the policy of flow through taxation of passive income.

We have deep concerns with how any measures to deal with the perceived re-characterisation of trading income may be achieved and how such measures would be effectively limited to certain arrangements seen as being outside of the Government's policy.

We note the concerns raised by Treasury in consultation with achieving a "level playing field". There are historic reasons why there are differing levels of exposure to tax for different taxpayers and these are the result of deliberate policy implementation in relation in particular to the taxation of non-residents and superannuation funds. Australia is a net capital importer and any change in current laws would need to be balanced against the creation of adverse effects in that framework. Some investors have a lower rate of tax but this is the result of decades of tax law and policy implementation. We recommend that detailed quantitative analysis be undertaken to ensure the right target is in sight.

A stapled structure will be used when the economics, financing and duration of a project make it the most appropriate form of project vehicle. Treasury is aware of the profiles of infrastructure projects and the requirements of financiers to such projects to obtain fund flow and ensure that the security of the project cash flows are not subject to tax at the vehicle level but subject to tax in the hands of investors. Flow-though is a guiding principle and a fundamental pillar of Australian taxation law.

The range of industries and situations in which stapled structures are used will militate against a simple "one-size fits all" solution. Whether the magnitude of the purported tax problem is greater than the economic benefits that stapled structures offer investors, State and Federal governments, and which make Australia an attractive investment destination, compels a thorough analysis by Treasury.

We recommend that Treasury be given the resources necessary to undertake a thorough quantitative examination of the data to clearly delineate and define the problems which may need to be addressed. We recommend a measured and fully engaged consultation be undertaken in relation to any integrity measures. Any proposed measure would need to be very tightly focused and simple to comply with.

At a practical level any measures enacted to deal with a perceived re-characterisation of trading income could cause significant disruption to existing arrangements: financier and State government consents would be required; debt covenants with banks would need to be revisited, as might settlements with the ATO. Numerous and significant legal and practical issues would arise. This is unsurprising given stapled securities are frequently used in structured financial arrangements with an agreed, precise outcome within the context of a settled investment paradigm. Any alteration to the quantum, frequency or treatment of distributions affects not only the investors in the project but also its financiers and other third parties, such as customers and suppliers.

It is our belief that the current context, being one where existing integrity provisions, including the non-arm's length income rule (**NALIR**), the aggregation rules in Division 974, Division 6C of the *Income Tax Assessment Act 1936 (Cth)* (**Division 6C**) and thin capitalisation restrictions, as well as ultimately the potential application of Part IVA are the Commissioner's defence against tax schemes, would be preferable to any pre-emptory changes. This statement is not made lightly but the reasons for it are substantial. Part IVA has attracted a significant body of legal and administrative examination. Its application, if any, in relation to financing and privatisation structures and similar arrangements is well-understood by all parties, including financiers and State governments. Part IVA has been strengthened to ensure that certain defences against its application are no longer available and its scope accordingly extended. In addition, for Managed Investment Trusts (**MIT**) the Commissioner can make a determination under the NALIR such that any excess income is taxable to the trustee at 30%. The NALIR came into effect approximately nine months ago and there is no evidence to conclude that it will not be effective in achieving its purpose.

If the work undertaken by Treasury concludes that there is a need for a change to the law, Deloitte submits that the measures must provide security to relevant taxpayers, including but not limited to:

- grandfathering of current arrangements; and
- incorporation of long term transitional arrangements to allow the minimisation of financial disruption to projects in the movement to any new regime.

In addition, if stapled structures have to be restructured, each State and Territory would need to introduce matching relief provisions, otherwise the stamp duty leakage (at rates up to 5.75% for unlisted trusts and 5.15% for listed trusts) would be substantial and likely to preclude any transaction from occurring.

Appendix B: Summary of other key recommendations

1. A stapled structure will be used when the economics, financing and duration of a project make it the most appropriate form of project vehicle. These considerations include:

    a. lowering the weighted average cost of capital (**WACC**) for the project;

    b. reducing double taxation which emerges through franking credit traps;

    c. enabling cash returns to investors; and

    d. providing effective security nets for financiers.

    Stapled structures should therefore be retained to facilitate private investment in infrastructure, build-own-operate-transfer (**BOOT**) and concession schemes where the property reverts to the State at the end of the arrangement.

2. Stapled structures should also be retained to promote the ongoing success of the A-REIT sector and the growth in alternative real estate asset classes vital to Australia's future economic prosperity, including hotels, student accommodation, tourism parks, manufactured housing estates, agriculture, multi-family housing, retirement living and aged care.[2]

3. A REIT regime based on global REIT models should not be introduced, for the following reasons:

    a. the introduction of a REIT regime has been previously considered by the government and rejected, consistent with the recommendation of the Board of Taxation;[3]

    b. Australia already has a world class REIT framework, and existing global REIT regimes do not accommodate existing aggregated business REIT staples which have provided investors with the opportunity to invest in listed diversified real estate businesses in Australia for close to 30 years; [4] and

    c. a REIT regime would add cost, complexity and administrative difficulties which outweigh potential benefits.[5]

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[2] For example, refer to the discussion below based on Deloitte's findings set out in *Building the Lucky Country - Business imperatives for a prosperous Australia Positioning for prosperity? Catching the next wave*, 2013, discussed at 6.13 of this submission.

[3] *Review of the Tax Arrangements Applying to Managed Investment Trusts: A report to the Assistant Treasurer* - Board of Taxation, August 2009, Recommendation 6

[4] The first stapled security in Australia was Stockland Group, following a restructure of their operations in 1988.

[5] *Review of the Tax Arrangements Applying to Managed Investment Trusts: A report to the Assistant Treasurer* - Board of Taxation, August 2009, at 2.44

The introduction of a REIT regime would displace the outcomes of substantial effort and consultation regarding the development of the attribution MIT framework, including the NALIR applying more broadly to MITs, addressing the integrity of cross-stapled transactions generating income in the MIT.[6]

There is no evidence to suggest that the NALIR will not be an appropriate measure to deal with the integrity concerns it was designed to counter.

4. The eligible investment business rules could be modernised to replace the rental requirement with a passive income from the use of land test, as recommended by the Board of Taxation.7 This would remove the need for cross-stapled rental arrangements for a number of alternative real estate asset classes that derive third party passive income from the use of property which may not legally be rent.

In support of our recommendations we provide our further comments in relation to the following:

1. Preference for targeted integrity rules with appropriate transitional measures if change to law necessary.
2. Economic efficiencies offered by stapled structures for project vehicles, investors and financiers.
3. Stapling generally not being used not for the purposes of fragmentation or re-characterisation of trading income.
4. The misplaced concern with a level playing field (international and domestic).
5. Use of stapled structures for concession arrangements.
6. Use of stapled structures in the property industry.
7. The introduction of a new REIT regime based on international REIT models would not be appropriate.
8. Non-arm's length income rule removes the incentive for a MIT to shift profits from an active business.
9. Extending the scope of "eligible investment business".

[6] *Tax Laws Amendment (New Tax System For Managed Investment Trusts) Bill 2015*
Income Tax Rates Amendment (Managed Investment Trusts) Bill 2015 Medicare Levy Amendment (Attribution Managed Investment Trusts) Bill 2015 Income Tax (Attribution Managed Investment Trusts — Offsets) Bill 2015 Explanatory Memorandum, at 9.25
[7] *Review of the Tax Arrangements Applying to Managed Investment Trusts: A report to the Assistant Treasurer* - Board of Taxation, August 2009, Recommendation 8

1. *Preference for targeted integrity rules with appropriate transitional measures if change to law necessary*

1.1 As set out above, absent strong evidence of the need for amendments, we would recommend no change in law. Rather, reliance on existing integrity rules, and ultimately on Part IVA to address perceived revenue risks.

1.2 If a change in law is considered necessary, this should be in the form of targeted integrity measures in respect of re-characterisation, but only after thorough consultation with all stakeholders, through a co-design process.

1.3 The mere reversal or removal of transactions between separate entities in a stapled structure is an extremely blunt response to address any integrity concerns raised in the Consultation Paper.

1.4 It is also important to recognise that cross-stapled transactions also involve the company generating income from the trust, for example fund management fees, property development fees and asset management fees. Such transactions give rise to deductions (effectively at 15% for relevant non-resident investors in a MIT) or an increase in cost base in the property for the trust side, but would be subject to tax at 30% on the company side. Removing the benefits of stapled structures through any of the policy options set out in the Consultation Paper therefore has the potential to erode the corporate tax base to this extent.

1.5 The development of any targeted measures needs to involve thorough consultation with all stakeholders, through a co-design process involving testing and re-iteration to ensure that any measures are both effective in addressing perceived threats to the corporate tax base whilst providing an internationally competitive tax environment to attract global capital investment in Australian real estate and critical infrastructure.

1.6 Overall, a targeted integrity measure would be more appropriate to deal with integrity concerns with the re-characterisation of trading income into more favourably taxed passive income. This would be preferable to both or either of the removal of the benefits of stapled structures and/or the introduction of a new REIT regime which would likely have the effect of ending close to 30 years of diversified property investment in Australia, as well as undermining the enhancements provided by the new taxation system for MITs.

1.7 If the work undertaken by Treasury concludes that there is a need for a change in law, Deloitte submits that the measures must provide security to taxpayers whose investments are held through stapled structures, including but not limited to:

- grandfathering of current arrangements; and
- incorporation of long term transitional arrangements to allow the minimisation of financial disruption to projects in the movement to any new regime.

1.8 In addition, if stapled structures have to be restructured, each State and Territory would need to introduce matching relief provisions, otherwise the stamp duty leakage (at rates up to 5.75% for unlisted trusts and 5.15% for listed trusts) would be substantial and likely to preclude any transaction from occurring.

2. *Economic efficiencies offered by stapled structures for project vehicles, investors and financiers*

2.1 The commercial rationale for the use of stapled structures is important.

2.2 From a public-private partnership (**PPP**) transaction perspective, one of the reasons for the development of the 'securitised lease/licence structure' (which often requires a 'stapled' structure) was a response to the impracticality of applying what is now Division 250 of the *Income Tax Assessment Act 1997* (Cth) (**Division 250**).

2.3 Under Division 250, separate income tax calculations are required for each depreciating asset. With some projects having an extremely high number of assets, this can lead to significant and unproductive compliance costs.

2.4 More generally, some very important factors underlying the use of stapled structures include the following:

- the lowering of the WACC for the project;
- the distribution of cash to investors before the project has retained earnings; and
- franking credit trapping.

2.5 Each of these factors is briefly discussed below.

A. Lowering WACC

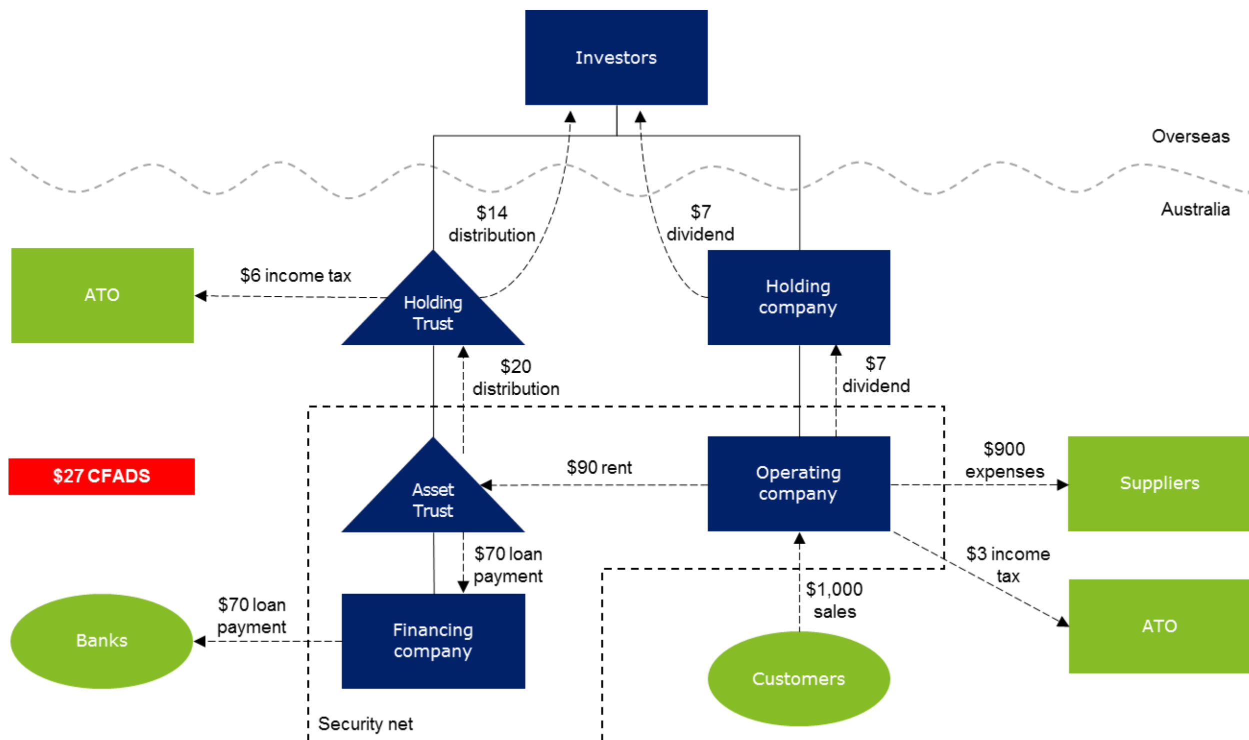
2.6 The WACC is a calculation of a firm's cost of capital in which each category of capital is proportionately weighted. All sources of capital, including shareholder equity and long-term debt, are included in a WACC calculation. Importantly, debt capital is generally cheaper than equity capital. Consequently, a higher proportion of debt capital to equity capital generally results in a lower WACC.

2.7 The WACC for a project is extremely important, as the cost of capital is a significant one that needs to be priced into a project. Therefore, if the WACC of one bidder is higher than another, the bidder with the higher WACC will be at a competitive disadvantage.

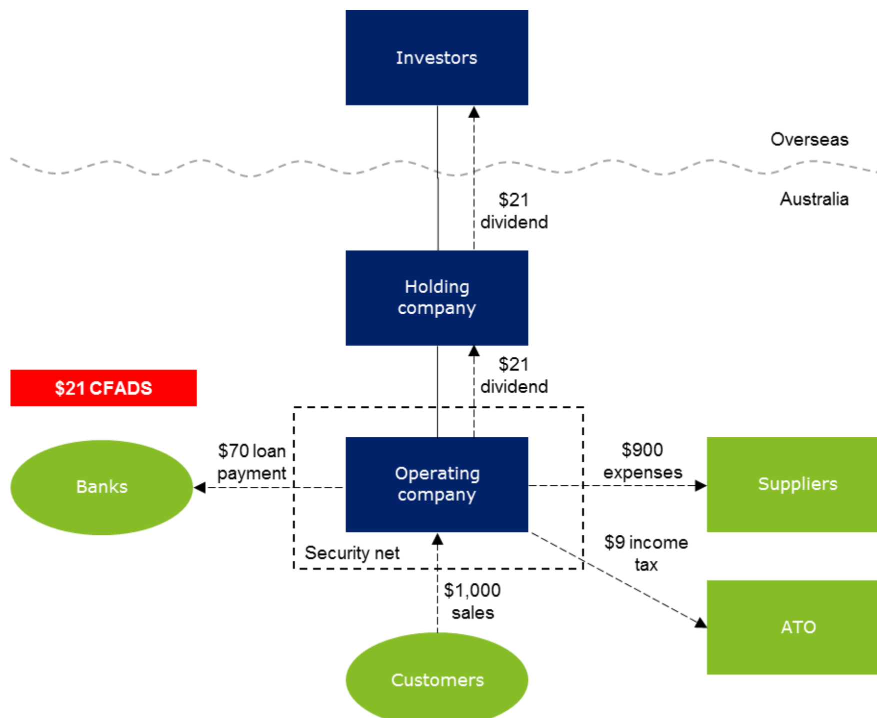
2.8 From a practical and commercial perspective, the use of a stapled structure can result in a materially lower WACC. This is because some of the key metrics that are used in determining the amount of debt that lenders are prepared to lend to a project only have regard to the cashflows of the project vehicles that are within the lenders' security net. This is logical, because it is only the cashflows of those entities that a lender could have recourse to in the event of a default.

2.9 For example, one of the important debt metrics that is considered is the cashflow available for debt service (**CFADS**). This is because it is this cash that is available to service the money that is lent to the project.

2.10 The following is an example of a typical security net where a stapled structure is used. As can be seen, the CFADS in this example is $27.



2.11 On the other hand, the following is an example where a corporate structure was used instead. As can be seen, the CFADS in this example are reduced by over 20% to $21 (from $27 in the stapled structure example). For illustrative purposes, we have left all cashflows the same between the stapled structure example and the corporate structure example. However, we note that the amount of debt that this corporate structure could obtain would likely be considerably less, given the significant reduction in the CFADS as compared to the stapled structure. In addition, there would be other important constraints on distributions from such a structure, including the ability to pay dividends and the timing of the generation of franking credits to attach to those dividends.



B. Cash distributions to investors

2.12 As stated above, one of the components of the WACC for a project is the return on equity capital. In this regard, many equity investors in projects require a minimum internal rate of return (**IRR**) on their investment.

2.13 A component of an IRR calculation is the time value of money. Therefore, the timing of when investors invest their money and when the returns on that investment will be received are important in determining the IRR and, ultimately, the cost of the equity capital, which feeds into the WACC calculation. Put another way, lower nominal cashflows can result in the same IRR if the timing of the investment can be delayed and the returns can be brought forward.

2.14 There are generally fewer legal and practical restrictions on the ability of a trust to distribute excess cash to its investors (e.g. section 254T of the *Corporations Act 2001* (Cth) does not apply to a trust). This means that distributions can generally be made to investors earlier than would be the case if a corporate structure is used, which means that lower nominal distributions can generally be made to equity investors whilst achieving their minimum IRR requirements.

C. Franking credit trap

2.15 As stated above, the timing of returns on investments in a project is important in achieving a competitive bid, because the earlier distributions can be paid to equity investors, the lower the overall nominal distributions will be to those equity investors whilst achieving their IRR requirements.

2.16 From an economic perspective, in a large infrastructure project, cash should be available to fund distributions to investors from the early years of the operations and maintenance (**O&M**) phase. This is because the cash inflows (e.g. availability payments from the State) should exceed the cash outflows (e.g. payments to third party service providers and debt service payments).

2.17 From an income tax perspective, in a large infrastructure project, significant tax losses generally arise during what is typically a multi-year design and construction (**D&C**) phase, principally from debt deductions arising from debt raised to construct the infrastructure asset. Consequently, it is generally not until many years into the O&M phase that the project vehicle(s) turn 'tax positive'.

2.18 If a stapled structure is used, despite the difference between the cash distribution profile and the income tax profile, income tax should be paid on the overall economic profit arising from the project. This is because the majority of distributions from a stapled structure are generally made through a trust and it is the investor who is generally subject to income tax on its proportionate share of the taxable income of such a trust.

2.19 However, if a corporate structure is used and cash is similarly distributed to the equity investors, a 'franking trap' is likely to arise. Very broadly, a 'franking trap' arises where cash is distributed by a company before the income tax has been paid on the profits from which those dividends have been sourced. In large infrastructure projects, this generally is a result of the significant amount of tax losses arising during the D&C phase being utilised in the earlier income years of the O&M phase, which results in no income tax generally being paid in those earlier income years. Ultimately, the company pays income tax on the economic profit

arising from the project, but it cannot distribute all of the franking credits arising from that income tax. This is because the cash to pay dividends to which those franking credits can be attached would have been paid out in earlier income years as unfranked dividends (unless they were capital returns). The practical consequence of the franking trap is essentially double taxation on the profits from which unfranked dividends were paid.

3. The use of stapling is generally not for the purpose of fragmentation or re-characterisation of trading income

3.1 It appears to Deloitte that recent infrastructure privatisations were potentially a significant factor prompting the issue of both the ATO's Taxpayer Alert TA 2017/1 (**TA 2017/1**) and Treasury's Consultation Paper. The use of stapled structures in this context is also covered in the ATO's January 2017 draft Privatisation and Infrastructure – Australian Federal Tax Framework (the **Framework**). The appropriate treatment of such structures is critical both in the context of privatisations of government assets and in private sector transactions involving brownfield assets.

3.2 To provide some context to a consideration of the use of stapled structures in this area, the current state of ATO practice, as reflected in both of the ATO documents referred to above is to allow the use of stapled structures for privatisations of government businesses that are land rich (e.g. ports and electricity transmission and distribution networks), subject to a number of restrictions more fully set out in Chapter 2 of the Framework. It is also evident from TA 2017/1 that the ATO will not challenge the use of stapled structures by an Australian REIT which derives all or most of its rental income from unrelated third party tenants and which has not entered into any arrangements proscribed by TA 2017/1 or for 'third party use of building' businesses, as described in TA 2017/1.

3.3 Beyond these classes of arrangements, however, it appears that the use of stapled structures for infrastructure and real estate assets may be challenged under the existing practice of the ATO. This would be on the basis that these structures may be seen to involve artificial fragmentation of an integrated trading business in order to re-characterise trading income into more favourably taxed passive income which can have the effect of reducing Australian tax applicable to that income for non-resident investors because:

- the asset trust in the staple is assessed on a flow-through basis;
- distributions from the asset trust may be subject to tax at rates lower than the corporate tax rate of 30% (e.g. because it qualifies as a MIT and a distribution is only subject to MIT withholding at 15% where distributed to certain investors or because a distribution reflects interest or royalties subject to withholding tax of 10% or less); and
- the operating entity in the staple, although subject to tax at the corporate rate of 30%, does not have significant taxable income largely because of deductible payments (e.g. interest, rent or royalties) made to the asset trust under cross-staple arrangements.

3.4 The working hypothesis of the ATO evident from TA 2017/1 is that in the absence of the stapled structure, it would be reasonable to expect that all of the income would be trading income and form part of the taxable income of a corporately taxed entity. In certain factual situations, an alternative reasonable hypothesis is a single operating trust or vertical trust group that involves a private trust (or trusts) under the rules in Division 6 of Part III of the *Income Tax Assessment Act 1936 (Cth)* where the project vehicle or trust group would not be treated as involving a corporately taxed entity. We have commented further below at paragraphs 4.6 –

4.7 on the views of the ATO in relation to such single trust or vertical trust groups and arrangements which are regarded as potentially re-characterising trading income into passive income.

3.5 The fundamental basis of the concerns identified by the ATO and Treasury in conjunction with stapled structures is that the relevant underlying business is so highly integrated that any fragmentation of business operations into each side of a stapled structure indicates a sole or dominant purpose of securing relevant tax advantages for non-resident investors (refer above at paragraph 3.3). There are also related concerns regarding the operating entity being economically dependent on the asset trust to such an extent that the asset trust relevantly controls its affairs or operations in respect of carrying on its trading business.

3.6 This may be contrasted with the comment in TA 2017/1 that traditional stapled structures in the commercial property investment sector involve the combination of separate businesses that are capable of being operated entirely independently. Cross-staple dealings tend to be immaterial compared to the core business operations of each entity. The fact that the asset trust in these stapled structures receives all or most of its income, such as rent, from unrelated third party tenants is clearly regarded by the ATO in TA 2017/1 as a distinguishing factor in the potential application of Part IVA to these structures. Moreover, the ATO recognises that the use of stapled structures for certain 'use of building' businesses should not attract the operation of Part IVA.

3.7 Similarly, the Consultation Paper refers favourably to businesses that are fragmented to ensure that Division 6C is not triggered. Treasury instances a property investment business with some peripheral operating activities and contrasts this with businesses that are fragmented predominantly to convert trading income into passive income to take advantage of the tax treatment applicable to non-residents deriving passive income on a flow-through basis via a trust.

3.8 It may be conceded that there are factual and legal differences between some infrastructure assets and the A-REITs described in the Consultation Paper. However, it does not necessarily follow that the objectively determined sole or dominant purpose of establishing a stapled group in either case is anything but ensuring that Division 6C is not triggered.

3.9 The consideration of primary importance in the case of infrastructure stapled groups, given that external debt levels can represent anywhere up to 75% of overall funding, is lender funding approvals. One of the most important considerations for a lending group will be whether tax is payable at the project entity level. Separation of the operations into an asset and operating entity stapled structure facilitates an outcome where this lender concern is substantially alleviated. The adoption of such a structure in these cases does not eliminate any tax in connection with the relevant operations, it simply results in that tax being imposed at the level of the investors, rather than on the asset trust.

3.10 On any reasonable interpretation of Part IVA, this does not involve a tax benefit for any party. When viewed in this commercial context, it would be maintained that

any beneficial tax outcomes for investors from the adoption of a stapled structure are no more than incidental to the main purpose of obtaining external debt funding that is critical to the successful acquisition of the relevant business.

4. The misplaced concern with a level playing field (international and domestic)

4.1 The Treasury paper notes the need for a capital-importing country such as Australia to have an internationally competitive tax system to best attract mobile capital. This represents a substantial justification for establishing Australia's MIT regime which is potentially relevant to land-based infrastructure assets that may not benefit from the ATO's approach to privatisations of land rich government assets in TA 2017/1 noted above. It would appear inconsistent with this overriding objective of the MIT regime to potentially render it inoperative in relation to such a significant infrastructure asset class as land-based assets (e.g. oil and gas pipelines that may well come to market in the immediate future). Another particular issue associated with pipeline assets is their characterisation as land for the purposes of Division 6C. This issue should be considered where the current review is potentially looking at the extension of the list of eligible investment business. Similar issues associated with land characterisation arise in the renewables industry in connection with wind turbines.

4.2 It is also noted in relation to international competitiveness and the attraction of foreign capital to invest in Australian infrastructure assets, that the typical investors in this asset class will be pension funds that are seeking to match their long-tail liabilities, sometimes as part of a government or municipal retirement benefits scheme, to a long-term and relatively low risk investment generating recurrent returns.

4.3 It has often been noted that Australian superannuation funds enjoy ideal tax settings to participate as investors in corporate structures in Australia, due to their zero or 15% rate of taxation and the ability to seek refunds of excess imputation credits. The same benefits do not typically apply to foreign investors, with the possible exception of the exemption for certain tax-exempt foreign pension funds in section 128B(3)(jb) of the *Income Tax Assessment Act 1936 (Cth)* (**Section 128B(3)(jb)**). In some cases, this exemption can be of limited benefit because the foreign pension fund may not be able to directly hold a significant voting equity stake in an Australian company due to foreign law restrictions (and the ATO will not rule that the exemption applies to a corporate blocker of the pension fund) or because dividends from the Australian corporate already represent corporate tax-paid income.

4.4 In essence then, there is no level playing field currently for a range of typical foreign investors into infrastructure assets where an Australian corporately taxed entity or group is seeking to attract investment. Although it would not be suggested that the policy settings for the taxation treatment of Australian superannuation funds and arrangements need to be revisited as a result of this, the ability to adopt a stapled structure in these cases can go some way to alleviating this comparative tax-led bias towards Australian super fund investors.

4.5 We understand that the concerns of the ATO and Treasury in relation to the re-characterisation of trading income into passive income are not limited to stapled groups and extend also to cases involving vertical trust structures (where the trust

is a private trust for the purposes of Division 6C) or entities under common ownership.

4.6 In the context of vertical trust structures, we are aware that the concern of the ATO is that the effect of unit holder loans into the top of the vertical structure is to convert asset level trading income into a form of passive return to the investor at a rate of withholding no greater than 10% (and possibly zero in the case of Section 128B(3)(jb)). The ATO's counterfactual in these cases would appear to be no loans from unit holders and a distribution of trading income by the head trust to non-resident investors that is subject to 30% tax at the trustee level under section 98 of the *Income Tax Assessment Act 1936 (Cth)*. We are also aware that the ATO's view is that a limitation of total funding within thin capitalisation limits will not necessarily insulate an investor against an application of Part IVA to the investor's choice to provide debt rather than equity into the structure.

4.7 The incorporation of these vertical trust group cases within the current review would suggest that all parties may benefit from a change to the law. From the perspective of the investor community, it would appear that this would provide certainty in application of the law rather than the uncertainty of a potential application of Part IVA. However, and although every case involving a potential application of Part IVA will rest on its own particular facts and circumstances, Treasury should be aware that some investors may prefer no change in this area of the law and may well be prepared to accept the uncertainties involved in a potential application of remedial action by the ATO. In any event, it would seem to us that this particular issue is better dealt with as part of any broader review of the effectiveness of the current thin capitalisation regime, rather than as part of a review of stapled structures.

5. Use of stapled structures for concession arrangements

5.1 Stapled structures have been fundamental in a range of privatisation arrangements, including BOOT schemes. They are of particular importance in concession arrangements where a taxpayer enters into a fixed term arrangement with a government to build and operate a project for a finite period before the reversion or transfer of the project property to the State. The return of cash to investors in the early years of a project is fundamental to the economics of the project model. This enables a lower cost of financing for the project. Given the involvement of superannuation funds as investors in such projects, and the unlikelihood of increasing the rate of tax on such funds, Treasury needs to ensure that in chasing a purported tax leakage, it does not create collateral adverse impacts for local investment and future concession type projects.

5.2 We strongly recommend that consideration be given to the exclusion of BOOT schemes from any change to the law where there is a reversion of the project infrastructure to the State at the termination of the arrangement. Any adverse impact on such projects will be felt by the broader economy, reducing jobs and national productivity and increasing the cost of vital infrastructure.

5.3 Australia has developed one of the most successful PPP models for infrastructure investment, where far more private capital has been brought to bear in infrastructure than in other jurisdictions. The United States of America, for example, has had very little success in attracting private capital.

6. *Use of stapled structures in the property industry*

A. Real estate investment using stapled structures

6.1 The Treasury consultation paper considers broad policy options to remove the benefits of stapled structures and the potential to introduce a REIT regime drawing from international REIT models. This approach would likely spell the demise of the business model used by diversified property groups in Australia.

6.2 The Australian REIT industry has been operating through stapled structures for close to 30 years. While part of the reason for the use of stapled structures is to facilitate the derivation of minor non-rental income peripheral to the ownership of investment property (as identified in the Consultation Paper), the use of stapled structures has its origins in the aggregation of complementary real estate businesses, being active trading businesses undertaken by the company group in the stapled structure.

6.3 The diversified property group stapled structure is used to facilitate investment in a range of trading businesses complementary to property investment, including funds management, asset management, property development and construction. For example, a trading business group entity may develop commercial real estate assets owned by the investment trust group, allowing investors to benefit from the uplift in value as well as the ongoing rental yield. This can be contrasted with the use of REITs in other jurisdictions, where the model has developed in a more restrictive context which does not facilitate the aggregation of complementary substantial trading businesses.

6.4 Leasing of real estate assets between stapled entities also has a long history in Australia and facilitates the development, ownership and operation of property assets within the same economic group, for example hotels, retirement villages, student accommodation, storage facilities, data centres and aged care facilities.

6.5 In the case of hotels and aged care facilities, the investment trust will own the building and will lease it to a stapled group company that operates the asset (charging the trust a fee) and generates third party income from the use of the property. The stapled company may also carry on complementary trading activities such as development of real estate assets owned by the investment trust group (charging the trust a fee). In other cases these trading activities may be undertaken by unrelated third parties.

6.6 In some cases, the need to operate through a stapled structure arises due to the legal nature of the passive income generated from the relevant real estate assets, for example retirement villages generate "exit fees" or "deferred management fees" which are passive rent-like returns but may not be rent from a legal perspective. Similarly, passive investments in real estate assets such as storage facilities, data centres and student accommodation may generate licence fees which are not legally rent. In these cases there is a need to lease the real estate assets from the investment trust to a stapled company, which would enter into the arrangements for the use of the property with third parties. The stapled company may also carry on complementary trading activities such as development of real

estate assets owned by the investment trust group as well as operating the assets (charging the trust a fee). In other cases these trading activities may be undertaken by unrelated third parties.

6.7 What all the above examples have in common is the investment in real property, being a building, with income being generated from the use of the property by third parties. The stapled company group allows the investors to gain economic exposure to operating the asset and other trading activities complementary to the investment in real property, like property development, funds management and asset management.

6.8 These distinguishing characteristics are generally recognised by the ATO in Taxpayer Alert 2017/1, as features of a 'third party use of building' business where:

> [the ATO's] *concern will focus on the arrangements between entities within the stapled structure (such as ensuring Operating Entity retains a sufficient share of the profits), rather than the stapled structure itself.*

6.9 Financing arrangements may also exist between the trust and company. These financing arrangements can arise at the time of formation of the group, or can be the result of a wide variety of circumstances, for example:

- stapled groups are generally required to raise capital based on relative net asset values such that that the funds obtained by the company or the trust from investors may need to be lent to the other entity, if this is where the funding is required (for example to undertake an acquisition); and
- the cash generated in the business (e.g. from the sale of a substantial asset) may be lent to the stapled entity to fund growth opportunities, rather than being re-invested or returned to security holders.

6.10 Based on the brief survey above, it is clear that transactions between stapled group entities take a variety of forms, for example:

- income generated by the company side from the trust side may include:
  - funds management fees;
  - development management fees;
  - asset management fees;
  - interest; and
- income generated by the trust side from the company side may include:
  - rent; and
  - interest.

6.11 Where the trust is a MIT, the NALIR operates to limit the income generated by the trust side to an arm's length return, which removes the incentive for a MIT to shift profits from an active business by engaging in non-arm's length activities.[8]

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[8] *Tax Laws Amendment (New Tax System For Managed Investment Trusts) Bill 2015 Income Tax Rates Amendment (Managed Investment Trusts) Bill 2015 Medicare Levy Amendment (Attribution Managed Investment Trusts) Bill 2015 Income Tax (Attribution Managed Investment Trusts — Offsets) Bill 2015* Explanatory Memorandum, at 9.25

B. Real estate investment to drive Australia's future economic prosperity

6.12 From a policy perspective, investments into alternative real estate asset classes are vital to Australia's future economic prosperity as these assets support industries that have the potential to deliver significant growth as Australia's economy transitions following the resources boom.

6.13 Deloitte's report *Building the Lucky Country #3 - Business imperatives for a prosperous Australia, Positioning for prosperity? Catching the next wave* considered how we can position Australia for future prosperity, assessing global and domestic trends that can be harnessed to fuel economic growth. *Positioning for prosperity?* identified the 'Fantastic Five' sectors that lie squarely at the intersection of global opportunity and Australian advantage, and added a further 19 Growth Pockets that businesses with the right mindset can exploit, and government with the right policies can foster:[9]

> *These Fantastic Five sectors are gas, agribusiness, tourism, international education and wealth management. Collectively, they have the potential to be as big as mining.*
>
> *The huge and common driver for this group will be Asia. Asian growth will benefit:*
>
> - *Agribusiness: as people buy Australia's fresh produce, including proteins*
> - *Gas: as countries seek to improve air quality and reduce greenhouse emissions*
> - *Tourism: as people seek space, nature, holidays and luxury experiences*
> - *International education: as students seek to study in an English-speaking country*
> - *Wealth management: as organisations and individuals tap into Australia's expertise.*
>
> *Exceptional growth in these five sectors could add about $250 billion to the economy between 2013 and 2033. That would equate to an additional $25 billion in GDP in 2033 … – or a boost of about 1% in an economy turning over $2.6 trillion …*

6.14 Positioning for prosperity in these five high growth sectors will involve significant investment in alternative real estate asset classes, including hotels, tourism parks, agricultural land and student accommodation.

6.15 Many of the 19 Growth Pockets across the remaining sectors of Australia's economy arise as a collision of megatrends – such as that of rising life expectancies, rising relative healthcare costs and tightening public sector health budgets. Of particular relevance to the real estate industry are the retirement living and leisure and residential aged care Growth Pockets, both of which will require substantial investment in retirement villages, manufactured housing estates, tourism parks, hotels and aged care facilities.

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[9] Appendix A provides the DG25 results matrix

6.16 Against this background the tax system needs to provide frameworks to encourage global institutional investment to underpin the growth drivers for Australia's future prosperity:

> *Our task is to build on our areas of advantage to improve Australia's performance relative to our global competitors and at home. This means creating things like a better-skilled vocational workforce, especially in focus areas such as aged care and ICT; more efficient regulatory and tax regimes; and a stable and clear set of policy rules for businesses. …*
>
> *Any comprehensive framework should also be developed in consultation with investment groups that take a long-term view and have the capacity to support plans over decades, such as institutional investors and super funds. This might have the added benefit of helping counter the short-term focus that many boards face from shareholders and the funds management community.*

6.17 While further improvements can be made to modernise the eligible investment rules (as discussed below), the fundamentals of the existing taxation system for MITs and the stapled structures available in the Australian market provide a solid foundation for attracting global investment into the real estate assets that will provide the growth opportunities for the future.

7. The introduction of a new REIT regime based on international REIT models would not be appropriate

7.1 Australia has an existing world class REIT framework based on the availability of "flow-through" taxation for trusts carrying on eligible investment business activities and stapled structures to facilitate the aggregation of complementary real estate businesses. For trusts that qualify as MITs, the existing framework also provides:

- withholding tax concessions to enhance international competitiveness, promote the growth of the Australian financial services sector and encourage investment in green buildings;
- the capital account election providing certainty of characterisation;
- a NALIR removing the incentive for a MIT to shift profits from an active business; and
- an elective tax system providing for attribution of tax to investors, providing investors with increased certainty and codifying various industry practices – it is largely expected that many MITs will elect to enter the new taxation system with effect from 1 July 2017 or in the near future.

7.2 Australia already has a leading REIT framework that has been further enhanced with the introduction of the NALIR and the new taxation system for MITs. The aggregation of substantial real estate trading businesses is typically not possible under international REIT regimes due to the level of assets held by the trading businesses on the company side of the staple. The adoption of a new REIT regime based on international models would therefore likely result in these business models no longer being available, and massive disruption to the market.

7.3 Following extensive consultation, the new taxation system for MITs was introduced, generally with effect from 1 July 2016, based on the recommendations of the Board of Taxation that were agreed to by the government. The new taxation system for MITs was developed within the existing stapled structures framework and includes a NALIR to limit the income generated by the trust to an arm's length return, which removes the incentive for a MIT to shift profits from an active business by engaging in non-arm's length activities.

7.4 The terms of reference for the Board of Taxation's review included consideration of the costs and benefits of establishing a separate taxing regime for REITs. The Board of Taxation concluded that this was not recommended:

> *2.44 The Board considers that any property-specific issues can be addressed within the new MIT regime. A separate REIT regime would add cost, complexity and administrative difficulties that would not be outweighed by the limited potential benefits such as market recognition and property-specific tax rules of such a regime. As a result, the Board does not recommend a separate REIT regime.*

7.5 The government agreed with this recommendation and with the recommendation to implement a new MIT regime.

7.6 The announcement of a new REIT regime as a response to integrity concerns regarding re-characterisation of trading income has the potential to defeat the benefits of the extensive work undertaken by the government, the Treasury, the ATO and numerous industry stakeholders in recent years to develop the new taxation system for MITs, building on Australia's long established and highly successful stapled structure framework.

7.7 Stapled groups and the funds management industry (including custodians and administrators) have spent significant amounts of time and money to be able to operate under the new taxation system for MITs, including the development of systems to facilitate reporting to investors and costs of amendments to the constituent documents of trusts to allow a MIT to elect to apply the new taxation system.

8. Non-arm's length income rule removes the incentive for a MIT to shift profits from an active business

8.1 An important integrity measure included in the new taxation system for MITs was the NALIR. This rule can operate in relation to rental income and interest income of a MIT to tax the trustee of the MIT at 30% on the non-arm's length amount. The NALIR limits the income generated by the trust to an arm's length return, which removes the incentive for a MIT to shift profits from an active business by engaging in non-arm's length activities.

8.2 The NALIR generally has effect from 1 July 2016, or for transitional arrangements from the 2019 income year (1 July 2018 for most taxpayers). The NALIR has only been in operation for approximately nine months, or is yet to commence operation for transitional arrangements, and there is no evidence to suggest that the NALIR will not be an appropriate measure to deal with the integrity concerns that it was designed to counter, being the incentive for a MIT to shift profits from an active business.

8.3 In these circumstances it is inappropriate to introduce new integrity rules dealing with fundamentally the same integrity concern, given the extensive consultation undertaken since 2008 resulted in the NALIR, and the administrative complexity and costs incurred by stapled groups to comply with the NALIR for a short period of time prior to the potential introduction of new integrity measures.

9. Extending the scope of "eligible investment business"

9.1 The Board of Taxation recommended that a MIT be treated as carrying on an eligible investment business if at least 90 per cent of its gross revenue is income from passive investments. The Board recommended that for the purpose of this test, passive investment would mean investment in real property (and movable property incidental to the investment in real property) to derive rent income and/or other passive (or non-trading) income, including:

- income from the provision of services incidental to the earning of rent from the investment in real property. For example, parking fees, utilities, and common security services provided in rental properties to lessees; and
- income from licenses and other rights to use real property, (other than hotel room and similar accommodation, such as serviced apartments) that is not associated with the sale or provision of facilities, goods or services[10].

9.2 This recommendation was not accepted by the government at the time, and therefore the existing uncertainties and restrictions inherent in Division 6C were not addressed as part of the new taxation system for MITs.

9.3 The Consultation Paper notes that "if an option to remove the tax advantages of stapled structures were to be introduced, current restrictions around the permitted levels of trading income in trust structures may need to be considered to ensure Australia's ability to attract global real estate capital is internationally competitive."

9.4 We consider that there is scope to modernise Division 6C in line with the recommendations of the Board. This would reduce the extent of cross-stapled rental arrangements in the real estate industry in relation to investments in alternative real estate asset classes that generate rent-like passive income from third parties, including retirement villages, storage facilities, data centres, student accommodation and manufacturing housing estates.

[10] *Review of the Tax Arrangements Applying to Managed Investment Trusts A report to the Assistant Treasurer* - Board of Taxation, August 2009, Recommendation 8

Appendix C: Deloitte Growth 25 Results Matrix