The GPT Group

20 April 2017

Division Head
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: stapledstructures@treasury.gov.au

Attention: Ms Kathryn Davy/Ms Ruth Gabbitas

Dear Madam and Dear Sir

RE: The GPT Group

Stapled Group Consultation

1. Thank you for inviting submissions to inform the Government's future approach to reviewing tax distortions that may arise from the use of stapled structures and recharacterisation of trading income.

About The GPT Group

2. The GPT Group is listed on the ASX and is one of Australia's largest diversified property groups with over 35,000 investors and a market capitalisation of almost $10 billion, placing it in the top ASX 50 companies in Australia. The GPT Group's total funds under management is $19 billion.

3. The GPT Group is comprised of GPT ("the Trust") and GPT Management Holdings Limited ("the Company"). The Company and the Trust are stapled under a stapling deed that was implemented in 2005. The Trust is a managed investment trust ("MIT").

4. The GPT Group's vision is to be the most respected property company in Australia in the eyes of our investors, people, customers and communities.

5. We create value by delivering superior returns to investors and providing environments that enable our people to excel and customers and communities to prosper. This is achieved by:

   - Building on our strong market position and high quality real estate investment portfolio to produce an income stream for our investors;

   - Maximising the value of development pipeline opportunities to create real estate investment assets that provide long term rental income streams;

   - Growing our leading position as a fund manager while ensuring that a strong capital position and efficient operating model is maintained.

6. The GPT Group's business is highly integrated and is conducted by leveraging its extensive real estate experience to deliver strong returns through disciplined investment, asset management and development activities. The development capability is focused on creating value for investors through enhancement of the core investment portfolio and the creation of new investment assets that produce high quality rental income streams. Below is a snapshot of GPT's property portfolio including a breakdown of external tenancies.

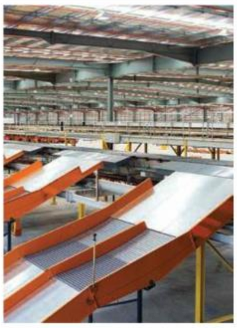
Retail Portfolio
- 13 shopping centres
- 930,000 sqm GLA
- 3,200 + tenants
- $5.3b portfolio
- $8.2b AUM

Highpoint Shopping Centre, Victoria

Office Portfolio
- 23 assets
- 1,120,000 sqm NLA
- 460 + tenants
- $4.3b portfolio
- $9.6b AUM

HSBC Centre, Sydney

Logistics Portfolio
- 24 assets
- 710,000 sqm GLA
- 60 + tenants
- $1.4b portfolio
- $1.4b AUM



TNT Erskine Park, Sydney

The GPT Group and Stapling

7. The GPT Group's business was founded in 1971 and was Australia's first property trust (A-REIT). The Trust structure provided an opportunity for "mum and dad" investors to own an interest in a portfolio of investment grade commercial property assets that would otherwise be unattainable.

8. The Trust was previously managed externally by Lend Lease. In 2005 GPT's investors approved a stapling proposal to remove Lend Lease as manager of the Trust and replace it with a management company that was stapled to the Trust. That decision was not driven by taxation considerations but rather a desire to create an independent property group that enabled a closer alignment between the interests of the manager with those of the investors in the Trust.

9. The commercial benefits that flowed from this initiative are:

   i. A reduction in management fees that were paid to the then external manager.

   ii. Enabling investors to benefit from commercial activities that were complementary to or highly integrated with the ownership of commercial real estate. These activities include property management, responsible entity services, funds management and property development and development management.

   iii. Participation in other property related initiatives that are complementary to the Trust's investment activities such as developing real estate for profit by way of sale without tainting the Trust's flow through status under Division 6C of the Income Tax Assessment Act 1936 ("the Tax Act").

10. When viewed objectively and in retrospect the decision to staple the Company was principally driven by the need to preserve the flow through tax status of the Trust. However, the commercial driver underpinning the change was to enable complementary businesses to be "added" or "aggregated" to business activities of the Trust.

11. These aggregated businesses generated in excess of $243 million of income (approx.) in the last financial year that is subject to company taxation at 30%.

12. The GPT group has never engaged in "fragmenting" any part of its company business into structures that seek to avoid income taxation.

Executive Summary

13. The GPT Group acknowledges the integrity risks to the Australian tax base caused by abusive and contrived recharacterisation arrangements. However, it is important to recognise that the mischief is the recharacterisation of trading income. Whilst the structures involved may include stapling arrangements, stapling arrangements per se are not the mischief.

14. The recharacterisation mischief can be specifically targeted by introducing integrity measures without fundamentally altering the existing taxation framework applicable to A-REITs.

15. We submit that:

(a) An announcement be made in the upcoming Federal Budget that the Government will commence a detailed consultation process with key stakeholders aimed at stamping out abusive recharacterisation arrangements whilst fundamentally preserving the current A-REIT tax treatment.

(b) If a further consultation period is not possible, by way of illustration, conceptually, a specifically targeted integrity measure (referred to in this submission as "Related Party Payment Rule") can be introduced to address the risk of erosion to the Australian tax base by implementing **one** of the following measures[1]:

1. Deny tax deductions for cross staple payments (and possibly remove interest / MIT withholding tax exemptions for certain non-resident investors) where 50% or more of the Trust's gross income does **not** consist of (or is **not** sourced from) rent and other amounts that are derived for the "use of space" from external parties; **or**

2. Enliven the arm's length income rule in Division 275 to impose 30% corporate tax on the trustee in respect of cross stapled payments where 50% of the gross income of the Trust does **not** consist of (or is **not** sourced from) rent and other amounts that are derived for the "use of space" from external parties.

(c) If any of the (in our view, unnecessarily wide-reaching and disruptive) options canvassed in the Discussion Paper are to be adopted, they should be appropriately targeted by deeming certain asset classes (e.g. A-REITs or critical infrastructure projects) or certain class of entities (e.g. MITs or AMITs that have a wide investor base) as not being subject to the measures and remain eligible for tax benefits of stapled structures.

(d) The definition of "Rent" in Division 6C should be extended to include amounts that are derived from the use of space including licence fees.

(e) There is no mischief arising from cross staple financing where the financing arrangements are complementary to the real estate activities of the Trust.

(f) Remove the "all or nothing" approach to the operation of Division 6C so that where a trust breaches Division 6C, only income that is later found to be part of a separate business (trading activity) is taxed at the corporate tax rate.

(g) A specific REIT regime imposes unacceptable restrictions on how A-REITs operate and will adversely affect their ability to compete for global capital.

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[1] These are incompletely developed measures at present due to time constraints.

(h) All existing cross-staple arrangements should be grandfathered for a minimum of 7 years should the Government proceed with any of the (in our view, unnecessarily wide-reaching and disruptive) options canvassed in the Discussion Paper.

(i) The definition of “eligible investment business” in Division 6C should include designated infrastructure projects to allow flow through taxation for critical infrastructure projects that the Government considers as being in the national interest.

The Consultation Paper

16. The GPT Group acknowledges the integrity risks to the Australian tax base from abusive and contrived recharacterisation arrangements that do not have commercial substance. The GPT Group supports a specifically targeted response by the Government to protect the tax base using integrity measures.

17. However, we think it is critical that those integrity measures should be properly targeted and allow for meaningful consultation by affected stakeholders. The current consultation period of 4 weeks allows insufficient time to formulate detailed responses with respect to the proposals set out in the Consultation Paper.

18. The GPT Group’s view is that the Government should commit to a detailed process to co-design a targeted consultation process that fundamentally preserves the current A-REIT taxation framework whilst stamping out abusive and contrived income recharacterisation arrangements that could be announced in the upcoming Federal Budget.

19. We think it is possible to address the integrity risks of recharacterisation through measures that can be targeted at arrangements that are abusive such as royalty staples, synthetic staples and highly leveraged structures.

Specifically Targeted Integrity Measure

20. The Consultation Paper and recent taxpayer alerts note the integrity risks to the tax base arise from the recharacterisation of what would otherwise be trading income earned by a company into passive rental and interest income. That is, the mischief itself does not arise from specific stapling arrangements. In this regard, we note that recharacterisation can occur in different ownership structures and is not confined only to stapling arrangements.

21. In our view, these fundamental principles make it simpler to properly target abusive arrangements to protect the revenue rather than making external changes to the existing taxation frameworks that apply to A-REITs and other managed investment vehicles that are widely held.

22. The integrity measures proposed by the GPT Group could operate to target arrangements that involve related parties recharacterising trading income that would otherwise be subject to corporate taxation.

23. Two alternate specific measures could be introduced - these are further explored in the Appendix. Due to time constraints, please note that they are only intended to facilitate discussions and to illustrate possibilities. They should not be taken as complete proposals for suggested integrity measures.

Extended Definition of Rent

24. As correctly noted in the Consultation Paper, the current policy settings that regulate flow through tax treatment for A-REITs operate to effectively constrain the commercial activities undertaken by the Trust to almost purely passive rent arrangements.

25. In this regard, certain incidental and ancillary commercial activities that are related to the ownership of real estate assets (such as time based office co-sharing services, Wi-Fi services provided to tenants and customers of tenants, digital screen advertising, income from gift cards arrangements in shopping malls, car parking fees and fees paid for parcel post redirection) do not comfortably fit within the primary purpose test in Division 6C which has been unchanged since being put in place in 1985.

26. Some of these arrangements may be carried out by the Company. Because of their scale, size and separate business characteristics, it may not be feasible for the Trust to conduct these activities without jeopardising its tax flow through status.

27. Although the safe harbour amendments introduced in 2008 may go some way towards enabling the Trust to undertake ancillary activities, the ATO's narrow interpretation of the "primary purpose" and "incidental and relevant" tests operate as an impediment on the Trust's ability to continually maximise the use of space within its real estate portfolio outside the traditional mode of leasing property for exclusive use by tenants. The market and the sharing economy demands Wi-Fi access, workplace flexibility, and other attributes that do not necessarily give rise to traditional rental income. Additionally, changes in accounting standards proposed with respect to the disclosure of lease liabilities for financial reporting purposes may result in some amounts being paid for the use of space that do not constitute rent under a lease.

28. In GPT's view, from a policy perspective there should be no distinction made with respect to the tax treatment of amounts that take the legal form of "rent" and those that do not where the returns themselves come from the use of space on the land that is owned by the Trust. These legal distinctions of rent versus license fee may operate to stifle innovation and make Australian REITs less competitive in an always evolving digital and technological landscape.

29. Against that background, GPT supports amending the definition of eligible investment business ("EIB") to extend the meaning of "rent" to include "amounts that are derived from the use of space". This change would enhance the operation of Division 6C so that it is commercially relevant and appropriate to the way that A-REITs must continually evolve the use of space to attract tenants and increase visitation to assets owned by the Trust. An extended definition of "rent" would modernise Division 6C so that it encapsulates returns derived from the use of land regardless of the legal form of those returns.

30. While GPT welcomes an amendment that has the effect of extending the definition of "rent" to modernise Division 6C, this measure would not, in itself, operate to address the integrity risks arising from recharacterisation of what would otherwise be trading profits into passive income.

Cross Staple Finance Arrangements

31. The use of cross-staple financing is common practice in the current A-REIT environment for good and proper reasons.

32. Debt financing provided by the Trust to the Company is fundamentally passive in nature and constitutes "eligible investment business". This lending activity is within the original policy intent of Division 6C when it was introduced in 1985 and continues to be the law today.

33. The provision of loan financing (such as development and mezzanine finance) by the Trust is complementary to the Trust's property investment business. It enables the Trust to leverage its financial capacity to provide debt to the Company instead of using external financiers. The commercial benefit that arises from these arrangements is that third party financial intermediaries are removed from the value chain. This enables the Company to avoid transaction costs such as brokerage and loan establishment costs.

34. There is no mischief arising from higher levels of gearing in the Company than in the Trust. The higher gearing is reflective of the difference in credit ratings and underlying stability of cash flows that flow from the Trust's assets. It is usually not possible for the Company to obtain an investment grade credit rating when regard is had to its commercial and operating activities including its asset base.

35. That does not mean that an external financier would not provide financing to the Company at a higher interest rate and balance sheet gearing level. In this regard, there is no shortage of external financiers to provide debt funding for projects undertaken by the Company.

36. Some say that the Company is not credit worthy and would be unable to obtain external financing and as a consequence should be denied tax deductions for cross staple interest payments because the Company's gearing level is higher than that of the Trust.

37. With respect, GPT does not agree with that view because the Company is a separate legal entity that carries on a separate and independent business that is subject to corporate tax. There is no policy basis for aligning the gearing levels of the Company and the Trust because their commercial activities are fundamentally different and the level of risk inherent in each business is also different.

38. There is a clear and observable market for third party mezzanine debt that could be used by the Company to finance projects whose debt funding extends beyond the traditional Loan to Value Ratio levels that a senior lender is typically willing to provide. In today's market, this is usually beyond 60-70% of the Total Development Cost or ("TDC") of the project in question. A Mezzanine Lender will typically be prepared to advance up to around 90%+ of the TDC with the remaining 10% considered to be the project equity which the developer (the Company) is required to contribute as their "skin in the game" or risk capital, usually being the land.

39. Examples of commercial lenders in this space include Holden Capital and Balmain Capital. Please refer to:
http://www.therealestateconversation.com.au/2016/08/02/what-mezzanine-funding/1470136992
http://www.holdencapital.com.au/about/
http://www.balmain.com.au/Commercial/Default.aspx

40. It is for these reasons that we see no policy basis for aligning the levels of gearing in the Company to that of the Trust so as to preclude the Trust from carrying on eligible investment business that takes the form of lending.

41. This outcome is implicit in the design of the arm's length rule where the safe harbour interest rate was introduced to provide a choice to use a lower benchmark interest as a proxy for an arm's length rate to minimise compliance costs for the Company and the Trust.

42. Given that extensive Treasury and ATO consultation preceded the introduction of the MIT Regime into law in July 2016 we can see no plausible justification to alter those arrangements that currently exist especially when regard is had to the proposed integrity measures mentioned above, the "excluded rent" rule in Division 6C, the section 974-80 amendments that are proposed and the ATO's ability to apply Part IVA to contrived arrangements.

43. The existence of such extensive integrity measures begs the question whether the policy response proposed is "overkill" for A-REITs. If implemented the proposed measures contemplated in the Consultation Paper will lead to increased compliance costs and a diminution in the competitiveness of A-REITs.

44. It is for these reasons that GPT does not support any further limitation on cross stapled finance arrangements for A-REITs.

Consequence of Breaching Division 6C

45. Currently, Division 6C is effectively an "all or nothing" regime. As noted above, notwithstanding the de minimis safe harbours, a small amount of active business activity within a Trust is sufficient to jeopardise the flow through status of the entire Trust. In GPT's view, this punitive outcome is disproportionate and has added to the pressure on A-REITs to utilise stapled structures where activities do not fit comfortably within the primary purpose or safe harbour test in Division 6C.

46. The GPT Group supports a more flexible approach where the Trust is allowed to carry out incidental and ancillary activities that are related to the ownership of real estate assets, with the proviso that should such activities be later determined to constitute a separate business, the income from such activities be treated as having been derived by the Company and taxed to the trustee of the Trust at 30%.

No REIT Regime

47. The GPT Group does not support the introduction of a specific REIT regime.

48. The GPT Group's view is that stapling arrangements provide commercial flexibility to carry out any type of business activity that is considered to be commercially aligned with the activities of the Trust.

49. The GPT Group agrees with the Board of Taxation's findings in 2009 as part of its review of MITs that a separate REIT regime would ***"add cost, complexity and administrative difficulties"*** that would **<u>not</u>** be outweighed by the potential benefits of a separate regime.

50. The GPT Group also considers that the potential restrictions that are likely to be placed on A-REITs under any potential REIT regime would adversely affect an A-REIT's ability to compete for capital in a global market place. This conclusion was also reached by the Board of Taxation in its 2009 report. In our experience, it is unlikely that a globally comparable REIT regime would enable a complementary and highly integrated fund management business to be carried on by a REIT.

51. The commercial benefits that accrue from integrating funds management, property management and property development/management manifest themselves in lower overhead and management costs for investors whilst allowing for investment diversification, capital partnering as well as synergistic benefits.

52. The GPT Group is currently one of Australia's highest performing fund managers and was ranked first in the Mercer/IPD Australia Wholesale PFI Office Sector over one year, three years, five years, seven years and nine years.

53. Any restriction on the size of the taxable REIT subsidiary ("TRS"), no matter how generous the permitted activities threshold is likely to be, could ultimately operate to restrict the scale of complementary property businesses and thereby impede the level of industry growth.

54. Although the ultimate form and scale of future complementary activity is likely to be difficult to predict, it is likely that many significant commercial real estate assets could be re-purposed into higher and better uses such as residential to alleviate the current housing shortage and congestion in Australia's largest cities. The size and scale of those potential developments may ultimately cause the relative size of the TRS to breach any pre-defined threshold if it was decided that the REIT should re-purpose some of its assets because they cease to satisfy financial hurdles for commercial real estate investment.

55. Stapling on the other hand provides optionality for the Company to undertake those developments itself enabling the investors to capture a "greater chunk" of the value chain than divestment would otherwise allow. All profits from those activities would be subject to corporate taxation at 30%.

Deeming stapled entities to be consolidated for tax purposes

56. Our view is that deeming stapled entities to be consolidated for tax purposes is unlikely to be effective in stamping out the contrived use of stapled schemes because the common ownership requirement under tax consolidation could be circumvented through the use of ownership structures that do not satisfy the proposed threshold requirement. Additionally, higher compliance costs would be incurred by A-REITs in differentiating transactions with third parties from those that occur within the stapled group for statutory and tax compliance purposes.

Designated infrastructure projects

57. To attract investments into infrastructure projects, the GPT Group also recommends that critical infrastructure projects are designated as an "eligible investment business" for Division 6C purposes so that such projects are confirmed as eligible for flow through tax status.

Yours sincerely

Bob Johnston
CEO & Managing Director

Anastasia Clarke
Chief Financial Officer

Appendix - Design features of a "Related Party Payments Rule"

Aim

Where a majority of a flow through Trust's gross income comes from a related party (e.g. a stapled company) that is subject to corporate tax rate and received in the form of rental or interest income (or other eligible investment income within Division 6C), the tax advantages of "streaming" the income away from the taxpaying entity and recharacterised as "eligible investment income" of the flow through Trust is removed.

Application

Where 50% or more of a flow through Trust's gross income is not derived from underlying rental, license fees or other payments made by external third parties for the use of space, the Related Party Payments Rule will apply.

As a variation to the same theme, the Related Party Payments Rule can also apply where the payments that are made from a stapled company to a flow through Trust represent more than 50% of the Trust's gross income and the payments are not themselves sourced from the use of the company's space.

Outcomes when the Related Party Payments Rule applies

Either:

a. Deny the stapled company tax deductions for the cross staple payments; or

b. The non-arm's length income rule in Division 275 is enlivened to impose tax on the trustee of the Trust at the corporate tax rate of 30%.

Further consideration needs to be given to the treatment of the related payment amount when it is ultimately received by investors in the flow-through Trust.

This could take the form of either:

- Tax credits/tax offsets in the hands of the recipient in respect of the tax already paid by the trustee or the related stapled company; or

- Disregarding distributions from the Trust to the investor to the extent they incorporate the related party payments.

Under Option A above, the cross staple payments will be subject to tax at 30%. The Company that makes the payments will be denied a 30% tax deduction.

In the hands of the Trust, the cross staple payments will be ignored.

Under Option B above, the tax liability falls on the trustee of the Trust at the corporate tax rate.

The Division 6C status of a flow through Trust is not affected by the application of the Related Party Payments Rule.

Withholding Tax exemptions

Further consideration needs to be given in respect of interest and MIT withholding tax exemptions enjoyed by certain non-resident investors that would otherwise apply to the recharacterised amounts where they are subject to the integrity measure above.

Mechanics of operation

In calculating whether the 50% threshold is breached, the following income amounts of a Trust should be deemed as rental, license fees or other payments made by external third parties for the use of space (i.e. not counted as the numerator):

- Distributions from sub-trusts, SPVs and joint venture arrangements that have assets consisting of underlying real estate investments and themselves satisfying the Related Party Payments Rule.

- Distributions from another AMIT/MIT that carries on eligible investment business (such as financing unit trusts) noting that AMIT/MITs have to satisfy the arm's length rule in Division 275.

- Interest income (both external interest and cross-staple interest), provided the rate satisfies the arm's length rule in Division 275.

- Capital gains made by the Trust.

- Consideration should also be given as to whether trusts can be grouped to address situations where the 50% threshold is breached unintentionally, e.g. a SPV trust with one property leased to one tenant which departs.

Other comments and observations

This integrity measure, when coupled with a change to the definition of rent contained in Division 6C (see our submission above), should operate to confine the integrity measures to abusive recharacterisation arrangements.

That is to say, the Related Party Payments Rule would operate as a "trigger" so that the tax law disregards the cross staple payments when calculating the taxable income of the Company in a similar way to that which applies under the tax consolidation regime and, possibly, removes any withholding tax exemptions enjoyed by non-resident investors in the flow-through Trust.

If the "trigger" is not activated, the cross staple payments would continue to be recognised for tax purposes and qualifying non-resident investors continue to enjoy withholding tax exemptions.