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Our ref Stapling submissions

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By email

20 April 2017

Dear Sir

Treasury Consultation Paper: Stapled Structures

KPMG welcomes the opportunity to comment on the Treasury Consultation Paper of March 2017 titled *Stapled Structures* ("Consultation Paper").

KPMG supports the Australian Taxation Office ("ATO") and Treasury in ensuring that taxpayers are not using aggressive tax structures to recharacterise what would otherwise be income from an active business, to more favourably taxed passive income.

KPMG acts for many of the major taxpayers operating in the property and infrastructure industries and our submissions are based upon our extensive and diverse experience. This submission is therefore restricted to the use of staples in the context of these industries. The Consultation Paper proposes a "holistic examination" of the taxation of investment income using stapled structures. Australia has long history of using stapled structures in the real estate and land based infrastructure asset classes where the use of such stapled structures have not historically given rise to anti avoidance concerns and do not currently operate on this basis. Our submission is loosely based upon this 'holistic examination' and therefore we have not specifically addressed each question.

Furthermore, the vertically integrated business structure of many Australian property participants is different to other jurisdictions and therefore requires a unique response. This is fundamentally different to the circumstances that resulted in other jurisdictions responding to 'early stage' staples.

Whilst KPMG is supportive of taking action to prevent the abuse of stapled structures where there is a recharacterisation of otherwise active income, such integrity concerns should be addressed using appropriately targeted integrity measures. Further, these measures should not adversely impact investments in real estate and infrastructure assets that currently use such stapled structures. To ensure that there are not unintended consequences for such investors, further consultation is required so as to design the on-going future regime for investment in these sectors.

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Industry Observations

In Taxpayer Alert 2017/1 the ATO advised taxpayers that it was scrutinising the use of aggressive staples where taxpayers are entering into arrangements in an attempt to recharacterise what would otherwise be active income derived by a trading business to passive income derived by a trust, which is then subject to nil or reduced rates of tax. The structures that have been identified by the ATO as being of concern include (but are not limited to) cross staple lease arrangements artificially placing assets into a trust and leasing those assets to a corporate stapled entity in circumstances where these assets would typically not be separated in this way. Cross staple loan arrangements, synthetic equity staples and cross staple royalty arrangements have also been identified as being of concern.

KPMG is supportive of the ATO and Treasury taking action to ensure that stapled structures are not manipulated in this way. Clearly the use of stapled structures in this way is not consistent with the original policy objective of ensuring that flow through taxation treatment is afforded to genuine real estate and critical infrastructure investments with significant land components. There are clear policy reasons for ensuring that passive investments in both real estate and infrastructure [assets continue to be afforded flow through tax treatment whilst active business activities are subject to corporate tax.

Given the complexity of the issues concerned and the need to ensure that the right outcomes are obtained, a consultation process is required to ensure the right way forward. A four week period for consultation is alone not sufficient time to determine the appropriate way forward given the complexity of designing a future regime that encourages appropriate investment into real estate and critical infrastructure.

It is important to maintain flow through taxation treatment in relation to investments in real estate and infrastructure. The Ralph Review of Business Taxation considered the position of Collective Investment Vehicles and the need to maintain flow through status. Some of its key recommendations of the Ralph Review included:

1. That a collective investment vehicle (CIV) be defined as an entity that:

    i. is a unit trust which is based in Australia;
    ii. is ‘widely held';
    iii. has units giving members a fixed equal beneficial interest in all the income and property of the trust;
    iv. undertakes only ‘eligible investment business' (that is, not trading business) broadly as defined in section 102M and 102N of the 1936 Act; and
    v. has made an irrevocable election to be excluded from the entity tax regime and taxed as a CIV.

2. That CIVs be excluded from entity taxation only if all, or virtually all, of their taxable income (representing income that would be taxable if received directly by a resident taxpayer) is distributed each year.

3. That distributions of tax-preferred income:

    vi. not be taxed when received by members; and
    vii. reduce the tax value of membership interests in a CIV.

The Ralph Review recognised that CIVs are widely held entities which offer managed investments and fully distribute profits. The adoption of flow-through taxation treatment for the taxation of income derived by a CIV is consistent with the treatment of direct investment. Further, the recommendation that tax preferred income is not taxed was consistent with the treatment of direct investment. The Ralph Review felt it necessary to balance the competitive neutrality between collective investment and entity taxation with the need for competitive neutrality between collective investment and direct investment. On balance, it was concluded that it was more important to balance competitive neutrality between collective and direct investment. However, the activities of CIVs needed to be restricted to passive investment as such a restriction was seen as a sufficient measure to ensure competitive neutrality between entities.

Economic analysis

Australia's prosperity is not only dependent on the wealth and income of our domestic population, but also on attracting foreign capital to fund the shortfall between the money we need to finance investment activities and what we can provide ourselves through our own savings. Data on our net international investment position shows this starkly, with foreign investors financing about $3.3 trillion of Australia's assets, of which one-third is through equity and two-thirds is through debt.

This foreign investment has afforded Australia the ability to generate significant economic benefits. Once foreign investment into the banking sector is excluded (on the basis it represents wholesale funding for domestic lending), then about one-third of the foreign investment into Australia has been directed towards the mining and infrastructure sectors. Since 2000 mining now represents 11% of Australia's Gross Value Added (on an industry basis), while electricity, gas and water has maintained its share at around 3%.

Global capital is locationally free. It moves to where it can earn the best risk-weighted post-tax return. KPMG appreciates that it is the pre-tax risk weighted return that is the predominate driver of where this capital is sought be to utilized by international investors, but at the margin tax matters. That is, where there are two investment opportunities with the same risk-weighted pre-tax return, how tax is treated on that investment by each respective jurisdiction will be one of the deciding factors of where that scarce resource will eventually go. To the extent that our tax system becomes less globally competitive and our ETR increases relative to other jurisdictions, our ability to attract that marginal foreign capital to help continue to grow and enhance our economic prosperity will start to be eroded.

We have undertaken economic analysis to support the comments above and would be happy to discuss this with you further, if that would be of assistance.

Observations on the Consultation Paper from a real estate perspective

There are clear policy reasons for the flow through taxation of real estate, as it facilitates the ownership of real estate by a pool of investors rather than a fragmented real estate market where real estate is owned by a limited number (where that pool of investors might not be able to successfully compete with one or more larger investors with sufficient capital to invest) and encouraging the sophistication of property investment by facilitating institutional investment into real estate. Such collective investment vehicles are globally understood and endorsed by investors.

Clearly investments into real estate through flow through vehicles is underpinned by sound policy reasons, which has seen the growth of REIT regimes in other jurisdictions such as the United States, United Kingdom, Canada, Germany and Asia (see for example the taxation regimes in Japan, Korea (Rep), Hong Kong, Singapore and the (relatively) recently introduced regime in India).

The receipt of tax deferred distributions by investors in Australia is a consequence of the policy setting of ensuring that investors in a pooled vehicle have the same tax profile as a direct investment in real estate. Again, this is consistent with the fundamental underpinnings of a collective investment vehicle regime to encourage investment and liquidity.

Stapled structures in the real estate sector

Whilst offshore jurisdictions have prohibited stapling of real estate structures it is important to understand that these prohibitions occurred for reasons specific to those jurisdictions. For example, whilst Canada introduced legislation to prevent the growth of stapled structures, this was driven by the growth of stapled structures which were clearly frustrating the policy objectives of the specified investment flow-through entity regime ("SIFTs") that had then been recently introduced.

The use of stapled structures for real estate investment in Australia arose as a result of the policy settings restricting the type of investments that could be undertaken by flow through trusts and did not seek to circumvent those tax policy settings.

In Australia, stapled structures developed to enable both sides of an expanded business (corporate and trust) to co-exist and be taxed at their appropriate tax rates (30% for the corporate structure and flow-through taxation for the passive vehicle). Australia has a very long history of stapled structures in real estate. As the Treasury Consultation Paper appears to acknowledge, stapled structures are not an integrity risk in the real estate sector. To the extent that stapled structures have emerged in the Australian real estate sector and there are cross staple dealings, this is not due to attempts to recharacterise trading income to passive income to be derived by a trust. Rather this is often driven by sound commercial reasons given the vertically integrated business model or because of deficiencies in Division 6C.

For example, cross staple loans from a flow through trust to a sister corporate vehicle are a common feature of staples in Australian real estate. Rather than being motivated by a desire to recharacterise income these loan arrangements are driven by limitations in respect of capital raising activities and a requirement that capital raising be on a NTA basis. Where the capital is

required on the corporate side of the staple because of an impending transaction this may then require a loan from the trust to the company (which may also be lending debt capital it has borrowed to the company because it will commonly be acting as group lender (because of its stable asset portfolio which it can provide as security to a third party lender)). Thus whilst loan arrangements may be entered into between cross staple participants, this is driven by commercial rationale rather than recharacterisation attempt and therefore real estate participants entering into such arrangements should not be adversely impacted by current integrity concerns.

Similarly, it is common for a flow through trust in a stapled structure to lease a portion of its property (a common example is car parking spaces in a commercial building) to a sister company. The purpose of these arrangements is not to recharacterise income since car parking income will usually not be 'active'; but rather, it is driven by the unfortunate distinction which Division 6C appears to make in deeming the derivation of legal form rent to be 'eligible' for the purposes of Division 6C whilst seemingly treating license fees from the licensing of parking spaces to third parties not to be 'eligible'. This is the case regardless of whether the licensing of the car parking is long term, does not involve any active trading activities on the part of the trust and that the income from these activities may be an extremely small proportion of the income that may be derived from leasing out of the commercial building itself.

Therefore Australia's position is fundamentally different in that stapling did not emerge as a means of tax avoidance and Australia has a very well established real estate market that relies on stapled structures which have been used for sound commercial reasons.

A targeted consultation process is required

As staples have a long history in the Australian real estate sector and have delivered benefits such as allowing Australian REITs to be internally managed and allowing them to run an integrated business platform, it is not the use of staples in the real estate sector that is the problem. Further, the problems associated with the re-characterisation of income have not arisen in the real estate sector.

For this reason it is critical that the Treasury response to an integrity issue is a targeted one that does not give rise to unintended adverse consequences.

Any policy changes which impact the ability for stapled structures to continue to operate in the real estate sector will impose significant and unnecessary costs for industry participants. For example, legislative changes to State and Territory stamp duty regimes may be required to ensure that there is not a stamp duty impost associated with any restructure. As experience has shown with the 'top hat" amendments introduced in Subdivision 124-Q in 2007, it has taken the relevant State and Territory Governments several years to introduce stamp duty relief for such restructure (and in some States or Territories relief is still not available).

Therefore we submit that an appropriate response at this early stage is further ongoing consultation dealing with many of the complex and sensitive issues that arise in designing an appropriate on-going regime for investment into real estate and critical infrastructure.

It will be important to ensure throughout this process that the outcome involves appropriate policy settings to ensure that Australia continues to attract foreign investment in Australian real estate and critical infrastructure.

The adoption of an Australian REIT regime

The Consultation Paper raises the prospect of an Australian REIT regime. As we comment below, there are some issues with the drafting of Division 6C which mean that the provisions are overly restrictive and do not reflect modern and increasingly sophisticated approaches to passive investment in real estate. The provisions are also far more restrictive and ambiguous in their definition of what is passive investment as compared to REIT regimes in other jurisdictions.

However, there are difficulties in using the REIT regimes introduced in other countries as a basis for a REIT regime in Australia. This is due to the manner in which REITs have used staple structures so as to segregate their passive investment in real estate from other complementary active business that they undertake. This may result in a preference to incrementally improve on the existing REIT regime rather than adopting a new one, especially given the costs and the complexity concerned and the significant time and resources that have already been devoted in adjusting to the newly introduced attribution managed investment trust regime.

The question of whether Australia should adopt a REIT regime is also not a new one. The Board of Taxation considered precisely this question in its August 2009 Report to the Assistant Treasurer, *Review of the Tax Arrangements Applying to Managed Investment Trusts*. After significant and detailed consideration of the various issues, the Board noted that "[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." Thus the Board ultimately recommended that "there should be no separate REIT regime" (Recommendation 6).

Furthermore, as Treasury has observed, overseas REIT regimes have limitations on the amount of trading income that can be derived from within the REIT structure. For example:

- ***US REIT's*** - may own a 'taxable REIT subsidiary' ("TRS") which can derive active income, provided the value of the TRS is not greater than 25% of the REITs total assets (reducing to 20% from 1 January 2018). At least 75% of the income of the US REIT must be "good" income.
- ***UK REITs*** - may carry on property rental business as well as other activities provided the property rental business profits and assets must broadly comprise at least 75% of the total profits and total assets as determined from IFRS accounts.
- ***German REITs*** - The REIT must generate at least 75 per cent of its gross revenue from real estate assets and at least 75 per cent of its total assets must consist of real estate assets.
- ***Singapore REITs*** - The REIT must have at least 75% of its property invested in income-producing real estate (inside or outside Singapore). Property development only permissible if the property will be held at completion.

- ***Canadian REITs*** - Canada's test is more complex but has a 'Passive Revenue Test' (90% of revenue from "good activities") and Property Test (90% of total FMV of non-portfolio property must be qualified REIT property).

Given the size of the corporate side of stapled real estate company and trust structures, many current real estate staples may not be able to comply with activity restrictions such as these without significant modification. This was also noted by the Board of Taxation in its 2009 Report where, in considering whether a limit should be placed on the size of trading activities that could be carried on by a subsidiary of a trust (if Australia were to adopt a regime similar to the United States in allowing a taxable subsidiary) noted arguments at that time that a "significant segment of the industry would not be able to comply with a new test that limited the ratio of active trading activities conducted by a controlled entity." Additionally the Board considered that "investors who have invested in stapled trusts/top hat structures that currently comply with the EIB rules in Division 6C should not be penalised by a change in taxation arrangements that would subject those trusts to company-like taxation."

A modernisation of Division 6C is required

Therefore rather than adopt a new REIT regime, incremental improvements should be made to the existing Division 6C to ensure that it is still relevant and competitive with foreign jurisdictions. These improvements should be the subject of the consultation process described above.

Currently, a public unit trust will not be a Division 6C trust and will be treated as a flow through trusts where the trust does not carry on or control a trading business. A trading business is defined as a business that does not wholly consist of eligible investment business. Eligible investment business is the business of investing in land for the purposes of deriving rent or investing in or trading in certain securities.

There are currently a number of significant practical issues with the application of this definition of eligible investment business. For example, the question of what is eligible investment business is uncertain and the consequences of a trust carrying on a business other than eligible investment business are very significant. These issues led to interim changes to the eligible investment business rules by the Tax Laws Amendment (2008 Measures No.5) Act 2008 which addressed some of the issues with Division 6C. However, we submit these changes did not go far enough and note the ATO recently formed a working group to work with industry in producing practical guidance that address areas of continuing uncertainty. We would be happy to provide specific examples of some of the areas of continuing uncertainty.

Observations on the Consultation Paper from an infrastructure perspective

As noted above, there are important economic reasons for continuing to allow flow-through taxation treatment and the continued use of stapled structures in respect of real estate and infrastructure investment. There has been long standing use of stapled structures for infrastructure investment, with the first stapled infrastructure investment being listed on the ASX in 1996. This position should continue to be allowed from a policy perspective, especially as these traditional infrastructure investments were not the focus of ATO concerns around the

characterisation of income that were outlined in Taxpayer Alert TA 2017/1. Further, this policy position should apply to all infrastructure investments rather than distinguishing between privatised infrastructure assets and other assets.

Overall, the Taxpayer Alert and Consultation Paper has created considerable uncertainty surrounding the tax outcomes for infrastructure investments. Whilst investors in these assets would like clarification as to the policy settings of the Australian Federal Government in respect of infrastructure assets going forward, such investors also are concerned that a 'knee jerk' policy response may give rise to on-going difficulties.

Whilst it is important for there to be clarification as to the on-going treatment of traditional infrastructure assets (including land based infrastructure assets and infrastructure assets of the class that has been recently privatised by State Governments), it is also important to ensure that sufficient time is given to designing a best practice on-going regime to encourage future infrastructure investment in Australia. It is important to recognise that as part of recent privatisations, there has been substantial engagement with both the ATO and FIRB as to the proposed structures and the associated taxation issues. Indeed, the structures for privatised assets were proposed by the relevant State Governments. This engagement with the ATO and FIRB is expected to continue given that infrastructure investment in Australia will continue to be funded from both local Australian superannuation funds and international funds (particularly, pension funds, sovereign wealth funds and global infrastructure funds). Such engagement will ensure that the ATO and FIRB continue to be aware of emerging trends so as to gain comfort that transaction structures remain appropriate and continue to stay "between the flags". It is also important to note that investors in Australian infrastructure assets are long term investors and so a key consideration for such investors is the certainty of the Australian regulatory framework, which includes the tax framework. For this reason, it is important to establish a consultation process so as to ensure that a robust future regime is established for infrastructure investment.

It is important that any consultation process results in a clear definition of infrastructure. This may include, for example, traditional/critical infrastructure or alternatively, use a concept based on 'infrastructure and related facilities' utilised in section 93L and section 93M of the Development Allowance Authority Act 1992. Such a definition would cover, amongst other things, land transport facilities, air transport and seaport facilities, electricity generation, transmission and distribution facilities, gas pipelines and various utilities (e.g. water and sewerage).

It is recommended that this definition is expanded to include certain renewable assets/projects and the more recently expanded concepts of infrastructure facilities. The Federal Government has enacted legislation to achieve Australia's Renewable Energy Target (RET). We understand that the purpose of this initiative was designed to reduce emissions of greenhouse gases in the electricity sector and encourage $40.4 billion of investment in facilities to generate electricity from sustainable and renewable sources. In light of this policy objective, it is important that renewables are included as part of the definition of infrastructure.

An alternative approach that the Government could look to in order to define “infrastructure” is to use the definition included in the UK’s Finance Bill 2017 as a basis. That legislation defines infrastructure to include:

- water, electricity, gas, telecommunications or sewerage facilities
- railway facilities [including rolling stock], roads or other transport facilities
- health or educational facilities
- training facilities for any of the armed forces or any police force
- court or prison facilities; and
- waste processing facilities

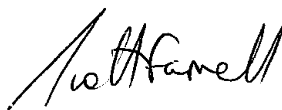
The current consultation period is insufficient to allow proper debate as to the type of infrastructure assets that should fall within any on-going definition. However, the above may be used to provide an indication of the type of infrastructure asset that the Australian government intends to include within any definition of infrastructure, from a policy perspective.

Finally, it is also important to review and modernise the current definition of “eligible investment business” within Division 6C as mentioned earlier and which is used for both MIT purposes as well as the public trading trust test. The current definition is overly restrictive from the perspective of traditional/critical infrastructure and there should be on-going consultation about the modernisation of this definition.

* * * *

If you have any wish to have any further discussions in relation to the above submission, please contact either Scott Farrell (02 9335 7366) or Brendon Lamers (07 3434 9148) in the first instance.

Yours sincerely



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