CONSULTATION PAPER - STAPLED STRUCTURES

APRIL 2017

1. Executive Summary

Perpetual Corporate Trust submits that Treasury has conflated stapled structures and re-characterisation of income. Whilst the primary concern in terms of tax base integrity relates to the latter, the former has become the focus area for reform. We believe that this approach is unwise given achieving a tax preferred outcome is only one of a number of commercial drivers for use of a stapled structure.

PCT submits the ATO can already draw upon an existing suite of measures to address re-characterisation of income and that further reform is not warranted at this stage. Any reform if indeed required, should be based on a more detailed and considered assessment of the impacts, costs, benefits and risks of change.

PCT is particularly concerned that the measures under consideration will adversely impact on Australia's reputation as a safe and stable environment for foreign investment, recognising that, unless all existing stapled structures are grandfathered, the policy options proposed will retrospectively change the after tax cash flow to foreign investors from Australian domiciled investments held in stapled structures. Where these interests were acquired through structures that have been set up based on good faith compliance with Australian tax laws; with the intention that these assets be held for the long term, a re-rating of political and sovereign risk in Australia will occur. Any resultant reduction in foreign investment inflows will lead to adverse outcomes for the domestic economy. The adverse outcomes will be compounded given the extent of restructuring costs that are likely to be required in response to the policy proposals documented in the Consultation Paper.

PCT submits that given the complex nature of the issues at hand, a more comprehensive discovery process to size the nature and extent of the issues and to assess the effectiveness of existing anti-avoidance measures is warranted. In addition, PCT believes the Board of Taxation should be engaged to undertake this review.

PCT is already experiencing the detrimental impacts of the uncertainty that has been generated by the TaxPayer Alert on Stapled Structures issued by the ATO on 31 January 2017 and this Consultation Paper on investment inflows from foreign institutional investors. Transactions in progress have paused as prospective foreign investors seek clarification as to the likely impact of the proposed changes. We understand from discussions with professional advisers that a number of other similar transactions have been paused until the uncertainty is resolved.

2. Introduction

Perpetual Corporate Trust (PCT) welcomes the opportunity to respond to The Treasury's *Stapled Structures Consultation Paper March 2017* ("the Paper").

Our submission represents the views of PCT only and should not be taken to be indicative or representative of the view of the broader Perpetual Group. Our comments are provided from the perspective of PCT's role as Trustee for Managed Investment Trusts ("MITs") that represent some $40 billion in property and infrastructure assets acquired by the Trustee mainly on behalf of Canadian and Singaporean beneficiaries.

PCT acknowledges the importance of ensuring integrity of Australia's tax base is preserved. However, we believe that there are adequate measures already in place (or in the process of being implemented) that enable tax base integrity to be maintained and that specific measures aimed at eliminating or discouraging the use of stapled structures are not required. We also note that the potential to re-characterise trading income as more favourably taxed passive income is a feature that is not only relevant to stapled structures and submit that the substance of any additional reforms should target 're-characterisation' generally rather than stapled structures in particular.

PCT believes that the Consultation Paper is premature, particularly given that it is less than twelve months *since The New Tax System for Managed Investment Trusts* ("New Tax System") was legislated and given the consultation process with respect to the ATO's *Privatisation and Infrastructure – Australian Federal Tax* Framework is in progress.

PCT submits that effective policy making is evidence based; drawing on a factual and analytical base that sizes the extent of any perceived issues with current policy settings and sets the context for engagement with industry. We note the evidence with respect to the nature and extent of the 're-characterisation' issue along with the tax leakage that arises as a result has not been provided in this Consultation Paper. We encourage Treasury to undertake further analysis to establish the fact base required to fully assess the economic impacts of these proposals, to inform the next stage of policy development, or to share the fact base with market participants if it is already available. We would be particularly interested to see the outcomes of economic modelling of the impacts (on a direct, indirect and multiplier basis) that might arise through the implementation of the policy options considered.

We encourage Treasury to take adequate time to assess the issues of concern and the consequences of change, measured not only in terms of the anticipated increase in income tax revenues, but the broader economic impacts that may arise if the changes adversely impact on foreign investment inflows into Australia. Moreover, all beneficiaries (whether domestic or international ,including domestic superannuation funds and retail investors) that currently hold direct and indirect interests in stapled structures will be adversely impacted as a consequence of the changes being contemplated if the outcome leads to a the reduction in return on investment. We believe the Board of Taxation should be engaged to lead a comprehensive review, so as to facilitate an orderly process and to avoid outcomes that give rise to unintended consequences.

As Treasury rightfully points out, stapled structures have been in use in Australia for more than 30 years. The cost of change associated with restructuring existing arrangements to comply with any of the options that have been tabled in the consultation paper will be significant. Moreover, retrospectively imposing changes on pre-existing arrangements, which have been established and operated on the basis of good faith compliance with Australian tax laws will result in reputational

damage and create sovereign risk. Put simply, in a global capital market, Australia runs the risk of being bypassed as a destination for foreign investment inflow through lack of regulatory certainty and the risk of retrospective regulatory change. Additionally, it is difficult to reconcile these initiatives with other Treasury policy priorities, including the introduction of a regulatory framework to facilitate the establishment of corporate and limited partnership collective investment vehicles, which are aimed at encouraging the further development of Australia as a regional financial services hub and promoting further foreign investment inflow.

The joint Infrastructure Partnerships Australia and Perpetual *Australian Infrastructure Investment Report 2016* (The IPA/Perpetual Report) "…highlights the critical importance of certainty in making decisions about where and when to invest. While Australia has many strengths as a destination for infrastructure investment, the market for infrastructure investment is global"[1].

PCT submits that it is both the nature of investment opportunities as well as Australia's reputation for effective government that drives foreign investment inflows. In fact, the IPA/Perpetual Report shows that, in 2016, concern about political risk had roughly halved from 68 per cent in 2015 (which was impacted by the cancellation by the Victorian Government of the East-West Road Link) compared to 35 percent in 2016; yet the survey occurred prior to the decision to block foreign bidders from taking a majority stake in Ausgrid. Qualitative comments based on depth interviews with market participants that were undertaken after the quantitative survey indicated that the Ausgrid decision brought political and sovereign risk back to top of mind. To quote one of the survey respondents:

"If you'd asked that question anywhere near the East West Link incident then everyone would've told you sovereign risk is one of the greatest concerns with investing in Australia, then for the next 12 months nobody would have said that - and then Ausgrid happened"[2].

PCT also cautions against introduction of asset class or sector specific arrangements, designed to treat certain investors differently based on the nature of assets being acquired. Whilst this ostensibly promotes the flow of funds into asset classes where there is an alignment with delivery of government policy objectives, we believe that there are more appropriate policy levers that government can apply to promote private investment in infrastructure. Indeed, the Productivity Commission, in reviewing public infrastructure, concluded that the "case for advantaging finance for infrastructure investments via special tax treatment…is weak"[3]. We submit that giving preferential treatment to a particular asset class is short sighted, given this will inevitably require ongoing realignment as policy priorities change over time.

[1] Infrastructure Partnerships Australia and Perpetual *Australian Infrastructure Investment Report 2016*, p 20.
[2] Ibid, p 14
[3] Productivity Commission *Public Infrastructure Inquiry Report, Volume 1*, May 2014, p 207.

3. Responses to Specific Consultation Questions

3.1 Background

Question 1

It should be noted at the outset that structure follows strategy when it comes to acquisition of property, infrastructure and agricultural assets. Based on our experience, the appropriate structure generally emerges as the investor completes their due diligence on the proposed investment; based on our experience, investors do not fit an acquisition or investment to a particular structure, rather, having identified the target investment, they seek professional legal and tax advice as to the optimal (and compliant) structure as part of their due diligence in determining the merits of committing their scarce capital to a particular investment.

It should also be noted that the privatisation of State Government owned assets has in recent times been achieved through sale of interests to consortia; the size of the capital commitment required to secure these assets is such that no single investor will generally has sufficient headroom in their own investment mandates to bid for the entirety of the asset to be privatised. The structure is generally established at the consortia level; with each consortium consisting of domestic and foreign investors.

In this context, it is the risk/return profile of the investment against the investor's strategy and objectives that is the key driver. Whilst achieving a tax effective structure is of importance, this is not the only driver for adopting a stapled structure:

1. The ability to match distribution cash flows with the investor's upstream payment obligations, which may be more problematic to achieve in a corporate structure, given the provisions of Section 254T of the Corporations Act 2001. For foreign pension funds, there is a desire to match the timing of expected pension payment liabilities in their home jurisdiction with cash flows from investments, particularly where the pension payment obligations arise from defined benefit schemes.

   The attribution managed investment trust regime implicitly recognises that the generation of taxable income for distributions might not necessarily match the investor's requirement for cash flow through explicitly providing for upwards and downwards revision of the cost base.

2. The ability to quarantine assets from operations so as to protect the assets from enforced liquidation in the event that the operating entity fails. This is particularly of significance given the underlying assets are not liquid, there are likely to be restrictions on ability to sell the assets when these are jointly owned by a consortia and the cost of disposal of the assets is likely to be significant.

3. Use of an investment entity to hold assets and an operating entity to run the business align to the commercial practices and risk appetites for certain counterparties. Taking a hotel as an example, the landlord looks to appoint an operator, not to fragment the business but in acknowledgement that they lack the specialist skills to run a hotel; the landlord is not willing to take on the operational risk associated with running the hotel business. Conversely, the hotel operator wishes to run the hotel and has the expertise, systems and processes to effectively manage the operational risk that it bears in doing so, but has no desire to commit the capital required or take on the investment risk associated with owning the property.

4. Investment through a stapled structure enables the ability to, in due course; sell the asset or the operating entity independently of each other, particularly when the stapled structure involves a landholding trust stapled to an operating company that is undertaking the development of the land.

5. For foreign investors, it should also be noted here that ownership does not necessarily imply 'control' – especially with respect to the managed investment trust. The additional eligibility criteria to qualify for concessional withholding tax mean that the MIT must be under local management and control, with a substantial part of investment management undertaken in Australia. Stapling the operating entity to the asset holding trust may in effect provide the foreign beneficiaries with the ability to exercise control over the operating entity whilst the local manager or Trustee retains control over the MIT. This is particularly relevant where the foreign investor has relevant operational skills or expertise that can be leveraged by the local entity, with the resultant knowledge transfer benefitting the domestic economy as this facilitates building capability and expertise.

Question 2

As noted above, we believe that the ability to match timing of expected pension payments with cash flow generated from investments is a significant consideration for foreign pension fund investors, especially for defined benefit pension schemes.

3.2 International Comparisons

Questions 3, 4, 7

PCT believes there is limited merit in drawing examples based on precedents from other jurisdictions. Each jurisdiction's investment framework and tax code has evolved primarily in response to domestic factors – legal system, size and stage of development of economy, depth and maturity of capital market, regulatory settings, domestic policy priorities, comparative advantage and promoting international competitiveness and the extent to which a jurisdiction is a net exporter or importer of capital represent some, but not all of the factors that would need to be adequately addressed to enable appropriate cross jurisdictional benchmarking to occur.

Simply put, PCT does not favour drawing international parallels in the absence of considering the broader economic, social, political and legal factors that drive each jurisdiction's regulatory framework for investment and tax policy.

3.3 Policy Considerations

Question 5

Tax is clearly a consideration when foreigners assess the relative merits of investing in Australia – the MIT withholding tax concessions clearly acknowledge this; as does Treasury in its recent consultation on Corporate Collective Investment Vehicles and withholding tax. We submit however that tax is only part of the equation in this regard – taking infrastructure investment as an example, based on our experience, infrastructure represents an attractive investment for foreign pension funds, on the basis that the arrangements can be structured in a way that delivers their target cash flow and capital growth return profile.

Effectively, the proposals being contemplated will unwind the MIT withholding tax concessions for certain foreign investors. We believe that this will be detrimental as it will be perceived as a retrospective change in in tax rules impacting on foreign investors, especially in situations where the foreign investor has acquired an interest based on professional advice as to compliance with Australian tax rules, the intention on acquisition of the investment was to hold for the long term and where the arrangements between the operating entity and MIT have been struck at arm's length.

3.4 Broad Policy Options

Questions 6

PCT acknowledges the importance of tax base integrity. However, we are concerned at any measures that broadly legislate against the use of stapled structures, particularly where these are long standing and/or have been established in good faith as to compliance with Australian tax laws.

Evidence based policy making requires that an appropriate factual base be established to inform the nature and extent of change. The case for change in tax treatment of stapled structures seems to be driven based on assumptions that stapled structures give rise to re-characterisation of income, yet the nature and extent of the issue does not appear to have been sized and the extent to which re-characterisation of income is only evident within stapled structures have not been addressed. Importantly, the effectiveness of existing anti-avoidance measures available to deal with re-characterisation of income does not appear to have been considered.

PCT submits that the ATO already has adequate measures designed to address any tax base integrity issues arising from stapled structures, including:

a. The 'non arm's length' income rules introduced as part of the New Tax System;
b. Thin capitalisation rules, that limit the deductibility of interest on related party debt to a safe harbour threshold of 60%;
c. Australia's transfer pricing rules;
d. The general anti-avoidance measures included in Part IVA of *The Income Tax Assessment Act 1936*

We also note the Treasury's recent consultation on *Improvements to the Debt and Equity Tax Rules*, which looked to implement the Board of Taxation recommendations aimed at simplifying and clarifying the rules that prevent taxpayers from splitting a single scheme into multiple schemes to achieve favourable tax outcomes; we believe a 'substance over form' approach provides a more appropriate policy response to dealing with income re-characterisation.

Moreover, it is less than a year since the New Tax System was legislated, after a period of some seven years in development. The industry is still in the process of embedding changes in systems and processes required in response to the New Tax System. Given the extensive development and consultation process and given that implementation remains work in progress, we believe it is unreasonable to subject the industry to an additional round of changes in advance of assessing the effectiveness of the New Tax System in achieving the desired policy objectives.

Questions 8, 9 and 10

As already noted, PCT believes the business case for reform focusing on stapled structures rather than re-characterisation of income generally has not been established and that no reforms are warranted to existing tax laws at this stage.

However, if the reforms are to be progressed, any structure where it can be demonstrated that the arrangements between the operating entity and investment entity have been struck at arm's length should be deemed out of scope for reform. Changes should be targeted only to structures that have been contrived to re-characterise income. Simply put, if the arrangement are compliant with existing tax laws (including the general anti avoidance provisions), we believe that the structure should be out of scope from application of any measures designed to prevent the use of stapled structures.

However, if a 'form over substance' approach is adopted, as implicit in a number of the proposals that are canvassed in the paper, PCT submits that:

a. All real estate investment trusts should be deemed out of scope; for avoidance of doubt, this includes listed and unlisted A-REITs.

   PCT submits that listed and unlisted REITs should be not subject to any reforms, given the size and maturity of the market and the potentially high costs that would be incurred if the sector was to undergo forced restructure to achieve compliance with a new framework.

   As an example, the listed A-REIT sector alone represents market capitalisation of some $132.9 billion[4], with stapled structures represent circa 94%[5] of A-REIT market capitalisation. Given the size and maturity of this market, the restructuring costs will be significant; which will ultimately represent a substantial opportunity cost to direct investors and Australian superannuation fund investors measured in returns forgone in lieu of restructuring costs.

   PCT endorses the Board of Taxation's finding that a separate REIT regime would add cost, complexity and administrative difficulties[6].

b. Stapled structures involving hotels, student accommodation and aged care should also be deemed out of scope, given there is a strong commercial rationale for separating ownership of the property from operations in these structures and given that the nature of payments that flow from the operator to the investment entity can be characterised as rent for the right to use the property to operate the business.

c. All existing stapled structures established as at the date that any changes are legislated be grandfathered, but remain subject Part IVA of *The Income Tax Assessment Act 1936.*

[4] ASX *Monthly Update* February 2017, available at http://www.asx.com.au/documents/products/asx_funds_monthly_update_feb_17.pdf

[5] Derived based on our analysis of the data available extracted from the above. According to this, there were 34 listed A-REITs that adopt a stapled structure, out of a listed A-REIT universe of 51 funds. Listed A-REITs that adopt a stapled structure represent circa $124.9 billion out of $132.9 billion in A-REIT market capitalisation.

[6] Board of Taxation *Review of the Tax Arrangements Applying to Managed Investment Trusts, Report to the Assistant Treasurer, August 2009*, Recommendation 6.

Questions 11 and 12

PCT submits that the Productivity Commission, in its comprehensive review of Public Infrastructure in 2014[7] has already critically evaluated the Public Infrastructure market and the mechanisms available for provision of government support. One of the conclusions that the Productivity Commission reached was that there was evidence supporting tax concessions for public infrastructure investment was weak and that the government has available a range of other policy levers that can be deployed to better target private sector participation in financing public infrastructure.

3.5 Impacts of Policy Options

Questions 13, 14, 15 and 16

In the absence of rigorous data and economic modelling of potential outcomes, quantification of impacts will be imprecise and subject to conjecture. The impacts in all likelihood will vary by sector, by structure, by domicile of investor and by the nature of contractual arrangements between the stapled entities.

All other things being equal, for a foreign owner of an infrastructure asset held in a stapled structure, if the structure delivers incremental yield benefits through enabling tax deferred distributions from inception, from a discounted cash flow perspective, any change in tax rules that result in a reduction in cash flows will result in a write down of the value of their investment. To the extent that the investment no longer delivers to the target return profile, the investor may determine to liquidate their holdings.

This, of course, presumes that exiting the investment is possible at that time. Where an interest in an investment has been acquired through membership of a syndicate, the investor will be reliant on the contractual arrangements between syndicate members that define the exit mechanism(s). The nature of liquidity mechanism provided and whether or not the timing for disposal is within a pre-determined 'lock-up' (minimum holding) period are of relevance in this context. All else being equal, the investor is likely to book a loss on disposal of asset, even if the buyer is a tax preferred domestic investor (such as a superannuation fund) based on a reduction in demand side competition that might arise if foreign investors opt out of contesting to acquire the asset and as the market prices in a risk premium for uncertainty resulting from the risk of retrospective regulatory change.

PCT submits that irrespective of the impact on observable metrics such as cost of capital, investment inflow and asset prices, a more fundamental impact on foreign investor sentiment towards Brand Australia will be experienced. Having experienced the impact of a change in regime part way through the expected holding period, foreign investors will re-rate the desirability of directing new investment flows into Australia. This of itself is problematic given Australia has historically been a net importer of foreign capital.

We are not in favour of reforms that prescribe a fixed ceiling as is implied in a legislated threshold for trading business permitted to be carried out by a Division 6 Trust.

There are obvious differences that will be experienced for new and existing investment. The business case for the former will be developed factoring in the new requirements and the

[7] Productivity Commission *Public Infrastructure Inquiry Report, Volume 1*, May 2014, p 207

investment decision ultimately taken on the basis of whether or not the business case justifies the deployment of scarce capital. This of course assumes that the investment proposal reaches business case stage. If the reforms fundamentally alter the risk return profile of existing investments in Australia, foreign investors may be unwilling to commit additional capital to Australia as they no longer have confidence in the stability of Australia's regulatory settings. Regulatory fatigue may act as another potential deterrent to new foreign capital inflows, given it has been less than a year since the long anticipated New Tax System was legislated. Simply put, ongoing tinkering with the MIT tax rules will result in a perceived rise in the cost of doing business in Australia by foreign investors.

For existing investments, investors' responses will depend on the impact of the changes - at minimum, advice will be sought to quantify the impact of the changes. Depending on that advice, the investor will choose either to continue to hold the asset in the current structure; restructure their holdings or divest. The latter two are likely to result in significant sunk costs and economic loss to the investor.

3.6 Implementation and Transitional Issues

Question 17

PCT questions the relevance of seeking to ascertain a typical term for third party finance for stapled groups (in fact, for any organisations), given the range of debt financing options that can be deployed. Third party finance can vary from a secured loan from a single lender, to a syndicated facility agreement involving multiple lenders, to arrangements involving senior and subordinated debt. Certain larger issuers also use debt instruments other than term loans, including corporate debt bonds, medium term notes, listed debt instruments and debentures. Based on our experience, term loans can range from short term bridging arrangements of three months to ten years; however we do not believe that this is informative given term loans represent only one of a number of different mechanisms through which debt finance may be obtained.

Questions 18 and 19

PCT submits that all arrangements set up prior to the date of enactment of any legislative changes should be grandfathered given the costs and consequences of not doing so are significant.

Moreover, we do not believe it appropriate to use the implementation of Division 6C as a benchmark for nature or duration of transitional arrangements. Significant liberalisation, globalisation and interconnectivity of markets have been experienced since Division 6C was first introduced in 1985. Moreover, given the scale and maturity of the stapled sector in Australia, the costs and consequences of change are much more substantial now compared to changes implemented more than 30 years ago.

When legislation to update the definition of a MIT was passed in May 2010, transitional provisions enabled trusts that qualified as MITs based on the previous definition to maintain their MIT status until the end of the 2016-17 income year; effectively providing for a circa seven year transitional period. Unless existing stapled structures are grandfathered, PCT submits that at minimum, a 10 year transitional period will be required so as to minimise adverse impacts on markets, investors and foreign capital inflows.

Question 20

The costs of restructuring existing arrangements will obviously vary depending on the nature of that arrangement and the nature of any regulatory change. There are significant costs associated with restructures that involve interests in real property, with stamp duty being an obvious example; yet stamp duty is a State Government impost that can be influenced but not controlled by the Federal Government. Unless stamp duty relief could successfully be negotiated, significant dead weight losses will be experienced; which will ultimately be reflected in lower returns to investors. Where restructuring gives rise to sale of interests and crystallisation of capital gains, rollover relief should be provided.

Irrespective of stamp duty relief and capital gains tax rollover relief, the potential costs associated with restructuring existing arrangements may be numerous and varied. To illustrate some of the key costs, these include transaction costs (where assets are to be sold), advice costs (reflecting the cost of legal advice and tax advice); agency costs (where there are third party contracts that will need to be varied and/or novated as a result of a restructure); potential break costs to be paid if external lending is to be repaid before term and significant opportunity cost in terms of time taken to work through the restructuring proposals and in terms of income lost as capital is diverted away from income generating activities to fund scheme restructuring costs.

4. Conclusion

PCT submits that this consultation should be paused as further work is undertaken to assemble the substantive fact base required to quantify the impacts, costs, benefits and risks associated with the reform proposals. PCT recommends the Board of Taxation be engaged to comprehensively assess the extent of re-characterisation of income through stapled and other structures, impacts on tax base integrity, the adequacy of current regulatory settings aimed at mitigating the risk of tax base erosion through re-characterisation of income and recommended policy responses.

At this point in time, we are particularly concerned with respect to the damage that the reform proposals will have on Australia's reputation as a stable destination for foreign investment, coming so close to the enactment of the New Tax System. In particular, the transitional period for the 'non arm's length income' rules has not yet expired and insufficient time has hence passed for the effectiveness of these changes to be examined. For existing stapled structures, we are also concerned that costs incurred to restructure arrangements will be significant and will ultimately translate to lower returns for investors. Simply put, foreign investors are likely to re-rate Australia as a reliable and stable location for foreign investment and a broad cross section of Australians, who own interests in A-REITs and other stapled structures directly or indirectly through their superannuation fund or other managed investment will experience lower than otherwise returns on their investment.

We encourage Treasury to adopt an evidence based approach to identify the extent to which reforms are needed (if any), particularly given the ATO has anti-avoidance measures already at hand to deal with re-characterisation of income related concerns. Above all, we urge Treasury to consider the ramifications of the uncertainty that is being generated amongst foreign investors as to the desirability of directing their scarce capital to Australia; concerns that are likely to be reiterated by domestic investors.