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20 April 2017

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

By email: Stapledstructures@treasury.gov.au

Dear Sir / Madam

STAPLED STRUCTURES – TREASURY CONSULTATION PAPER – SUBMISSION

A. INTRODUCTION

1. Thank you for the opportunity to provide comments on Treasury's Consultation Paper regarding stapled structures ("**Consultation Paper**").

2. By way of background, Pitcher Partners Advisors Proprietary Limited ("**Pitcher Partners**" or "**we**") comprises five independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively, we are one of the largest accounting associations outside the Big Four.

3. We predominantly focus on servicing the middle market. The typical managed fund in this space would have net assets of between $20 million to $500 million. These funds are generally operated by Australian private company businesses that conduct fund management operations in Australia. They would generally have between approximately 10 to 50 staff members.

B. COMMENTS ON THE CONSULTATION PAPER

4. The Treasury's Consultation Paper refers to integrity risks regarding the use of stapled structures. These integrity risks appear to be based solely on concerns that have been raised by the Australian Taxation Office ("**ATO**").

5. In our view, the term "integrity risk" refers to a transaction or arrangement that is inconsistent with the current policy framework. We highlight that this is different to "revenue risks" within the current policy framework.

6. We believe that outside of blatant Part IVA arrangements the vast majority of stapled arrangements are within the policy context of the current provisions and are therefore being incorrectly described as giving rise to "integrity risks". Based on our experience, we believe that there would be relatively limited circumstances where the ATO would be able to legitimately apply Part IVA to stapled structures.

7. We are also concerned with the statements in the Consultation Paper that refer to a "significant increase" in stapled arrangements involving mining and agriculture. As outlined in Appendix E, we do not believe that this is the case and believe it is important that Treasury properly outline these concerns for the purpose of future consultation on this matter.

8. As outlined in Appendix 0, we believe that the current policy context is reasonably clear and currently provides for guidelines as to what is an acceptable split between a passive and active component of a "fragmented business".

9. To the extent that the Government is considering a change to the policy setting with respect to stapled arrangements due to revenue risks or concerns, then we think it would be prudent to have Treasury verify this by way of financial projections. Moreover, to the extent that the Government makes a decision to change the policy based on such an exercise, we do no object to such changes on a prospective basis. We note that this could have consequences for investment in Australia, for the promotion of Australia as a financial services hub, and thus impacts on services and jobs provided by Australians. However, such policy decisions and their impacts are clearly a call for Government.

10. We highlight that changing the provisions for existing arrangements would be unfair for those taxpayers who have operated within the confines of the existing policy and law. We note that restructuring property holdings would likely involve significant stamp duty and capital gains tax costs and would not be simple to implement. Furthermore, a change in the law brings with it sovereign risk issues for managed funds that are illiquid funds.

11. We believe that it is important for the Government to properly articulate the intention of Division 6C and what is regarded as an acceptable arrangement. We highlight that there is now some degree of confusion as to whether stapled structures that carry on "rent-like" businesses would be acceptable. This includes hotels, student accommodation and car parking businesses. We believe that the Government needs to clarify this issue with some degree of urgency.

12. If these arrangements are viewed as being acceptable from a stapled perspective, we would highly recommend that the Government amend Division 6C so that a licence (or a similar arrangement) for the use of property is treated as being an acceptable eligible investment business under section 102M. This (in itself) would remove the need to have stapled structures in these basic cases and would help to make it clearer as to what is acceptable or unacceptable in terms of obtaining flow-through taxation.

13. We also highlight that any legislative amendments dealing with stapled structures need to be properly thought through and balanced. For example, a number of arrangements use stapled structures where there is no apparent tax advantage associated with the structure. An example is where multiple flow-through trusts (established as managed funds) are stapled together to ensure that securities can only be sold together. It would be inappropriate for the proposed amendments to apply to such arrangements.

C. RECOMMENDATIONS

14. Having regard to the above, we believe that the following recommendations should be considered by Treasury and the Government.

15. We believe it is firstly important for the Government to clearly identify and stipulate the policy of the relevant provisions as a whole. Having regard to Appendix 0, recent amendments make it very unclear as to what the actual policy is with regards to flow-through taxation. Certain tax concessions are currently being provided to various structures in the form of reduced tax rates, discount capital gains or tax deferred distributions. Accordingly, it is important for the Government to assess those benefits and concessions and outline whether those concessions are still legitimate or not.

16. For example, if the main concern of Government is in the provision of reduced withholding tax rates to non-residents in certain situations, identifying a policy change with respect to this principal would help to isolate the relevant stapled structures issue that would be subject to the proposed changes.

17. The policy assessment should have regard to whether the Government is still seeking to create a financial services hub in Australia and whether the Government is looking to encourage investment into certain types of property and infrastructure projects. The current ambiguity of the policy setting makes it difficult for fund managers to assess what structures are currently acceptable and unacceptable and whether their structures will be attacked in the future. It is therefore important to provide certainty on this matter.

18. The ATO should be free to apply Part IVA to those contrived arrangements that are similar to those contained in Example 3, TR 2012/D5 (withdrawn). We agree that those types of stapled arrangements lack commercial substance and undermine the integrity of the system.

19. Transitional rules should be provided with respect to assets acquired prior to a certain date. We believe that this would address the concern with “stuffing” assets into quarantined structures. Transitional rules should provide protection from both the new rules, as well as Part IVA (except in the cases outlined in paragraph 18).

20. Amendments should be considered for Division 6C to ensure that “rent-like” arrangements involving property do not result in the relevant trust being regarded as a public trading trust. This should cover hotel arrangements, accommodation arrangements and car parking licences. This simple amendment alone would help to ensure that there is a clearer distinction as to what will constitute an unacceptable stapled arrangement in the future (i.e. as a hotel would therefore be considered something that would ordinarily satisfy Division 6C).

21. Any legislative change needs to be properly thought through and considered. The policy should first clearly identify those stapled arrangements that are acceptable and unacceptable. It should also clearly identify what would happen if an arrangement moved from being acceptable to unacceptable (and vice versa).

22. We are not at this stage in favour of treating a stapled group as being consolidated for income tax purposes. We believe that this would give rise to complex CGT interactions for the stapled securities, would require a supporting single entity rule and would enable the creation of MEC-like structures (which could give rise to further integrity issues or concerns).

23. We believe that there is merit in considering an amendment to section 102N so that the control test is satisfied where a trust is stapled in an unacceptable arrangement. However, we highlight that there would still be practical problems with this type of solution such as those raised in paragraph 21.

24. Care needs to be taken on any new provision that abolishes stapled arrangements. This would ignore the commercial reasons for establishing a stapled structure. A stapled arrangement between two passive trusts should not be of a concern. Furthermore, a stapled arrangement between a passive and active entity should not be a concern where they are essentially independent and the stapling is used to restrict trading in independent securities.

25. Subject to clarification of the Government's imperative for a change in law (i.e. integrity risk or revenue risk), we do not believe that a working group needs to be created to resolve this issue. We believe that the issue should be resolved as soon as possible to provide certainty to the funds management industry. If the policy is appropriately determined, we believe it would not be difficult to implement amendments to the legislation to achieve that policy outcome in a relatively easy and efficient manner.

We would welcome the opportunity to discuss any of the items above at your convenience. Please contact either Stuart Dall on (03) 8612 9450 or Alexis Kokkinos on (03) 8610 5170 if you would like to discuss any aspect of this submission. We would also welcome the opportunity to further consult on any proposed amendments, or if you require further input into suggestions or potential solutions to any issues identified.

Yours sincerely

S J DALL
Executive Director

A M KOKKINOS
Executive Director

D. APPENDIX – POLICY SETTING

26. We believe that the current policy context is fairly clear and currently provides for guidelines as to what is an acceptable split between a passive and active component of a fragmented business.

27. Division 6C provides the framework for determining was is acceptable for flow-through arrangements where the trust is public.

28. The arm's length rule was introduced as a compliment to Division 6C, to provide a safe harbour for the types of assets and the amount of income that could be split from active businesses. The arm's length rule was introduced specifically in relation to deal with stapled arrangements, as articulated and outlined in the Board of Taxation report to Treasury.

29. The safe harbour was developed with the full understanding that such income could be subject to a reduced withholding tax rate.

30. Reduced rates of withholding tax are currently provided to managed investment trust structures to encourage investment into property related managed funds (AREITs). The objective of this concession was to create further jobs in the funds management industry in Australia and to assist in increasing funds under management in Australia to $2.5 trillion by 2015. In particular, it was acknowledged that this policy setting would likely promote the creation of new AREITs and property funds. This objective is explicitly stated in the Explanatory Memorandum to Tax Laws Amendment (Election Commitments No. 1) Bill 2008.

31. Division 6B was repealed in 2015, as the Government at the time took the view that Division 6C (together with the arm's length rule) set an appropriate benchmark as to what would constitute an acceptable split between passive income and active income.

32. Since 2009, the ATO have only raised concerns (publicly) with staple structures that are significantly contrived to create artificial income. For example, reference is made to the withdrawn TR 2012/D5, which highlighted concerns with stapled arrangements that were funded 99% into the trust and 1% into the operating company (whereby excess cash was used as a loan from the trust to the company to convert profits to interest). We also note that these structures have been highlighted in the "related schemes" draft amendments recently released for Division 974. We agree that these types of arrangements are contrived and should not fit within the existing policy framework. We believe that these types of arrangements should be capable of falling within the parameters of Part IVA.

33. We highlight that a significant source of investment in manage funds in Australia does not come from foreign residents. The majority of investment is through Australian resident superannuation funds and individuals (i.e. 91%). There is currently approximately $2.6 trillion of funds under management[1] ("**FUM**") in Australia, which is the third largest pool of contestable funds in the world. However, compared to other jurisdictions in the Asia-Pacific region, Australia only manages approximately 9.9% of

[1] FSC/UBS Asset Management: State of the Industry 2016.

funds under management[2]. Although this has increased from the mere 3% in 2008, the current statistics do not support the conclusion that there has been a proliferation of the use of stapled structures in the managed funds industry to avoid paying Australian income tax and corporate taxation.

34. Accordingly, we do not agree that the managed funds industry is currently being used to create artificial income streams for the purpose of providing lower withholding tax rates to foreign residents.

[2] IBISWorld Industry Report K6419a Funds Management Services in Australia (September 2016).

E. APENDIX – INDUSTRY SPECIFIC COMMENTS

35. We note that the Consultation Paper has made specific reference to certain a significant expansion of stapled structures in recent years to agriculture and mining. We make the following comments on this statement.

(a). Mining industry

36. We are surprised by the comments in the Consultation Paper relating to the mining industry. We are currently not aware of circumstances where stapled structures have been used in the mining industry and do not understand the reference to the significant expansion in this context.

37. According to our understanding, each State in Australia has specific legislation that provides a legal and administrative framework for the ownership of mining land and for the operation of mines. These provisions apply to both State owned land and private land. In order to mine land, we understand that specific licences are required to be granted by the State to the operator (e.g. exploration licences).

38. If exploration proves successful, we understand that mining leases can also be granted by State, which will generally allow the miner to extract minerals from the land for profit. These licences and leases are generally entered into a registration list, which is maintained by each State.

39. We therefore understand that there would be significant difficulties in converting a mining business operation into a stapled structure, given that the party operating the mining business would generally be the party required to have the lease or licence with respect to the land.

40. We are therefore interested in understanding the exact integrity concern that has been raised in the Consultation Paper and the reference to the significant increase in the use of stapled structures for mining business operations. Understanding the problem would (in our view) help to better formulate a solution for this perceived issue.

(b). Farming industry

41. We are also surprised with the comments in the Consultation Paper with respect to faming stapled arrangements.

42. We are only aware of a handful of stapled structures relating to farming operations in the managed funds space. That being said, we believe that this is not a new structure and that such structures (or similar structures) have always existed.

43. The segregation of land and the business operations for farming purposes has historically been a preferred structure, irrespective of tax concessions available. Most family farming businesses would operate in this manner. Reference is also made to Product Ruling 2006/25, being over ten years old, which provides an example of a farming operation through two separate MIS structures (one for the land trust and the other for the "growers"). Therefore, we do not agree that this is a new structure that has only recently come into existence and is currently resulting in a significant increase in the use of stapled structures as compared to what has occurred in the past.

44. The use of a stapled structure in a farming operation provides capital protection to investors in respect of the most valuable asset (being land). If an accident were to occur in relation to the business operations, or if the business operations were to be unsuccessful, the land would be segregated and better protected under a stapled structure.

45. We note that the operation of the tax provisions do not assist in providing significant tax benefits to faming stapled structures. That is, while tax depreciation benefits are contained in Division 40 for farming enterprises (e.g. horticultural deductions and irrigation deductions), these provisions require the relevant entity to carry on a business of farming. Due to the operation of Division 6C, a land trust cannot benefit from these tax preferred deductions.

46. Farming land is also generally zoned as "farming" and thus in most cases cannot simply be converted to other uses. This results in a limitation on the capital appreciable value of farming land and the potential to realise significant capital gains on such land.

47. Given the size of Australia's mining and agricultural industry, the potential gravity of these statements for the purpose of Government formulating its policy should in our view be precisely clarified.