



Australian Government

Stapled Structures

Integrity Measures Proposal Paper

June 2018



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Manager
Media and Speeches Unit
The Treasury
Langton Crescent
Parkes ACT 2600
Email: medialiaison@treasury.gov.au

Contents

- Consultation Process1**
- Request for feedback and comments1

- Why do we need integrity rules?2**
- 1. Objectives2
- 2. Summary of approach2
- 3. Rationale for differential approaches3
- 4. Staples eligible for the seven year transition3
- 4.1. Non-Arm’s Length Income Rule3
- 5. 15 year transition and infrastructure concession4
- 5.1. Existing economic infrastructure staples4
- 5.2. New economic infrastructure assets.....5
- 5.3. Interaction of the Concessional Cross-Staple Rent Caps with the NALIR.....7

Consultation Process

Request for feedback and comments

All information (including name and address details) contained in formal submissions will be made available to the public on the Australian Treasury website, unless it is indicated that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain confidential should provide this information marked in a separate document.

A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 12 July 2018

Email	Stapledstructures@treasury.gov.au
Mail	Principal Adviser Corporate and International Tax Division The Treasury Langton Crescent PARKES ACT 2600
Enquiries	Enquiries can be initially directed to Brendan McKenna
Phone	02 6263 4449

Why do we need integrity rules?

Under the proposed tax changes to stapled structures outlined in the Treasurer’s press release of 27 March 2018 (**Transition Date**), existing staples and approved new infrastructure staples can access concessional Managed Investment Trust (MIT) withholding tax rates on cross-staple rental arrangements for periods of either seven years (generally) or 15 years (economic infrastructure).

In Taxpayer Alert 2017/1, the Australian Taxation Office (ATO) warned that some stapled structures might attract the operation of the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936*. Following the implementation of the policy package, the general anti-avoidance rule will not apply with respect to the choice of a stapled structure to obtain a deduction in respect of cross staple rent during the transition period or during the concession period for approved infrastructure projects.

Integrity rules are needed to safeguard against aggressive cross-staple pricing arrangements during the transition / concession periods.

Stakeholder views are sought on the proposed rules outlined in this paper.

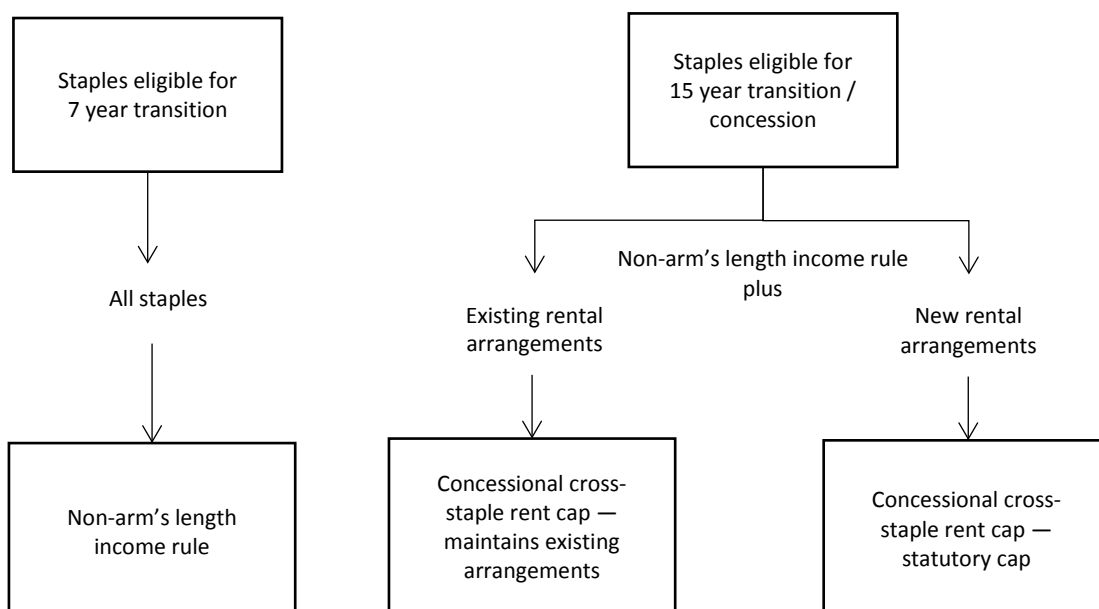
1. Objectives

The objectives of these integrity rules are to:

- Safeguard against aggressive cross-staple pricing during concessional periods; and
- Minimise impact on commercial arrangements while mitigating tax integrity risks.

2. Summary of approach

The following figure provides a summary of the proposed approach to the integrity rules:



3. Rationale for differential approaches

The Non-Arm's Length Income Rule (NALIR) was introduced in 2015 as part of the *Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015*, and the rule becomes operative for pre-existing MITs from the start of the 2018–19 income year. The NALIR is expected to be an appropriate safeguard against aggressive cross-staple pricing for sectors that have readily available data on comparable Australian third party market transactions.

It is anticipated that staples in sectors which have access to the seven year transition rule would be able to obtain and point to this information when determining whether the pricing of their cross-staple rental arrangements are acceptable.

However, for economic infrastructure staples that are eligible for the 15 year transition period and new approved infrastructure staples, it is generally not possible to identify directly comparable Australian transactions where the infrastructure asset is rented to a third party operator. Given this, the NALIR by itself may not act as a sufficient safeguard against aggressive cross-staple pricing for these staples.

Accordingly, existing economic infrastructure staples and new approved infrastructure staples will need to comply with some additional integrity safeguards.

4. Staples eligible for the seven year transition

4.1. Non-Arm's Length Income Rule

Staples eligible for the seven year transition period will need to continue to comply with the existing NALIR.¹

Minor technical amendments to the NALIR will be made to ensure that all cross-staple rental payments in excess of the amounts allowable under the NALIR will be subject to the 30 per cent trustee tax under the NALIR if that income is reflected in a distribution to a MIT.

This would include for example, ensuring that a MIT that subsequently acquires a participation interest in a stapled arrangement is a party to the scheme for the purposes of applying the NALIR.

Under the NALIR, where a MIT receives rent (or amounts attributable to rent) in excess of the amounts allowable under the NALIR, these amounts would be subject to the 30 per cent trustee tax.

In this regard, it is expected that property and agriculture staples, which would be eligible for the seven year transition, would be able to identify comparable Australian market pricing for the cross-staple lease of their assets. New integrity rules are not required for these staples.

1 Subdivision 275-L ITAA97

Example 1: Hotel staple eligible for the seven year transition period

Asset Trust (a MIT) and OpCo are stapled entities that operate a hotel. Asset Trust owns the land and buildings in relation to the hotel business and leases the assets to OpCo to operate the business.

The rent to be charged by Asset Trust to OpCo is determined based on the pricing methodology used in comparable situations where the owner of a hotel has leased the assets to a third party operator to run the hotel. In this regard, Asset Trust identified several hotels with similar characteristics (eg location and amenities) and considered the pricing for the lease of their assets (e.g. method of determining the rent in terms of \$/m²) to the third party operators.

Given that this market data provides evidence of the arm's length pricing that would be expected in a third party transaction, the NALIR is considered sufficient to ensure that the cross-staple pricing remains appropriate during the transitional period.

5. 15 year transition and infrastructure concession

5.1. Existing economic infrastructure staples

Under this approach, existing economic infrastructure staples eligible for the 15 year transition period can continue to charge cross-staple rent in accordance with the rent calculation methodology that existed before the Transition Date for the period of transition and still access the 15 per cent MIT rate.

Any cross-staple rent that exceeds the amount that would have been payable under the existing methodology will be treated as non-concessional MIT income (**NCMI**) and subject to the 30 per cent MIT withholding rate.

That is, the pre-transition method will act as a cap on the cross-staple rent that can access the concessional MIT rate (the **Concessional Cross-Staple Rent Cap — existing arrangements method**). If during the transition period, a different method of calculating rent is adopted, any rent that exceeds the cap will be NCMI.

This provides a safeguard in addition to the NALIR against aggressive cross-staple rent pricing for integrated business staples that do not have readily identifiable comparable third party data. Under this approach, existing staples will not be able to increase the amount of income that accesses the tax concessional tax rate by changing the way in which rent is calculated during the transitional period.

Key aspects of the cap

Staples will be able to access this rule for existing assets where:

- the Asset Entity and Operating Entity (i.e. the entities that are a party to the cross-staple lease) had executed (signed) a lease agreement prior to the Transition Date that specifies the rent to be charged under the lease, or the methodology to calculate the rent; and
- there is evidence that an objective methodology existed which was in use prior to the transition date to determine the amount of rent under the lease agreement (e.g. based on contractual terms or other contemporaneous documentation which evidences how rent was calculated under the rental agreement). Note, the contract may, but does not need to, incorporate this methodology.

Taxpayers that cannot identify a particular methodology (i.e. formula) but that establish a fixed amount of rent that was being charged prior to the transition date can continue to charge this amount during the period of the transition. An annual Consumer Price Index adjustment will be allowed in this case.

Taxpayers will not be able to use rent re-set dates to change their methodology and increase their rent caps. However, if the original methodology clearly identified specific changes to the formulas to calculate the rent at future points in time, then this will not be seen as a change to the existing methodology.

An expense allocation ordering rule will be implemented to ensure expenses must first be allocated to the rental income that can access the 15 per cent MIT rate.

The cap will only impact on whether cross-staple rent can access the 15 per cent MIT rate.

Example 2: Port staple with existing cross-staple rental arrangement

Asset Trust (a MIT) and OpCo are stapled entities. Asset Trust owns a port and leases the port to OpCo to operate. The stapled entities were established in December 2016 as part of a privatisation process. Asset Trust holds the land and fixtures and leases these assets to OpCo to run the port business.

There is a lease agreement (signed contract), which was executed in December 2016 between the stapled entities that stipulates the cross-staple rent (in dollar terms) payable for the assets which are the subject of the lease.

The stapled entities have contemporaneous documentation that provides evidence of the rent calculation formula used to determine the rental amounts contained in the lease agreement. Under this formula, Asset Trust is entitled to receive rent equal to 6% of the regulated asset base (RAB) of the asset.

This documentation provides evidence that an objective methodology was used to calculate rent and was in use prior to the transition date.

For the 2017-18 income year, OpCo pays rent of \$60m (i.e. 6 per cent of the RAB of \$1bn). In 2019-20, the RAB has increased to \$1.2bn due to addition of new port facilities and therefore, the existing methodology requires rent of \$72m to be paid by OpCo.

Under the integrity rule, the \$72m rental payment can access the 15 per cent MIT rate.

5.2. New economic infrastructure assets

Certain qualifying assets that were not owned or in operation in the staple at the Transition Date will be eligible for the transitional rules. Additionally, cross-staple rent on new economic infrastructure assets will be able to access a 15 year concessional rate of withholding if approved by the Treasurer. These assets do not have existing rental methodologies.

In these situations, the amount of cross-staple rent that can access the 15 per cent MIT withholding rate will be capped to the amount worked out using a statutory formula (**Concessional Cross-Staple Rent Cap — statutory formula method**). The statutory formula will operate so that if the cross-staple rent results in more than 80 per cent of the current year taxable income of the project being allocated to the asset entity, the excess rent amount would be treated as NCMI and subject to the 30 per cent MIT withholding. Further details on the calculation of the cap are provided in the method statement in Figure 1.

An expense allocation ordering rule will be implemented to ensure expenses must first be allocated to the rental income that can access the 15 per cent MIT rate.

Figure 1: Method statement for determining excess rent under the cross-staple rent cap

Step 1 – Identify the operating entity and asset entity that are parties to the cross-staple arrangement

- These entities would contain the total income and expense in respect of the project.

Step 2 – Determine the combined taxable income (or tax loss) of the operating entity and asset entity for the current year (prior to applying any carry forward losses)

- This would involve adding up the current year tax positions for each of the entities to determine a notional current year taxable income for the project (i.e. the outcome that would be expected to arise if the project was undertaken in a single entity).

Step 3 - Multiply the amount at Step 2 by 0.8

- This step calculates the amount of trust net income that the asset entity would have if 80 per cent of the project's current taxable income or loss was allocated to it.

Step 4 – Determine the amount of cross-staple rent that would result in 80 per cent of the project's current year taxable income (or loss) being allocated to the asset entity

- In doing so, assume that all other revenue and expense items of the asset entity are unchanged.
- The amount worked out under Step 4 is the Concessional Cross-Staple Rent Cap amount.

Step 5 - Work out by how much the cross staple rent exceeds the Concessional Cross-Staple Rent Cap

- If the actual rent exceeds the amount worked out under Step 4, the difference is treated as Excess Rent.
- Excess Rent is treated as NCMI.

Example 3: Approved Infrastructure Staple

In December 2019, the Treasurer approved a new project to access the new economic infrastructure tax concession.

The staple was established on the 1 July 2020 but the asset was in construction phase until 30 June 2022. The project began operations on 1 July 2023, and a lease agreement was entered between Asset Trust and OpCo from this date such that the OpCo leased the assets from Asset Trust to operate the business. The pricing of the lease was set up to be compliant with the NALIR.

For the income years from 1 July 2020 – 30 June 2022, because the asset was not operational and there were no amounts of cross-staple rent payable under the lease, the staple does not have a Concessional Cross-Staple Rent Cap.

For the income years from 1 July 2023 onwards, OpCo and Asset Trust would need to determine if any part of the rent paid under the lease agreement would be NCMI because it breaches the statutory cap.

To do this, it would follow the method statement at Figure 1. In doing so, it would calculate the combined taxable income amount for the project (for each year) by adding up Asset Trust and OpCo's individual tax positions (ignoring any carried forward tax losses). This calculation would eliminate the impact of any transactions between the two stapled entities and show the project's taxable income for any given year.

Once the notional taxable income for the project is determined, Asset Trust would need to work out the amount of cross-staple rent that would result in it having 80 per cent of the taxable income or tax loss of the project – the Concessional Cross-Staple Rent Cap. This process essentially requires grossing up Asset Trust's net income for its other actual expenses and income to determine a gross amount of cross-staple rent, which is then treated as a notional 'cap' for the purpose of determining whether any amount of the actual rent paid to Asset Trust is 'Excess Rent'.

Provided the amount actual rent does not exceed the Concessional Cross-Staple Rent Cap, the integrity rule would not apply.

However, if the actual rent exceeds this amount, then the Excess Rent would be treated as NCMI. In this regard, Excess Rent will be subject to the 30 per cent MIT withholding rate if it is part of a fund payment distributed to a foreign investor.

Importantly, if Asset Trust does have Excess Rent, when Asset Trust undertakes its expense allocation against the cross-staple rental income, expenses can only be used to reduce this amount if all of the concessional rent amounts have been exhausted.

5.3. Interaction of the Concessional Cross-Staple Rent Caps with the NALIR

The Concessional Cross-Staple Rent Caps will operate as a safeguard in addition to the existing NALIR. This means that staples that cannot support cross-staple rent up to the rent cap as being arm's length are expected to continue to organise their affairs to be compliant with the NALIR – consistent with the current law.

Conversely, if the arm's length income of the MIT is more than the concessional rent cap, then the excess rent will be deemed to be NCMI even though the arrangements may comply with the NALIR.

If both the NALIR and NCMI rule can apply to an amount of rent, the NALIR will have priority.

The existence of the statutory cap is not intended to provide an indication of arm's length pricing for the rent of economic infrastructure assets and therefore should not be taken as a reference point for determining an arm's length price for cross-staple rental arrangements involving economic infrastructure assets.