
TREASURY LAWS AMENDMENT (MAKING SURE FOREIGN INVESTORS
PAY THEIR FAIR SHARE OF TAX AND OTHER MEASURES) BILL 2018

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
ADI	authorised deposit-taking institution
AMIT	attribution managed investment trust
CGT	capital gains tax
Commissioner	Commissioner of Taxation
GST Act	<i>A New Tax System (Goods and Services) Act 1999</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MIT	managed investment trust
NANE income	non-assessable non-exempt income
TAA 1953	<i>Taxation Administration Act 1953</i>

Chapter 1

Non-concessional MIT income

Outline of chapter

1.1 Schedule 1 to this Exposure Draft Bill amends the ITAA 1997 and the TAA 1953 to improve the integrity of the income tax law for arrangements involving stapled structures and to limit access to tax concessions for foreign investors by increasing the MIT withholding rate on income attributable to non-concessional MIT income to a rate equal to the top corporate tax rate.

1.2 An amount of a fund payment will be non-concessional MIT income if it is attributable to:

- MIT cross staple arrangement income;
- MIT trading trust income;
- MIT agricultural income; or
- MIT residential housing income.

1.3 Transitional rules apply so that, for fund payments made in relation to existing investments, the existing MIT withholding tax rate of 15 per cent will continue to apply in certain circumstances.

Context of amendments

MIT cross staple arrangement, trading trust and agricultural income

1.4 A stapled structure is an arrangement involving two or more commonly owned entities (at least one of which is a flow-through entity), that are often legally bound together such that the interests in them cannot be bought or sold separately.

1.5 Staples have been used in Australia by the property sector since the 1980s. Prior to the introduction of the MIT regime in 2008, profits made by stapled entities bore a similar level of Australian tax as if they had been made by companies. Domestic and foreign direct investors were taxed in Australia at their marginal tax rates on business income (although they enjoyed some timing benefits). Generally, foreign investors in managed funds would have paid tax at the corporate tax rate.

1.6 The MIT regime was aimed at increasing the attractiveness of Australia's fund management industry (especially property funds) to

mobile foreign investment. It did this by lowering the withholding taxes deducted from certain distributions to foreign investors from MITs, particularly for distributions attributable to rental income. For members of a MIT who are residents of an exchange of information country, the rate of MIT withholding tax is generally 15 per cent.

1.7 As a result of the MIT regime, foreign investors in stapled businesses no longer bear tax at the corporate tax rate. If the trust side of the staple is a MIT, tax is generally withheld on rental income at 15 per cent.

1.8 This does not raise significant integrity issues for traditional property stapled structures. The trust side of traditional property stapled structures generally hold portfolios of property assets that derive passive rental income from third party tenants. A lower tax rate on this income is an intended outcome of the MIT regime. Trading activities (for example, property development) are undertaken by the company side of the staple, which continues to pay corporate tax. There is no conversion of active income into passive income.

1.9 Over time, the tax rate differential has encouraged an increase in the use of stapled structures to convert active business income into passive rental income.

1.10 For example, a single business is fragmented between an asset entity and an operating entity. A foreign investor holds an interest in a MIT. The land assets necessary for use in the business are held by the MIT (either directly or indirectly through another asset entity) and leased to an operating entity. The taxable income of the operating entity is reduced by rental payments to the asset entity. The rental payments distributed from the asset entity obtain access to the 15 per cent MIT withholding tax rate when distributed to foreign investors. In this way, the active income of a trading business is converted into concessionally taxed passive income.

1.11 Increasingly, businesses in a broad range of sectors are seeking to access the MIT concession by using stapled structures and other similar arrangements to convert active income into passive income. Further, some foreign investors have entered into arrangements that generate debt greater than the prescribed thin capitalisation debt limits by using 'double gearing' structures, leading to the ability to claim greater debt deductions. In some cases, these arrangements have no clear commercial justification other than to reduce effective tax rates for foreign investors. Schedule 2 to this Exposure Draft Bill addresses this concern.

1.12 Meanwhile, globally, sovereign wealth funds and pension funds have grown rapidly. As these types of investors have access to a range of additional tax concessions, effective tax rates on distributions from stapled

businesses for these investors can be between zero and 15 per cent. Schedules 3 and 4 to this Exposure Draft Bill address these concerns.

1.13 In effect, stapled structures have resulted in the unintended emergence of a dual corporate tax system that taxes foreign institutional investors in land-rich industries at rates anywhere between zero and 15 per cent. Meanwhile, other large businesses remain subject to the current top corporate tax rate of 30 per cent. This creates a tax bias in investment decisions, potentially drawing capital away from businesses that are capital intensive, knowledge based and/or research and development intensive, rather than land-rich.

1.14 The Government has decided that it is necessary to address the use of stapled structures and to limit access to tax concessions for foreign investors in order to protect the integrity of Australia's tax system. This will provide more certainty for investors and a fairer and more predictable investment environment in the future.

1.15 Therefore, a final MIT withholding tax set at the top corporate tax rate will apply to distributions derived from trading income (non-concessional MIT income) that has been converted to passive income using a MIT, excluding rent received from third parties.

1.16 In addition, distributions derived from investments in agricultural land will be non-concessional MIT income that is subject to a final MIT withholding tax set at the top corporate tax rate.

1.17 The Government also decided as part of the staples package to:

- close a loophole in the thin capitalisation rules;
- narrow the superannuation funds for foreign residents withholding tax exemption; and
- codify and limit the sovereign immunity tax exemption to certain portfolio like investments.

1.18 These concessions combined with a stapled structure can result in very low rates of tax for some foreign investors. These changes are explained in Chapters 2, 3 and 4.

MIT residential housing income

1.19 In the 2017-18 Budget, the Government announced a package of measures designed to improve outcomes across the housing sector.

1.20 Several of these measures specifically address housing affordability for members of the community earning low to moderate incomes by providing incentives for investors to increase the supply of affordable housing.

1.21 States and territories have their own affordable housing policies which are designed to encourage affordable housing investment and the Government's affordable housing measures are intended to complement these existing policies.

1.22 In the 2017-18 Budget package, the Government announced that MITs would be prevented from investing in residential premises unless they are commercial residential premises or affordable housing.

1.23 Following consultation, and to adopt an approach more consistent with the stapled structures measures that were subsequently developed, the announced approach has been refined.

1.24 As a result, MITs will be able to invest in residential housing that is held primarily for rent. However, distributions derived from investments in residential housing that are not used to provide affordable housing will be non-concessional MIT income that is subject to a final MIT withholding tax set at the top corporate tax rate.

Summary of new law

1.25 Schedule 1 to this Exposure Draft Bill amends the ITAA 1997 and the TAA 1953 to improve the integrity of the income tax law for arrangements involving stapled structures and to limit access to tax concessions for foreign investors by increasing the MIT withholding rate on income attributable to non-concessional MIT income to a rate equal to the top corporate tax rate.

1.26 An amount of a fund payment will be non-concessional MIT income if it is attributable to:

- MIT cross staple arrangement income;
- MIT trading trust income;
- MIT agricultural income; or
- MIT residential housing income.

1.27 Transitional rules apply to fund payments attributable to existing investments. If the transitional rules apply, the existing MIT withholding tax rate of 15 per cent will continue to apply until, broadly:

- for MIT cross staple arrangement income relating to a facility that is not an economic infrastructure facility — 1 July 2026;
- for MIT cross staple arrangement income relating to a facility that is an economic infrastructure facility — 1 July 2034;
- for MIT trading trust income — 1 July 2026;

- for MIT agricultural income — 1 July 2026; and
- for MIT residential housing income — 1 October 2027.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>MIT withholding tax applies to fund payments made by a MIT to foreign resident members.</p> <p>For members who are residents of an exchange of information country, to the extent that the fund payment is attributable to non-concessional MIT income, the rate of MIT withholding tax will be the top corporate tax rate.</p> <p>An amount of a fund payment will be non-concessional MIT income if it is attributable to:</p> <ul style="list-style-type: none"> • MIT cross staple arrangement income; • MIT trading trust income; • MIT agricultural income; or • MIT residential housing income. <p>Transitional rules will apply to fund payments attributable to existing investments. If the transitional rules apply, the existing MIT withholding tax rate of 15 per cent will continue to apply until, broadly:</p> <ul style="list-style-type: none"> • for MIT cross staple arrangement income relating to a facility that is not an economic infrastructure facility — 1 July 2026; • for MIT cross staple arrangement income relating to a facility that is an economic infrastructure facility — 1 July 2034; • for MIT trading trust income — 1 July 2026; • for MIT agricultural income — 1 July 2026; and • for MIT residential housing income — 1 October 2027. 	<p>MIT withholding tax applies to fund payments made by a MIT to foreign resident members.</p> <p>For members of a MIT who are residents of an exchange of information country, the rate of MIT withholding tax is generally 15 per cent.</p>

Detailed explanation of new law

1.28 Schedule 1 to this Exposure Draft Bill amends the ITAA 1997 and the TAA 1953 to improve the integrity of the income tax law for arrangements involving stapled structures and to limit access to tax concessions for foreign investors by increasing the MIT withholding rate on income attributable to non-concessional MIT income to a rate equal to the top corporate tax rate (currently 30 per cent), rather than 15 per cent.

1.29 An amount of a fund payment will be non-concessional MIT income if it is attributable to:

- MIT cross staple arrangement income;
- MIT trading trust income;
- MIT agricultural income; or
- MIT residential housing income.

1.30 To the extent that a fund payment is attributable to non-concessional MIT income in an income year, the trustee of a trust that is a withholding MIT, a custodian and some other entities must withhold an amount from the fund payment at a rate equal to the top corporate tax rate. *[Schedule 1, items 2 to 4, paragraphs 12-385(3)(a), 12-390(3)(a) and 12-390(6)(a) in Schedule 1 to the TAA 1953]*

MIT cross staple arrangement income

1.31 A MIT will have an amount of MIT cross staple arrangement income if, broadly, it derives, receives or makes an amount that is attributable to a cross staple arrangement between an operating entity to an asset entity.

What is an asset entity?

1.32 An **asset entity**, in relation to an income year, is a trust or a partnership (if it were treated as a trust) that is *not* covered by subsection 275-10(4) of the ITAA 1997 in relation to the income year. *[Schedule 1, items 7 and 8, subsections 12-455(1) and (3) in Schedule 1 to the TAA 1953 and the definition of 'asset entity' in subsection 995-1(1) of the ITAA 1997]*

1.33 A trust is covered by subsection 275-10(4) of the ITAA 1997 if, broadly:

- in the case where the trust is a unit trust, the trust is a trading trust for the purposes of Division 6C of Part III of the ITAA 1936; or
- in the case where the trust is not a unit trust:

- the trust carries on a trading business (within the meaning of Division 6C of Part III of the ITAA 1936); or
- the trust controls, or is able to control directly or indirectly, the affairs or operations of another person in respect of the carrying on of a trading business by that other person.

1.34 Therefore, an asset entity includes a unit trust that is not a trading trust. In addition, an asset entity includes other types of trusts or a partnership that, if it were treated like a unit trust, would not be a trading trust.

1.35 In essence, an asset entity is an entity that only derives income from eligible investment business — *eligible investment business* is defined in section 102M of the ITAA 1936 to mean, broadly, a business that consists of investments that are passive in nature.

What is an operating entity?

1.36 An ***operating entity***, in relation to an income year, is a trust that is covered by subsection 275-10(4) of the ITAA 1997 in relation to the income year. [*Schedule 1, items 7 and 8, subsection 12-455(2) in Schedule 1 to the TAA 1953 and the definition of ‘operating entity’ in subsection 995-1(1) of the ITAA 1997*]:

1.37 An ***operating entity***, in relation to an income year, is also a partnership or company that, if it were treated as a trust, would be covered by subsection 275-10(4) of the ITAA 1997 in relation to the income year. [*Schedule 1, item 7, subsections 12-455(2) and (3) in Schedule 1 to the TAA 1953*]

1.38 Therefore, unlike an asset entity, an operating entity would be an entity that can derive trading income (as defined in Division 6C of Part III of the ITAA 1936). In essence, any entity that is not an asset entity will be an operating entity.

What is a cross staple arrangement?

1.39 A ***cross staple arrangement*** is an arrangement that is entered into by two or more entities (the arrangement entities) if:

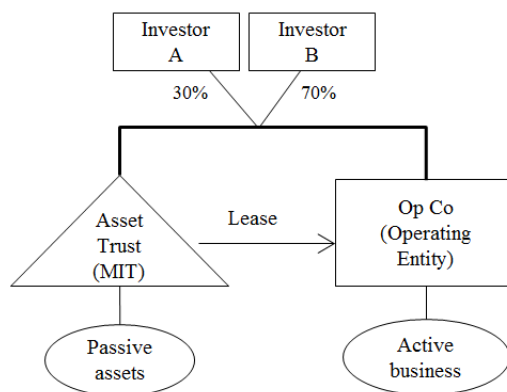
- at least one of the arrangement entities is an asset entity;
- at least one of the arrangement entities is an operating entity; and
- the following conditions are satisfied:
 - one or more other entities who are not party to the cross staple arrangement (the external entities) each hold a total participation interest (that is, direct and indirect participation interests) in each arrangement entity (that is, in both the asset entity and the operating entity); and

- the sum of the total participation interests held by the external entities in each arrangement is 80 per cent or more.

[Schedule 1, items 7 and 8, subsection 12-455(4) in Schedule 1 to the TAA 1953 and the definition of ‘cross staple arrangement’ in subsection 995-1(1) of the ITAA 1997]

1.40 In working out the sum of total participation interests held by external entities in each arrangement entity, a particular direct or indirect participation interest held in the arrangement entity is taken into account only once. *[Schedule 1, item 7, subsection 12-455(5) in Schedule 1 to the TAA 1953]*

Example 1.1: Cross staple arrangement



Asset Trust is an asset entity and Op Co is an operating entity.

Investor A holds 30 per cent of the units in Asset Trust and 30 per cent of the shares in Op Co.

Investor B holds 70 per cent of the units in Asset Trust and 70 per cent of the shares in Op Co.

Investor A and B, which are entities that are not parties to the cross staple arrangement, together hold 100 per cent of the participation interests in Asset Trust and Op Co.

Therefore, the lease entered between Asset Trust and Op Co is a cross staple arrangement.

1.41 The total participation interests that an investor holds in another entity is adjusted if:

- an entity (the test entity) has a total participation interest in two or more entities that entered into the cross staple arrangement; and
- either:

- the amount (the lowest participation interest amount) of one of those participation interests falls short of the amount of each of the other participation interests; or
- the amount (the lowest participation interest amount) of two or more of those participation interests falls short of the amount of each of the other participation interests.

[Schedule 1, item 7, subsection 12-455(6) in Schedule 1 to the TAA 1953]

1.42 In these circumstances, for the purpose of working out the total participation interests that an investor holds in another entity, the amount of the test entity's total participation interest amount is equal to the lowest participation amount. *[Schedule 1, item 7, subsection 12-455(7) in Schedule 1 to the TAA 1953]*

1.43 This ensures that if external entities have disproportionate interests in the asset entity and operating entity, only the common ownership percentage is counted.

Example 1.2: Cross staple arrangement — total participation interest

Assume the facts are the same as Example 1.1, except that:

- Investor A holds 40 per cent of the units in Asset Trust and 50 per cent of the shares in Op Co;
- Investor B holds 60 per cent of the units in Asset Trust and 40 per cent of the shares in Op Co; and
- Investor C holds no units in Asset Trust and 10 per cent of the shares in Op Co.

Investor A's 40 per cent interest in Asset Trust falls short of the 50 per cent participation interest in Op Co. Therefore, for the purpose of determining whether a cross staple arrangement exists, Investor A's 50 per cent participation interest is treated as being equal to the lowest participation interest (that is, 40 per cent).

Similarly, as Investor B's 40 per cent holding in Op Co falls short of its 60 per cent holding in Asset Trust, its participation interest is treated as 40 per cent.

Investor C is treated as holding a nil participation interest because it holds no participation interests in Asset Trust.

Investor A and B are external entities (that is, they are entities that are not parties to the cross staple arrangement) which together hold 80 per cent of the participation interests in Asset Trust and Op Co.

Accordingly the lease entered between Asset Trust and Op Co is a cross staple arrangement.

1.44 A cross staple arrangement that is for the lease of land (and fixtures on the land) between two or more parties would be covered by the

definition of a cross staple arrangement. A cross staple financial arrangement, such as a total return swap, is also covered by the definition.

What is a stapled entity?

1.45 Each of the entities that have entered into the cross staple arrangement is a ***stapled entity***. [*Schedule 1, items 7 and 8, subsection 12-455(8) in Schedule 1 to the TAA 1953 and the definition of ‘stapled entity’ in subsection 995-1(1) of the ITAA 1997*]

When does a MIT have an amount of MIT cross staple arrangement income?

1.46 A MIT will have an amount of MIT cross staple arrangement income in relation to an income year if:

- the MIT has an amount of assessable income for that income year;
- the amount of assessable income is, or is attributable to, an amount that is derived, received or made from a separate entity (the second entity) — the second entity will generally make a payment of the amount (directly or indirectly through, for example, interposed trusts) to the MIT; and
- the amount of assessable income is not an amount that is excluded from being a fund payment of a MIT — broadly, amounts that are not a fund payment of a MIT include:
 - dividends, interest and royalties;
 - capital gains in relation to a CGT asset that is not taxable Australian property; and
 - amounts which are not Australian sourced income.

[*Schedule 1, item 7, subsection 12-440(1) in Schedule 1 to the TAA 1953*]

1.47 Therefore, interest income from a cross staple arrangement (for example, from a cross staple loan) is not MIT cross staple arrangement income.

1.48 An amount will be MIT cross staple arrangement income of a MIT if:

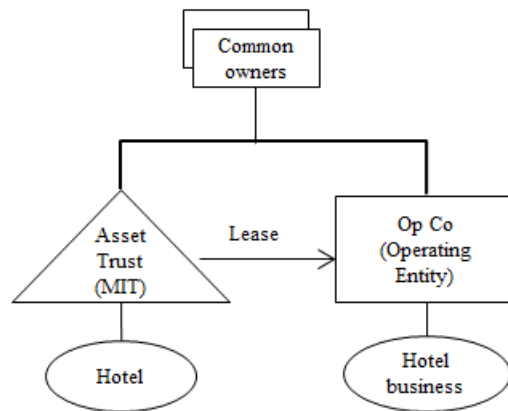
- the MIT is an asset entity in relation to the income year and is a stapled entity in relation to the cross staple arrangement;
- the second entity is an operating entity in relation to the income year and is a stapled entity in relation to the cross staple arrangement; and

- the amount is derived, received or made by the MIT from the second entity — this amount would be an assessable amount to the MIT.

[Schedule 1, item 7, subparagraphs 12-440(2)(a)(i), (b)(i) and (c)(i) in Schedule 1 to the TAA 1953]

1.49 Therefore, where a MIT is a direct party to a cross staple arrangement and, for example, an amount of cross staple rent is paid from an operating entity to the MIT, that amount will be treated as MIT cross staple arrangement income. However, an amount will not be MIT cross staple arrangement income if it is covered by one of the exclusions contained in subsections 12-440(3), (4), (5), (6) and (8).

Example 1.3: Direct cross staple arrangement



Asset Trust and Op Co are stapled entities.

Asset Trust is a MIT that owns a hotel. Asset Trust earns \$100 of rent from land that it has leased to Op Co (an operating company).

The \$100 rent received by Asset Trust from Op Co (the second entity) is MIT cross staple arrangement income unless a specific exception applies.

1.50 An amount will also be MIT cross staple arrangement income of a MIT if:

- the second entity is an asset entity in relation to the income year and is a stapled entity in relation to the cross staple arrangement;
- another entity (the third entity) is an operating entity in relation to the income year and is a stapled entity in relation to the cross staple arrangement; and
- the amount is attributable to an amount that is derived, received or made by the second entity from the third entity

— this amount would be an assessable amount to the asset entity.

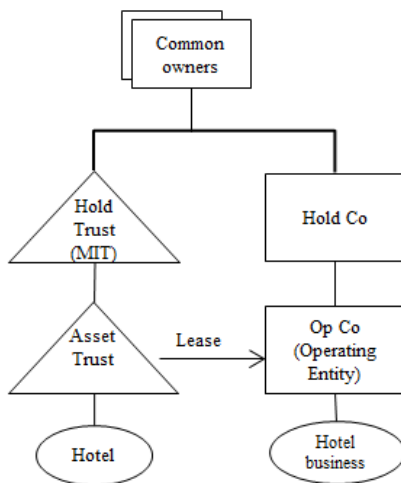
[Schedule 1, item 7, subparagraphs 12-440(2)(a)(ii), (b)(ii) and (c)(ii) in Schedule 1 to the TAA 1953]

1.51 Therefore, where a MIT is not a direct party to a cross staple arrangement but has an amount of assessable income that is indirectly attributable to a cross staple arrangement, that amount will be treated as MIT cross staple arrangement income.

1.52 This would occur if the MIT receives a distribution from an asset entity, where the net income of the asset entity includes an amount of assessable income in relation to a cross staple arrangement. For example, this will arise where the MIT is a beneficiary of another trust that is a party to a cross staple arrangement.

1.53 In addition, an amount may be indirectly attributable to a cross staple arrangement even if there are multiple tiers of flow through trusts interposed between the MIT and the second entity (that is, the asset entity which is a party to the cross staple arrangement).

Example 1.4: Amount attributable to cross staple arrangement



Assume the facts are the same as Example 1.3, except that:

- Hold Trust, which is a MIT, owns all of the units in Asset Trust;
- Asset Trust is not a MIT;
- Asset Trust, in calculating its net income for the year, has no other assessable income and deductible expenses of \$30.

- Hold Trust is presently entitled to all of the income from Asset Trust and, for the purposes of calculating its net income for the income year, includes its share of the net income of Asset Trust (\$70) in its assessable income.

Therefore, the assessable income of Hold Trust (\$70) is attributable to the cross staple rent Asset Trust (the second entity) receives from Op Co (the third entity) and is MIT cross staple arrangement income unless a specific exception applies.

1.54 There are five circumstances in which an amount that is attributable to a cross staple arrangement will *not* be MIT cross staple arrangement income of a MIT. These are:

- where cross staple rent can be traced to an amount of third party rent from land investment charged by an operating entity;
- where the income from a cross staple arrangement satisfies the de minimis rule for an asset entity;
- where the income from a cross staple arrangement is, or is attributable to, rent from an approved economic infrastructure facility;
- where the income from a cross staple arrangement is, or is attributable to, MIT trading trust income; and
- where the income from a cross staple arrangement is, or is attributable to, a capital gain that arises because an operating entity acquires an asset from the asset entity.

[Schedule 1, item 7, subsections 12-440(3), (4), (5), (6) and (8) in Schedule 1 to the TAA 1953]

The third party rent exception

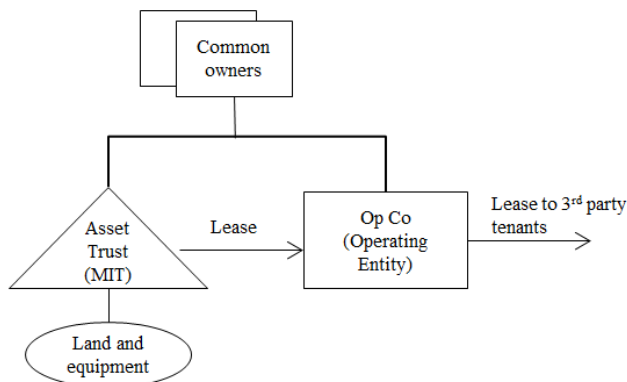
1.55 An amount that is attributable to a cross staple arrangement will *not* be MIT cross staple arrangement income of a MIT to the extent that it is attributable to an amount of rent from land investment that is derived, received or made by a stapled entity in relation to the cross staple arrangement from an entity that is not a stapled entity in relation to the cross staple arrangement. *[Schedule 1, item 7, subsection 12-440(3) in Schedule 1 to the TAA 1953]*

1.56 An amount of rent is ***rent from land investment*** if it is derived or received from investments in land (including investments in certain moveable property that are specified in subsection 102MB(1) of the ITAA 1936). *[Schedule 1, item 8, definition of ‘rent from investment in land’ in subsection 995-1(1) of the ITAA 1997]*

1.57 If an operating entity derives a combination of third party income that is rent from land investment and other income then, to the

extent that cross staple rent received by the asset entity from the operating entity is not attributable to that third party rent from land investment, the amount will be MIT cross staple arrangement income.

Example 1.5: Amount attributable to cross staple arrangement



Asset Trust owns land and certain ancillary safety equipment, being moveable property that is taken to be an investment in land under section 102MB of the ITAA 1936.

Asset Trust leases both the land and equipment in their entirety to Op Co in consideration for payments of rent. This arrangement is a cross staple arrangement entered into by Asset Trust (an asset entity) and Op Co (an operating entity).

Op Co enters into a sub-lease agreement with a third party tenant. Under the terms of this agreement, Op Co also sub-leases the safety equipment to the tenant. This is to ensure that the tenant can safely access and utilise the land.

Op Co has no other income or expenses (other than the cross staple lease payment).

The rent received by the Asset Trust will not be MIT cross staple arrangement income as it is wholly attributable to rent from land investment (comprising of rent payments for the use of both land and moveable property) that is derived by Op Co (a stapled entity in relation to the cross staple arrangement) from a third party tenant (that is, an entity that is not a stapled entity in relation to the cross staple arrangement).

The de minimis exception

1.58 An amount from a cross staple arrangement, or that is attributable to a cross staple arrangement, will *not* be MIT cross staple arrangement income of a MIT if the de minimis exception in section 12-445 applies. [Schedule 1, item 7, subsection 12-440(4) in Schedule 1 to the TAA 1953]

1.59 If a MIT is an asset entity in relation to the income year and is a stapled entity in relation to a cross staple payment, the de minimis exception applies for an income year to the MIT's direct MIT cross staple arrangement income if the amount of the direct MIT cross staple arrangement income for the previous income year did not exceed five per cent of the MIT's assessable income (disregarding any net capital gains) for that previous income year. *[Schedule 1, item 7, paragraph 12-440(4)(a), subsections 12-445(1), (3) and (4) in Schedule 1 to the TAA 1953]*

1.60 If the MIT was not a MIT in the previous income year (because it did not exist or was a trust that was not a MIT), the MIT can work out whether the de minimis exception applies based on reasonable estimates of MIT cross staple arrangement income, assessable income and total assessable income for the current income year. *[Schedule 1, item 7, subsections 12-445(6) and (7) in Schedule 1 to the TAA 1953]*

1.61 In addition, the de minimis exception applies to amounts of MIT cross staple arrangement income which a MIT receives indirectly through a lower tier trust — that is, where the MIT has an amount attributable to an amount derived, received or made by a second entity from a third entity. In these circumstances, the de minimis test will apply to the second entity (i.e. the lower tier asset entity) as if it were a MIT.

1.62 In this regard, if the second entity is an asset entity in relation to the income year and is a stapled entity in relation to a cross staple payment, the de minimis exception applies for an income year to the second entity if, assuming that the second entity were a MIT, the requirements in subsection 12-445(1) would be satisfied in relation to the second entity. In these circumstances, the de minimis exception is applied at the second entity level rather than on an aggregate basis for the MIT. *[Schedule 1, item 7, paragraph 12-440(4)(b) and subsection 12-445(5) in Schedule 1 to the TAA 1953]*

1.63 If the second entity did not satisfy the requirements in subsection 12-445(1) for the previous income year because it did not exist, subsections 12-445(6) and (7) will apply so that the second entity can work out whether the de minimis exception applies based on reasonable estimates of MIT cross staple arrangement income, assessable income and total assessable income for the current income year.

1.64 For the purposes of determining whether the de minimis exception applies in relation to an income year, subsections 12-440(4) and (5) are disregarded in working out the amount of MIT cross staple arrangement income of the asset entity (that is, the MIT or the second entity as the case may be) for the previous year. *[Schedule 1, item 7, subsection 12-445(2) in Schedule 1 to the TAA 1953]*

1.65 Therefore, if an entity has an amount that would have been MIT cross staple arrangement income in the previous income year and the

de minimis exception or the approved economic infrastructure facility exception did not apply to the entity in that previous income year, that amount will be taken into account as MIT cross staple arrangement income for the purposes of applying the de minimis exception in the current income year.

1.66 If the de minimis exception applies to a MIT, any amount that is attributable to a cross staple arrangement will *not* be MIT cross staple arrangement income of the MIT. *[Schedule 1, item 7, subsection 12-440(4) in Schedule 1 to the TAA 1953]*

Example 1.6: Application of the de minimis exception

Asset Trust and Op Co are stapled entities. Asset Trust is a MIT.

In the current year, Asset Trust has cross staple rental income from Op Co of \$60.

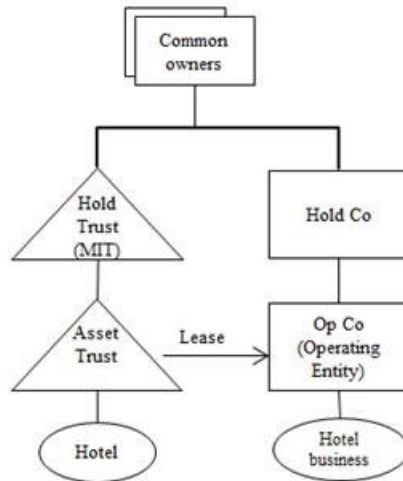
In the previous income year, Asset Trust had cross staple rental income from Op Co of \$45.

Asset Trust's total assessable income in the previous year (disregarding any net capital gain) was \$1,000.

For that income year, the percentage of income attributable to cross staple arrangement income was 4.5 per cent of assessable income.

Because Asset Trust's MIT cross staple arrangement income did not exceed 5 per cent of its assessable income in the previous income year, the de minimis exception will apply so that the amount of cross staple rent (\$60) will not be MIT cross staple arrangement income of the MIT in the current income year.

Example 1.7: Application of the de minimis exception where MIT receives a distribution from a trust that has a cross staple arrangement



Hold Trust is a MIT that owns all of the units in Asset Trust.

Asset Trust (which is not a MIT) and Op Co are stapled entities in relation to a cross staple lease arrangement. Asset Trust is a second entity mentioned in section 12-440.

In the 2020-21 income year:

- Asset Trust received \$70 of cross staple rental income from Op Co; and
- Hold Trust, which is presently entitled to all of the income of Asset Trust, includes \$70 in its assessable income — this amount will be MIT cross staple arrangement income unless the de minimis exception in paragraph 12-440(4)(b) is satisfied.

As Asset Trust is a second entity in relation to a cross staple arrangement, the de minimis exception is applied to Asset Trust (subsection 12-445(5)), rather than on an aggregate basis for the MIT.

To determine whether the de minimis exception applies to the MIT cross staple arrangement income of Asset Trust, it is necessary to consider the amount of the Asset Trust’s MIT cross staple arrangement income and assessable income for the previous income year.

In the 2019-20 income year:

- Asset Trust received \$60 of cross staple rental income from Op Co; and
- Asset Trust’s total assessable income (disregarding any net capital gains) was \$1,000.

Therefore, for the 2019-20 income year, the percentage of MIT cross staple arrangement income for Asset Trust was 6 per cent of its assessable income (disregarding net capital gains).

As Asset Trust exceeded the de minimis exception threshold of 5 per cent in the 2019-20 income year, any MIT cross staple arrangement income for the 2020-21 income year will not be disregarded.

Consequently, when the MIT cross staple arrangement income for the 2020-21 income year flows to a foreign investor through Hold Trust, it will be non-concessional MIT income that is subject to MIT withholding at the top corporate tax rate. In this regard, it does not matter whether, on an aggregate basis, Hold Trust had less than 5 per cent of its assessable income attributable to MIT cross staple arrangement income in the 2019-20 income year.

The approved economic infrastructure facility exception

1.67 An amount that is attributable to a cross staple arrangement will *not* be MIT cross staple arrangement income of a MIT if:

- the amount is, or is attributable to, rent from land investment; and
- the approved economic infrastructure facility exception in section 12-450 applies.

[Schedule 1, item 7, subsection 12-440(5) in Schedule 1 to the TAA 1953]

1.68 The transitional rule for MIT cross staple arrangement income (which is discussed later in this Chapter) also applies to a facility. The question as to when a collection of assets comprise a facility is considered in the explanation of the operation of that transitional rule.

1.69 The approved economic infrastructure facility exception applies in relation to a fund payment of a MIT that is attributable to a cross staple payment of rent in relation to a facility at a time if:

- the facility is covered by an approval of the Treasurer that is in force at that time; and
- that time is no later than the end of the period of 15 years beginning on the day on which an asset that is part of that facility is first put to use.

[Schedule 1, item 7, subsection 12-450(1) in Schedule 1 to the TAA 1953]

1.70 This allows approved economic infrastructure projects to be held in a stapled structure and for cross staple rent from land investment to be eligible to access the 15 per cent MIT rate for a period of 15 years from the time when an asset that is part of that facility is first put to use. The facility or an asset that is part of that facility will be first put to use when

it becomes operational (even if it does not produce assessable income). At the end of the 15 year period, the cross staple rent from land investment will be MIT cross staple arrangement income.

1.71 Importantly, to access this concession, the asset entity must satisfy the usual conditions in Division 6C of Part III of the ITAA 1936 which require the investment in the infrastructure facility to be an investment in land for the purpose, or primarily for the purpose, of deriving rent.

1.72 An Australian government agency (other than the Commonwealth) may make an application to the Treasurer in respect of a particular infrastructure facility specified in the application. [*Schedule 1, item 7, subsection 12-450(2) in Schedule 1 to the TAA 1953*]

1.73 An *Australian government agency* is defined in subsection 995-1(1) of the ITAA 1997 to mean:

- the Commonwealth, a State or a Territory; or
- an authority of a Commonwealth, a State or a Territory.

1.74 The Treasurer may approve the facility specified in the application if the Treasurer is satisfied that the following criteria are met:

- the facility is an economic infrastructure facility;
- the estimated capital expenditure on the facility is \$500 million or more;
- the facility is yet to be constructed, or the facility is an existing facility that will be substantially improved;
- the facility will significantly enhance the long-term productive capacity of the economy; and
- approving the facility is in the national interest.

[*Schedule 1, item 7, subsection 12-450(3) in Schedule 1 to the TAA 1953*]

1.75 Generally, economic infrastructure will be enduring facilities that support or enable economic activity and improve national productivity in Australia.

1.76 A facility is an *economic infrastructure facility* if it is:

- transport infrastructure;
- energy infrastructure;
- communications infrastructure;
- water infrastructure.

[*Schedule 1, items 7 and 8, subsection 12-450(4) in Schedule 1 to the TAA 1953 and the definition of 'economic infrastructure facility' in subsection 995-1(1) of the ITAA 1997*]

1.77 Examples of economic infrastructure facilities may include:

- electricity distribution networks;
- toll road networks; and
- ports used to transport goods.

1.78 Examples of facilities that would not typically be economic infrastructure include:

- a mining operation; and
- a water facility built for use by a single commercial business.

1.79 The Treasurer's approval may apply to a new facility or to the substantial improvement of an existing facility.

1.80 In determining whether a facility (or a substantial improvement to a facility) will significantly enhance the long-term productive capacity of the economy, the Treasurer may consider whether:

- the economic benefits resulting from the facility (or the substantial improvement) outweighs, or will outweigh, the economic costs; and
- in the opinion of Infrastructure Australia, the facility is nationally significant infrastructure within the meaning of the *Infrastructure Australia Act 2008*.

1.81 The Treasurer may also consult with other Commonwealth Government departments and agencies to assess whether a facility (or a substantial improvement to a facility) will significantly enhance the long-term productive capacity of the economy.

Example 1.8: Substantial improvement to a facility

An application is made by a State Government to the Treasurer for the approved economic infrastructure facility exception.

The application relates to a proposed expansion of an existing port facility which is projected to result in:

- a significant increase in the port's capacity; and
- a significant extension of the life of the port.

The estimated capital expenditure on the substantial improvement is \$650 million.

The proposed \$650 million expansion of the port facility relates to a substantial improvement of an economic infrastructure asset. Therefore, the Treasurer may approve the proposed substantial improvement of the facility if the Treasurer is satisfied it meets the relevant criteria.

1.82 The Treasurer's approval of an economic infrastructure facility must be in writing, must specify the facility that is approved, must specify the date on which the approval comes into force and may contain any other information the Treasurer considers appropriate. *[Schedule 1, item 7, subsection 12-450(5) in Schedule 1 to the TAA 1953]*

1.83 The Treasurer may publish an approval of a particular facility in any way that the Treasurer considers appropriate. *[Schedule 1, item 7, subsection 12-450(6) in Schedule 1 to the TAA 1953]*

1.84 If the Treasurer decides not to approve a facility, the Treasurer must notify the applicant of the decision in writing as soon as practicable after making the decision. *[Schedule 1, item 7, subsection 12-450(7) in Schedule 1 to the TAA 1953]*

1.85 If the approved economic infrastructure facility exception applies to a facility, any amount that is attributable to a cross staple arrangement and that is rent from land investment will not be MIT cross staple arrangement income of a MIT. *[Schedule 1, item 7, subsection 12-440(5) in Schedule 1 to the TAA 1953]*

1.86 That is, the approved economic infrastructure facility exception applies only in respect of MIT cross staple arrangement income that is attributable to rent from land investment arising from cross staple arrangements. It does not apply to other cross staple arrangements (for example, a total return swap) entered into in respect of the infrastructure facility or to MIT trading trust income.

1.87 In addition, although a facility may be an economic infrastructure facility, the facility would need to include an interest in land that is capable of giving rise to rent in order to benefit from the exception.

1.88 New section 25-115 of the ITAA 1997 provides a specific deduction to an operating entity that has entered into a cross staple lease in respect of an approved infrastructure facility for rent it pays to the asset entity for the duration of the concession period, provided certain conditions are met.

1.89 In this regard, an entity that is an operating entity in relation to the cross staple arrangement can deduct an amount, for an income year, of rent from land investment if:

- another entity derives, receives or makes an amount of rent from land investment from the operating entity in the income year;
- the rent from land investment is derived or received on or after 27 March 2018;
- the cross staple arrangement was entered into in relation to an asset that is part of an approved economic infrastructure facility throughout the income year;

- the amount of rent from land investment from the operating entity is attributable to the asset;
- the other entity is an asset entity in relation to the cross staple arrangement;
- apart from subsection 25-115(1), the operating entity could otherwise deduct the amount under subsection 8-1 of the ITAA 1997; and
- each of the stapled entities that are party to the cross staple arrangement have made a choice in relation to the cross staple arrangement.

[Schedule 1, item 1, subsection 25-115(1) of the ITAA 1997]

1.90 A choice that is made under paragraph 25-115(1)(f) of the ITAA 1997:

- must be made by the entity in the approved form before the start of the income year in which the asset is first put to use or such later time as is allowed by the Commissioner;
- must be given by the entity to the Commissioner within 60 days after the entity makes the choice; and
- is irrevocable.

[Schedule 1, item 1, subsections 25-115(2) and (3) of the ITAA 1997]

1.91 The choice will only need to be made by the entities who are the parties to the cross staple arrangement in relation to the approved economic infrastructure facility that gives rise to rent from land investment. This will be the operating entity which incurs the rent and the asset entity which derives the rent.

1.92 Entities that make this choice will be subject to additional integrity rules to safeguard against aggressive cross-staple pricing arrangements during the concession period. Exposure draft legislation for these rules is currently being developed and will be released shortly.

The MIT trading trust income exception

1.93 An amount that is attributable to a cross staple arrangement will *not* be MIT cross staple arrangement income of a MIT to the extent that it is, or is attributable to, MIT trading trust income of the MIT. *[Schedule 1, item 7, subsection 12-440(6) in Schedule 1 to the TAA 1953]*

1.94 However, MIT trading trust income is non-concessional MIT income of the MIT under the MIT trading trust income rules (section 12-460) which are discussed later in this Chapter.

1.95 Arrangements such as a cross staple lease between an asset entity and an operating entity that is a trading trust will be MIT cross staple arrangement income, rather than MIT trading trust income. This is because the rental income received by the MIT (or indirectly flowing to the MIT from a second entity which has a cross staple arrangement) from the trading trust does not arise because of the total participation interest held by the MIT.

The capital gains exception

1.96 An amount that is attributable to a cross staple arrangement will *not* be MIT cross staple arrangement income of a MIT to the extent that it is attributable to a capital gain that is made in an income year by an asset entity because:

- an operating entity acquires an asset from the asset entity; and
- the asset entity and the operating entity are stapled entities in relation to the cross staple arrangement.

[Schedule 1, item 7, subsections 12-440(7) and (8) in Schedule 1 to the TAA 1953]

Example 1.9: MIT cross staple arrangement income that is attributable to a capital gain

Asset Trust and Op Co are stapled entities.

Asset Trust is a MIT that owns a building that has been held for rental purposes.

Asset Trust sells the building to Op Co for \$10 million (at market value).

The capital gain made by Asset Trust on disposal of the building to Op Co (the second entity) will not be MIT cross staple arrangement income because of the capital gains exception.

MIT trading trust income

1.97 The MIT trading trust income rules ensure that distributions from a trading trust to a MIT (either directly or indirectly through a chain of flow-through entities) are treated as non-concessional MIT income and subject to MIT withholding at the top corporate tax rate.

1.98 A MIT will have an amount of MIT trading trust income in relation to an income year if:

- the MIT has an amount of assessable income for that income year;
- the amount of assessable income is, or is attributable to, an amount that is derived, received or made from a separate entity (the second entity) — in this case, the second entity

will generally make a payment of the amount (directly or indirectly through, for example, interposed trusts) to the MIT; and

- the amount of assessable income is not an amount that is not a fund payment of a MIT — these amounts include:
 - dividends, interest and royalties;
 - capital gains in relation to a CGT asset that is not taxable Australian property; and
 - amounts which are not Australian sourced income.

[Schedule 1, item 7, subsection 12-460(1) in Schedule 1 to the TAA 1953]

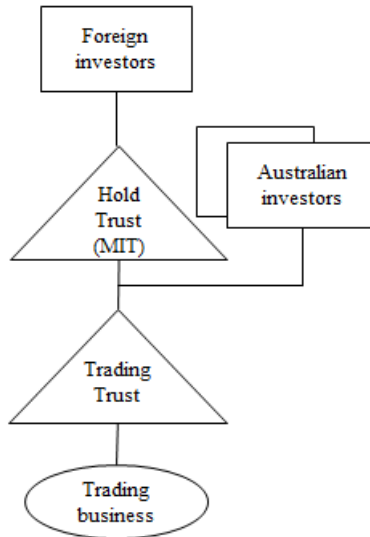
1.99 The amount will be **MIT trading trust income** of the MIT if:

- the MIT holds a total participation interest (as defined in section 960-180 of the ITAA 1997) in the second entity of greater than nil;
- the amount arises because of that total participation interest;
- the second entity is:
 - a trading trust in relation to the income year — a *trading trust* is defined in section 102N of the ITAA 1936 to mean, broadly, a unit trust that carries on trading business (that is, business other than eligible investment business) or that controls, directly or indirectly, the affairs or operations of another entity that carries on trading business; or
 - a partnership or a trust that is not a unit trust that, if it was a unit trust throughout the income year, would be a trading trust; and
- the second entity is *not* a public trading trust in relation to the income year.

[Schedule 1, items 7 and 8, subsection 12-460(2) in Schedule 1 to the TAA 1953 and the definition of ‘MIT trading trust income’ in subsection 995-1(1) of the ITAA 1997]

1.100 An amount constitutes MIT trading trust income under section 12-460 to the extent that a MIT receives distributions directly, or indirectly through interposed entities, from a trading trust (or another entity which would be a trading trust if it were a unit trust) because these amounts represent trading profits, and therefore are taxed at the top corporate tax rate.

Example 1.10: Distributions from trading trusts



Trading Trust is a trading trust (as defined in section 102N of the ITAA 1936). As it is not a public unit trust under section 102P, it is taxed on a flow-through basis under Division 6 of Part III.

For the income year ended 30 June 2020, Trading Trust has net income of \$1000 consisting of services income and a capital gain on the sale of a parcel of land.

Hold Trust is a MIT and holds 10 per cent of the units in Trading Trust. For the 30 June 2020 income year, Hold Trust is presently entitled to 10 per cent of the net income of Trading Trust, and therefore includes \$100 in its assessable income.

The \$100 of assessable income is non-concessional MIT income for Hold Trust.

MIT agricultural income

1.101 The MIT agricultural income rules ensure that amounts of assessable income of a MIT that are attributable to an asset (whether or not held by the MIT) that is Australian agricultural land for rent are treated as non-concessional MIT income and subject to MIT withholding at the top corporate tax rate.

1.102 **MIT agricultural income** includes amounts of assessable income of a MIT to the extent that they are attributable to an asset (whether or not held by the MIT) that is Australian agricultural land for rent. [Schedule 1, items 7 and 8, subsection 12-465(2) of Schedule 1 to the TAA 1953

and the definition of ‘MIT agricultural income’ in subsection 995-1(1) of the ITAA 1997]

1.103 **Australian agricultural land for rent** is an asset that is real property situated in Australia if the asset:

- is used, or could reasonably be used, for carrying on a primary production business; and
- is held primarily for the purposes of deriving or receiving rent.

[Schedule 1, items 7 and 8, subsection 12-465(6) of Schedule 1 to the TAA 1953 and the definition of ‘Australian agricultural land for rent’ in subsection 995-1(1) of the ITAA 1997]

1.104 Agricultural land held by an entity that is used by that entity to carry on a primary production business would not constitute Australian agricultural land for rent. However, if agricultural land was held in a trust not primarily for the purposes of deriving rent, the MIT trading trust income rules may apply.

Example 1.11: Agricultural land left vacant

A MIT holds land that is leased to a third party who previously used it for a dairy farm. Although the milking station and the shed are still standing, there are no more cows on the land. The land is left vacant by the tenant due to a recent drop in milk prices.

The land is Australian agricultural land for rent because it could reasonably:

- be used for carrying on another primary production business; and
- be held by the MIT primarily for the purposes of deriving rent.

The rental income, and any gain made on the disposal of the land, is MIT agricultural income as it will be attributable to Australian agricultural land for rent. This remains the case even if the future purchaser intends to use the land for non-primary production business.

1.105 MIT agricultural income includes capital gains on certain membership interests held by an entity. This applies where:

- the entity (the holding entity) holds a membership interest in another entity (the test entity) — the holding entity may or may not be the MIT;
- the test entity holds an asset that is Australian agricultural land; and
- the holding entity makes a capital gain because a CGT event happens to the membership interest.

[Schedule 1, item 7, subsection 12-465(3) of Schedule 1 to the TAA 1953]

1.106 In these circumstances, the capital gain is taken to be attributable to the asset that is Australian agricultural land for rent provided that the membership interest passes a modified version of the principal asset test in section 855-30 of the ITAA 1997 immediately before that time. The modification requires references to *taxable Australian real property* in the test to be treated as if they are references to *Australian agricultural land for rent*. [Schedule 1, item 7, subsection 12-465(4) and (5) of Schedule 1 to the TAA 1953]

1.107 An interest will pass the standard principal asset test if the combined market value of all the assets of the test entity that are taxable Australian real property exceed the combined market value of all of its other assets.

1.108 An entity will satisfy the modified principal asset test if the sum of the market values of all of the assets that are both Australian agricultural land for rent and taxable Australian real property (or membership interests that are treated as such) exceed the value of all of the entity's other assets.

Example 1.12: Sale of indirect interests in agricultural land

A MIT is the sole unit holder of Trust X. The trustee of Trust X is the sole unit holder of Trust A and Trust B. The MIT sells its interest in Trust X.

Trust A holds only agricultural land that is leased to a third party who uses the land to operate an agricultural business. The market value of the agricultural land assets held by Trust A at the time of sale is \$80 million.

Trust B holds only commercial properties that are leased to a third party. The market value of the commercial properties held by Trust B at the time of sale is \$20 million.

As references in section 855-20 of the ITAA 1997 to *taxable Australian real property* are instead taken to be references to an asset that is *Australian agricultural land for rent*, units in Trust X will pass the principal asset test in section 855-30.

This is because 80 per cent of the asset of Trust X is made up of its interest in Trust A, which is treated as having the same character (Australian agricultural land for rent) as its underlying assets.

Therefore, when the MIT sells its units in Trust X, all of the capital gain is MIT agricultural income.

1.109 Effectively, both capital gains arising from the disposal of a membership interest in a test entity and the assessable income of other entities ultimately attributable to such gains will be MIT agricultural income if:

- the assets of the test entity are principally Australian agricultural land for rent; and

- the entity holding the interest has a substantial interest in the underlying assets (see subsection 855-30(4) of the ITAA 1997).

MIT residential housing income

1.110 The MIT residential housing income rules ensure that amounts of assessable income of a MIT that are attributable to an asset (whether or not held by the MIT) that is residential housing (other than affordable housing) are treated as non-concessional MIT income and subject to MIT withholding at the top corporate tax rate.

1.111 **MIT residential housing income** is defined as any assessable income of a MIT to the extent it is attributable to an asset that is:

- a dwelling;
- taxable Australian real property; and
- residential premises but not commercial residential premises.

[Schedule 1, items 7 and 8, subsections 12-470(1) and (2) of Schedule 1 to the TAA 1953 and the definition of 'MIT residential housing' in subsection 995-1(1) of the ITAA 1997]

1.112 MIT residential housing income includes all amounts of the assessable income of a MIT attributable to such assets (such as rent, capital gains and licence fees).

1.113 However, an amount is not MIT residential housing income to the extent it is referable to times when a dwelling was used to provide affordable housing. *[Schedule 1, item 7, subsection 12-470(6) in Schedule 1 to the TAA 1953]*

Example 1.13: MIT residential housing and income from mixed use developments

MWT is a MIT that has an interest in a mixed use residential development, consisting of a number of units.

The units are dwellings, residential premises (but not commercial residential premises) and taxable Australian real property. Some but not all of the units in the development are used to provide affordable housing.

Amounts of the assessable income of MWT that are attributable to the units that are not used to provide affordable housing are MIT residential housing income. Fund payments attributable to those amounts are subject to MIT withholding tax at a rate equal to the top corporate tax rate (currently 30 per cent).

However, amounts of the assessable income of MWT that are attributable to the units that are used to provide affordable housing are not MIT residential housing income. Fund payments attributable to

those amounts are subject to MIT withholding tax at the existing rate (usually 15 per cent).

Dwelling

1.114 The first requirement for income to be MIT residential housing income is that it must be attributable to an asset that is a dwelling. In this context, dwelling takes its existing meaning in the income tax law. *[Schedule 1, item 7, paragraph 12-470(2)(a) in Schedule 1 to the TAA 1953]*

1.115 *Dwelling*, as defined in section 118-115 of the ITAA 1997, includes:

- a building (for example a house) or part of a building (for example an apartment or townhouse) that consists wholly or mainly of accommodation; and
- any land immediately under the unit of accommodation.

1.116 It also includes certain adjacent land that, together with the land under the dwelling, does not exceed two hectares, and adjacent structures (for example, a storeroom, shed or garage).

Taxable Australian real property

1.117 The second requirement for income attributable to a dwelling to be MIT residential housing income is that the dwelling must be taxable Australian real property. *[Schedule 1, item 7, paragraph 12-470(2)(b) in Schedule 1 to the TAA 1953]*

1.118 The term *taxable Australian real property* is defined in section 855-20 of the ITAA 1997 to include, relevantly, real property situated in Australia (including a lease of land, if the land is situated in Australia).

1.119 This requirement reflects that the policy of the Government relates to residential housing in Australia rather than in other jurisdictions.

Residential premises

1.120 The third requirement for income attributable to an asset to be MIT residential premises income is that the asset must be residential premises. *[Schedule 1, item 7, paragraph 12-470(2)(c) in Schedule 1 to the TAA 1953]*

1.121 The term *residential premises* is defined in subsection 995-1(1) of the ITAA 1997 as having the same meaning as in the GST Act. Section 195-1 of the GST Act provides that the term *residential premises* means land or a building that:

- is occupied as a residence or for residential accommodation;
or

- is intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation.

1.122 The definition specifies that land or a building that meets these requirements is residential premises regardless of the term of the occupation or intended occupation. It also specifies that residential premises includes a floating home.

1.123 Due to its use in the GST law, this defined term is already the subject of considerable judicial scrutiny and interpretative guidance. Broadly, land or a building will be residential premises if it provides, at a minimum, shelter and basic living facilities and is either occupied by a person or designed for occupation. This is to be ascertained by an objective consideration of the character of the property — the purpose for which an entity may hold the property is not relevant.

1.124 Residential premises need only be suitable for occupation, rather than long-term occupation — it includes, for example, a room that may only be suitable for short term accommodation. However, it does not include things that people may occupy that are not land or a building, such as a caravan or mobile home.

1.125 While caravans, houseboats and other mobile homes are included in the definition of dwelling for CGT purposes, they are not residential premises and are outside the scope of this measure.

Commercial residential premises

1.126 However, even if an amount of income is attributable to a dwelling that is residential premises, it will not be MIT residential housing income if the dwelling is commercial residential premises. [*Schedule 1, item 7, paragraph 12-470(2)(c) in Schedule 1 to the TAA 1953*]

1.127 The term *commercial residential premises* is defined as having the same meaning as in the GST Act. Section 195-1 of the GST Act defines *commercial residential premises* as:

- a hotel, motel, inn, hostel or boarding house;
- premises used to provide accommodation in connection with a school;
- a ship that is mainly let out on hire in the ordinary course of a business of letting ships out on hire;
- a ship that is mainly used for entertainment or transport in the ordinary course of a business of providing ships for entertainment or transport;
- a marina at which one or more of the berths are occupied, or are to be occupied, by ships used as residences;

- a caravan park or a camping ground; or
- anything similar to residential premises described in the preceding dot points.

1.128 The definition of commercial residential premises expressly excludes premises to the extent that they are used to provide accommodation to students in connection with an educational institution that is not a school. For further information about commercial residential premises refer to Goods and Services Tax Taxation Ruling GSTR 2012/6 — Goods and services tax: commercial residential premises.

1.129 The exclusion of commercial residential premises reflects the intention of the amendments to remove tax advantages for MITs investing in dwellings suitable for use as housing.

Providing affordable housing

1.130 An amount of income attributable to an asset will not be MIT residential housing income to the extent that it is referable to the use of the asset to provide affordable housing. [*Schedule 1, item 7, subsection 12-470(6) in Schedule 1 to the TAA 1953*]

1.131 The circumstances in which a dwelling is used to *provide affordable housing* are defined in section 980-5 in item 3 of Schedule 3 to the Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018 which is currently before the Parliament.

1.132 Broadly, to satisfy this definition for a day, an asset must be tenanted or available to be tenanted under the management of an eligible community housing provider and that provider must have issued the owner with a certificate covering the asset for the relevant period. The tenants or occupants must also not hold an interest of more than 10 per cent in the MIT.

1.133 Where an asset is used to provide affordable housing and for other income producing purposes, only the amount of income that results from providing affordable housing is excluded from being MIT residential income.

Capital gains from assets used to provide affordable housing

1.134 If an amount of assessable income is attributable to a capital gain, it will only be treated as being referable to the use of the dwelling to provide affordable housing if the asset has been used to provide affordable housing for least 3,650 days. The days must occur after 1 July 2017 but before the CGT event and do not need be consecutive. [*Schedule 1, item 7, subsections 12-470(7) and (8) in Schedule 1 to the TAA 1953*]

Indirect income

1.135 MIT residential housing income includes all amounts included in a MIT's assessable income that are attributable to assets that meet the requirements of the definition. This can include amounts a MIT receives, whether directly or indirectly, if those amounts are ultimately attributable to the use of a relevant asset by that entity or another entity.

1.136 This will be the case even if the MIT has an amount of assessable income that is ultimately attributable to income from such an asset that has passed through a number of intermediaries.

1.137 This ensures that the same outcome applies to all amounts of assessable income of a MIT that are ultimately attributable to a dwelling that is residential premises but not commercial residential premises.

Example 1.14: MIT residential housing income

A MIT holds an interest in Trust A, which holds an interest in Trust B.

Trust B derives income that is:

- attributable to a dwelling that is residential premises (but not commercial residential premises); and
- is not used to provide affordable housing.

Therefore, any amount included in the assessable income of the MIT as a result of a distribution from Trust A that is attributable to the income from the dwelling received by Trust B is MIT residential housing income.

Capital gains from membership interests

1.138 Special rules apply when working out if a capital gain or an amount attributable to a capital gain is attributable to a dwelling that is taxable Australian real property and residential premises if the capital gain occurs because a CGT event happens to a membership interest that an entity (the holding entity) holds in another entity (the test entity).

1.139 Such gains are treated as being attributable to such an asset only if, immediately before the time the CGT event occurs, the interest would pass the principal asset test in section 855-30 of the ITAA 1997 if the references in that section to *taxable Australian real property* instead referred to assets for which any attributable income would be MIT residential housing income of a MIT. [*Schedule 1, item 7, subsections 12-470(3), (4) and (5) in Schedule 1 to the TAA 1953*]

1.140 An interest passes the standard principal asset test if the market values of all the assets of the test entity that are taxable Australian real property exceed the market value of all of its other assets. Assets that are a

membership interest in another entity may be treated as wholly or partly taxable Australian real property if the other entity holds assets that are taxable Australian real property (including because of this rule).

1.141 An entity passes the modified principal asset test if the sum of the market values of all of the assets that are dwellings, taxable Australian real property and residential premises (but not commercial residential premises) exceed the value of all of the entity's other assets. [*Schedule 1, item 7, subsection 12-470(5) in Schedule 1 to the TAA 1953*]

1.142 Effectively, a capital gain relating to membership interests in another entity will be treated as being attributable to a dwelling that is taxable Australian real property and residential premises (but not commercial residential premises) to the extent that the underlying assets of the entity are such assets or membership interests to which these rules would apply (provided that the entity holding the membership interest has a substantial interest in the underlying assets — see subsection 855-30(4) of the ITAA 1997).

1.143 As a result, capital gains arising from the disposal of a membership interest in another entity, as well as the assessable income of other entities ultimately attributable to such gains, are MIT residential housing income if the assets underlying the value of the entity are principally residential premises in Australia.

Example 1.15: Membership interests and residential premises

MIT Q is the sole unit holder of Trust X.

The trustee of Trust X is the sole unit holder of Trust A and Trust B.

Trust A's only assets are dwellings that are residential premises (but not commercial residential premises) and taxable Australian real property, that are not used to provide affordable housing. The market value of Trust A's assets is \$80 million.

Trust B's only assets are commercial properties that are leased to a third party. The market value of Trust B's assets is \$20 million.

As Trust X's interest in Trust A constitutes 80 per cent of its assets, MIT Q's interest in Trust X passes the modified principal asset test. This is because:

- Trust X's interest in Trust A makes up more than 50 per cent of its assets; and
- under the principal asset test, this interest is treated as having the same character as the underlying assets.

Passing the modified principal asset test means that MIT Q's entire interest in Trust X is treated as being an asset that is a dwelling, taxable Australian real property and residential premises but not commercial residential premises.

Accordingly, when MIT Q disposes its units in Trust X, the whole amount of any gain is MIT residential housing income. Fund payments attributable to this amount are subject to MIT withholding tax at a rate equal to the top corporate tax rate (currently 30 per cent).

Application and transitional provisions

1.144 The amendments made by Schedule 1 to this Exposure Draft Bill apply to a fund payment made by a MIT in relation to an income year if:

- the fund payment is made on or after 1 July 2019; and
- the income year is the 2019-20 income year or a later income year.

[Schedule 1, item 9, subitem (1)]

1.145 The amendments also apply for the purposes of working out the MIT cross staple arrangement income of a MIT for a previous income year as mentioned in section 12-445 in Schedule 1 to the TAA 1953 — that is, for the purposes of applying the de minimis exception for MIT cross staple arrangement income. *[Schedule 1, item 9, subitem (2)]*

1.146 Therefore, for fund payments made in relation to the 2019-20 income year, the de minimis exception that applies to MIT cross staple arrangement income may be available if, in the 2018-19 income year, the amount of notional cross staple arrangement income of the relevant test entity would not have breached the de minimis thresholds set out in section 12-445 in Schedule 1 to the TAA 1953.

1.147 Transitional rules apply to fund payments attributable to existing investments. If the transitional rules apply, the existing MIT withholding tax rate of 15 per cent will continue to apply until broadly:

- for MIT cross staple arrangement income relating to a facility that is not an economic infrastructure facility — 1 July 2026;
- for MIT cross staple arrangement income relating to a facility that is an economic infrastructure facility — 1 July 2034;
- for MIT trading trust income — 1 July 2026;
- for MIT agricultural income — 1 July 2026; and
- for MIT residential housing income — 1 October 2027.

1.148 The amendment to allow an entity that is an operating entity in relation to a cross staple lease of an approved economic infrastructure facility to deduct an amount of rent from land investment for an income year (in item 1 of Schedule 1) applies in relation to an amount of rent

from land investment that is derived or received in relation to the 2019-20 income year or a later income year. *[Schedule 1, item 9, subitem (3)]*

1.149 Under the transitional rules, an entity that is an operating entity in relation to the cross staple lease of a transitional facility can deduct an amount of rent from land investment. This amendment applies to cross staple lease payments made on or after 27 March 2018. *[Schedule 1, item 10, subitem (4)]*

Transitional rules — MIT cross staple arrangement income

1.150 Transitional rules apply in relation to MIT cross staple arrangement income that is attributable to a facility that existed or is sufficiently committed to at the time of announcement of the measure.

1.151 These transitional rules will also cover future expansions and enhancements where assets are added to an existing facility to improve or extend its functionality. However, an assessment will need to be made on a case by case basis as to whether the additions or enhancements form part of the existing facility or are a new facility. If the new assets are a new facility in their own right, that new facility will not benefit from the transition rules.

Application of the transitional rules

1.152 The MIT cross staple arrangement income transitional rules apply if:

- before 27 March 2018, an Australian government agency:
 - decided to approve the acquisition or creation of a facility;
 - publicly announced that decision; and
 - took significant preparatory steps to implement that decision;
- either:
 - a cross staple arrangement has been entered into in relation to the facility before 27 March 2018; or
 - it is reasonable (as at 27 March 2018) to conclude that a cross staple arrangement will be entered into in relation to the facility;
- all the entities that will be stapled entities in relation to the cross staple arrangement already exist before 27 March 2018; and
- each entity that is a stapled entity in relation to the cross staple arrangement, or that will become a stapled entity in

relation to the cross staple arrangement, has made a choice to apply the transitional rule.

[Schedule 1, item 10, subitem (1)]

1.153 The MIT cross staple arrangement income transitional rules will also apply if:

- either:
 - an entity entered into a contract before 27 March 2018 in respect of the acquisition or creation of a facility; and/or
 - an entity holds a facility at a time before 27 March 2018;
- either:
 - a cross staple arrangement has been entered into by that entity in relation to the facility before 27 March 2018; or
 - it is reasonable to conclude that a cross staple arrangement will be entered into by that entity in relation to the facility;
- all the entities that will be stapled entities in relation to the cross staple arrangement already exist before 27 March 2018; and
- each entity that is a stapled entity in relation to the cross staple arrangement, or that will become a stapled entity in relation to the cross staple arrangement, has made a choice to apply the transitional rule.

[Schedule 1, item 10, subitem(2)]

1.154 A choice that is made under subitem 10(1) or (2):

- must be made by the entity in the approved form no later than 30 June 2019 or such later time as is allowed by the Commissioner;
- must be given by the entity to the Commissioner within 60 days after the entity makes the choice; and
- is irrevocable.

[Schedule 1, item 10, subitems (6) and (7)]

1.155 The choice will need to be made by the entities who are the parties to the cross staple arrangement giving rise to rent from land investment. This will be the operating entity which incurs the rent and the asset entity which derives the rent.

1.156 Entities that make this choice will be subject to additional integrity rules to safeguard against aggressive cross-staple pricing

arrangements during the concession period. Exposure draft legislation for these rules is currently being developed and will be released shortly.

Example 1.16: Is an option a contract in respect of the acquisition of a facility?

An entity entered into a call option to purchase an infrastructure facility before 27 March 2018. The call option provides the entity with an option, but not the obligation, to purchase the infrastructure facility.

The option is valid until 30 June 2018, but had not been exercised at 27 March 2018. The holder of the option exercised their rights to acquire the infrastructure facility on 1 June 2018 and the infrastructure facility became the subject of a cross staple lease.

The option agreement is not a contract in respect of the acquisition of the infrastructure facility.

The transitional rules will not apply to MIT cross staple arrangement income attributable to the infrastructure facility.

1.157 A facility is a collection of assets that are connected and together perform a particular function such as, for example, an infrastructure facility or a property facility. In determining whether a collection of assets together comprise a facility, regard should be had to:

- whether the assets are functionally interconnected;
- whether the assets give rise to a separately identifiable revenue stream;
- the legal rights of the parties in respect of the assets — such as:
 - the scope of any existing and proposed lease agreement;
 - the applicable regulatory framework; and
 - any applicable licence or concession arrangements;
- whether the financial viability of assets that existed at the transition time are dependent on the expansions or enhancements that occur to the facility after the transition time; and
- any other factors that are relevant in the circumstances of a particular case.

1.158 The question as to whether a collection of assets comprise a facility must be determined taking into account all of the facts and circumstances of a particular case.

1.159 The list of factors above provides guidance as to matters that should be considered in determining whether a collection of assets together comprise a facility. None of the factors are determinative. It is

possible that in some cases one or more of the factors may not be present or do not assist in the relevant determination.

Amount will not be MIT cross staple arrangement income

1.160 If the MIT cross staple arrangement income transitional rules apply to a MIT, an amount derived, received or made by the MIT will not be MIT cross staple arrangement income of the MIT if:

- the amount is, or is attributable to, an amount derived, received or made from another entity (the second entity);
- the amount relates to an asset that is part of the facility;
- the second entity is a stapled entity in relation to the cross staple arrangement;
- either:
 - if the MIT is an asset entity in relation to the income year and is a stapled entity in relation to the cross staple arrangement — the amount is rent from land investment paid from an operating entity to the MIT; or
 - if the second entity is an asset entity in relation to the income year and is a stapled entity in relation to the cross staple arrangement — the amount is attributable to rent from land investment paid from an operating entity to the second entity; and
- the time when the amount was derived, received or made by the MIT meets the timing requirements in subitem 10(5).

[Schedule 1, item 10, subitem (3)]

1.161 The renewal of a lease agreement, covering the same facility and between the same parties, during the applicable transitional period would not be expected to create a new cross staple arrangement.

Deduction for cross staple arrangement payments

1.162 If the MIT cross staple arrangement income transitional rules apply, an entity that is an operating entity in relation to the cross staple arrangement can deduct, for an income year, an amount of rent from investment in land if:

- another entity derives or receives the amount from the operating entity at a time that:
 - is in the income year;
 - is on or after 27 March 2018; and
 - meets the timing requirements in subitem 10(5);

- the amount is attributable to an asset that is part of a facility;
- the other entity is an asset entity in relation to the cross staple arrangement; and
- apart from subitem 10(4), the operating entity could otherwise deduct the amount under subsection 8-1 of the ITAA 1997.

[Schedule 1, item 10, subitem (4)]

Timing requirements

1.163 Where the facility to which the cross staple arrangement relates is *not* an economic infrastructure facility, the timing requirements are met if the time is both:

- before 1 July 2031; and
- before the later of:
 - 1 July 2026; and
 - the end of the 7 year period beginning on the day upon which an asset that is a part of the facility is first put to use for the purpose of producing assessable income.

[Schedule 1, item 10, paragraph (5)(a)]

1.164 Where the facility to which the cross staple arrangement relates is an economic infrastructure facility, the timing requirements are met if the time is both:

- before 1 July 2039; and
- before the later of:
 - 1 July 2034; and
 - the end of the 15 year period beginning on the day upon which an asset that is a part of the facility is first put to use for the purpose of producing assessable income.

[Schedule 1, item 10, paragraph (5)(b)]

1.165 Therefore, if the facility that qualifies under the MIT cross staple arrangement income transitional rules is an existing facility that is already in use and is currently producing income, the transitional rules apply to an amount that is derived, received or made before:

- if the facility is an economic infrastructure facility — 1 July 2034;
- otherwise — 1 July 2026.

1.166 If the facility that qualifies under the MIT cross staple arrangement income transitional rules is currently being constructed, or

construction of the facility has not yet commenced, the transitional rules will apply to an amount that is derived, received or made after the time that an asset that is a part of the facility is first put to use and starts producing assessable income and:

- if the facility is an economic infrastructure facility — before the earlier of:
 - 1 July 2039; and
 - the end of the 15 year period beginning on the day upon which an asset that is a part of the facility is first put to use for the purpose of producing assessable income;
- otherwise — before the earlier of:
 - 1 July 2031; and
 - the end of the 7 year period beginning on the day upon which an asset that is a part of the facility is first put to use for the purpose of producing assessable income.

Examples of the operation of the MIT cross staple arrangement income transitional rules

Example 1.17: Enhancement to an existing, non-income producing facility

In June 2017, stapled entities entered into a contract with the State Government to acquire and expand an existing un-tolled public highway.

The arrangement involved:

- the asset entity acquiring a long term lease from the State Government over the highway; and
- the asset entity sub-leasing the highway to the operating entity which runs the toll road business.

In July 2025, the expansion is completed and the toll road becomes operational and starts to earn assessable income.

The expansion is an enhancement to the existing facility because:

- the expansion is functionally connected to the existing un-tolled road;
- the revenue stream generated from the enhancement to the road is not separately identifiable from the existing road; and
- the legal arrangements support this outcome.

As at 27 March 2018, the facility (the un-tolled road) is an existing economic infrastructure facility that has never been used to produce assessable income.

As a result, the transitional period for the facility will:

- commence on 1 July 2025; and
- cease on 1 July 2039 — as this is the earlier of the date listed in paragraph 10(5)(b) and the end of the period of 15 years beginning on the day on which the toll road is first put to use for the purpose of producing assessable income.

Example 1.18: Enhancements to an existing income producing facility

Prior to and on 27 March 2018:

- Electricity Network Trust (Asset Trust) and Electricity Network Co (Operating Entity) are parties to a cross staple arrangement;
- Asset Trust has a leasehold interest in land on which there is an existing electricity network; and
- Operating Entity:
 - leases that land from Asset Trust and operates a business of providing electricity, in accordance with a project deed with the State Government; and
 - holds certain other tangible assets that are required to operate the electricity network.

The project deed requires Operating Entity to provide services to a set standard and to a set geographical area. The project deed does not specify the enhancements to the network that may be required to satisfy obligations under the project deed. The total revenue that can be generated from the electricity network is regulated.

The electricity network is an economic infrastructure facility that:

- existed before 27 March 2018;
- was held in a cross staple arrangement; and
- has previously been used to produce assessable income.

As a result, the transitional period will commence on 1 July 2019 and end on 1 July 2034.

In 2025, the State Government announces the development of a new suburb, and construction commences. Asset Trust incurs costs of expanding the existing electricity network to the new suburb (which is within the Operating Entity's geographical area). Under the arrangement between the Asset Trust and Operating Entity, the rent

that Asset Trust charges to Operating Entity is based on the value of the regulated facility base (which includes the value of any enhancements).

The new assets are functionally interconnected to the existing electricity network and are built to satisfy obligations that are inherently linked to the delivery of the services provided by the existing network. Therefore, network connections to the new suburb are enhancements to the existing electricity network facility.

Cross staple rent paid in respect of the extension will be able to access the transitional treatment until 1 July 2034.

Example 1.19: Enhancement of a facility

Hotel Asset Trust is party to a cross staple arrangement that includes Hotel Operating Co. Hotel Asset Trust owns a single building that has approval to operate as a hotel. Hotel Operating Co leases the hotel and has been operating a hotel business since early 2016.

The facility is eligible for a seven year transitional period, commencing on 1 July 2019 and ending on 1 July 2026.

In January 2020, the Trustee of Hotel Asset Trust and Board of Hotel Operating Co approved an expansion to the existing building to add four new floors. Hotel Operating Co intends to market the new floors as the new 'executive wing' of the Hotel once the expansion is complete. The executive wing is expected to become operational in late 2020.

The new floors are an enhancement to the existing facility that has previously been used to produce assessable income. Therefore, the rent charged on the premium wing will not be treated as MIT cross staple arrangement income until 1 July 2026.

Example 1.20: Application of transitional arrangements to a facility contracted before 27 March 2018

In May 2017, the Trustee of Hotel Asset Trust and the Board of Hotel Operating Co approved plans to add a commercial car park adjacent to the Hotel on the same block of land.

The commercial car park is separate to the car park that the hotel has for its guests and will be available for use by the public for a fee.

The car park will not be functionally interconnected with the operation of the hotel facility. The revenue stream arising from the car park will be separately identifiable.

Before 27 March 2018, Hotel Operating Co had entered into a contract with Builder Co to build the car park. Documents considered by the Trustee and the Board outline that the car park, once constructed, would be operated by Hotel Operating Co through a cross staple arrangement with the Hotel Asset Trust.

The commercial car park is a separate facility to the hotel and a new facility in relation to which a cross staple arrangement will be entered into. The commercial car park is built and first put to use for the purpose of producing assessable income on 1 January 2020.

As the facility was contracted for before 27 March 2018, transitional treatment will apply for a period of seven years, commencing on 1 January 2020.

Example 1.21: Non-concessional MIT income for a new facility

In May 2017, the Trustee of Hotel Asset Trust and the Board of Hotel Operating Co considered plans to build a new hotel adjacent to the existing Hotel (on the same block of land).

In June 2018, the Trustee enters a contract with Builder Co to build the new hotel and enters into a cross staple arrangement with Hotel Operating Co in relation to the new building.

The operation of the new hotel facility will not be functionally interconnected with the operation of the existing hotel facility. The revenue stream arising from the new hotel facility will be separately identifiable.

While the new hotel is located on the same block of land as the existing hotel, it is considered a separate and new facility, rather than an enhancement to the existing hotel facility.

As no contracts were entered into in respect of this new facility as at 27 March 2018, any cross staple rent relating to the hotel will be treated as MIT cross staple arrangement income — that is, it will not receive the benefit of the transitional rule.

Transitional rules — MIT trading trust income

1.167 Transitional rules apply in relation to MIT trading trust income that is attributable to assets that exist at the time of announcement of the measure.

- 1.168 The MIT trading trust income transitional rules apply if:
- a MIT would have an amount of MIT trading trust income (the relevant amount) for an income year disregarding this transitional rule;
 - immediately before 27 March 2018, the MIT held a total participation interest in the second entity of an amount (the pre-announcement TPI amount) greater than nil; and
 - the amount was derived, received or made by the MIT before 1 July 2026.

[Schedule 1, item 11, subitem (1)]

1.169 If a MIT held all of its total participation interests in the second entity immediately before 27 March 2018, the MIT trading trust income transitional rules apply so that all of the relevant amount is taken not to be MIT trading trust income and will continue to be subject to the concessional 15 per cent MIT withholding rate for the specified period. *[Schedule 1, item 11, subitems (2), (3) and (5)]*

1.170 If a MIT acquires new participation interests in the second entity on or after 27 March 2018, the MIT trading trust income transitional rules apply so that a part of the relevant amount is taken not to be MIT trading trust income and will continue to be subject to the concessional 15 per cent MIT withholding rate for the specified period. The relevant part is worked out using the following formula:

$$\frac{\text{Pre-announcement TPI amount}}{\text{Post-announcement TPI amount}}$$

[Schedule 1, item 11, subitems (2), (3) and (4)]

1.171 The pre-announcement TPI amount is the amount of the total participation interests held by the MIT in the second entity immediately before 27 March 2018. *[Schedule 1, item 11, paragraph (1)(b)]*

1.172 The post-announcement TPI amount is the amount of the total participation interests held by the MIT in the second entity at the end of the most recent income year ending before it derived, received or made the relevant amount. *[Schedule 1, item 11, subitem (4)]*

Example 1.22: Transitional rules for trading trusts

Investment Trust (a MIT) owns 10 per cent of the units in Trading Trust (a trading trust) immediately before 27 March 2018. This represented a 10 per cent total participation interest in Trading Trust.

On 1 July 2019, Investment Trust acquired an additional 5 per cent of the units in Trading Trust. As a result, the total participation interest held by Investment Trust in Trading Trust is increased to 15 per cent.

Trading Trust is a flow-through trust at all times (as it is not a public unit trust under Division 6C of Part III of the ITAA 1936).

On 30 June 2020, Investment Trust received a distribution of \$45 from Trading Trust which it included in its assessable income. In the absence of the transitional rule, this entire amount would be MIT trading trust income for Investment Trust.

The transitional rule is relevant in working out whether the amount is MIT trading trust income for Investment Trust because:

- Investment Trust held a total participation greater than nil immediately before 27 March 2018; and
- the distribution was received before 1 July 2026.

In this regard, only 67 per cent of the assessable distribution is eligible for the transitional relief under the MIT trading trust income transitional rules because:

- Investment Trust's pre-announcement TPI amount was 10 per cent; and
- Investment Trust's post-announcement TPI amount was 15 per cent.

Consequently, for Investment Trust:

- \$30 of the assessable distribution will be eligible for the transitional relief (and will not be MIT trading trust income); and
- \$15 of the assessable distribution will be MIT trading trust income.

Transitional rules — MIT agricultural income

1.173 Transitional rules apply so that an amount is not treated as MIT agricultural income of a MIT if:

- an amount is included in the assessable income of the MIT;
- the amount would be MIT agricultural income (disregarding the transitional rule) of the MIT because it is attributable to an asset that is Australian agricultural land for rent;
- the asset was held just before 27 March 2018 by an entity (whether or not the MIT);
- that entity held the asset throughout the period that started just before 27 March 2018 and ended when the MIT derived, received or made the amount;
- if the asset was held by another entity, the MIT had a participation interest in the entity for the whole of that period; and
- the MIT derived, received or made the amount before 1 July 2026.

[Schedule 1, item 12]

1.174 The MIT agricultural income transitional rule ensures that assessable income derived from investments in Australian agricultural land for rent held, directly or indirectly, as at 27 March 2018 (the date of announcement for this measure) will not be treated as MIT agricultural income until 1 July 2026.

Transitional rules — MIT residential housing income

1.175 Transitional rules apply so that an amount is not treated as MIT residential housing income of a MIT if:

- an amount is included in the assessable income of the MIT;
- the amount would be MIT residential housing income of the MIT disregarding this transitional rule;
- the asset was held just before 4.30 pm (by legal time in the Australian Capital Territory) on 14 September 2017 by an entity (whether or not the MIT);
- that entity held the asset throughout the period that started just before 4.30 pm (by legal time in the Australian Capital Territory) on 14 September 2017 and ended when the MIT derived, received or made the amount;
- if the asset was held by another entity, the MIT had a participation interest in the entity for the whole of that period; and
- the MIT derived, received or made the amount before 1 October 2027.

[Schedule 1, item 13]

1.176 The MIT residential housing income transitional rules ensure that entities directly or indirectly holding residential premises when details of this measure were first announced have a 10 year transitional period before the measure applies to their existing assets.

Chapter 2

Thin capitalisation

Outline of chapter

2.1 Schedule 2 to this Exposure Draft Bill amends the ITAA 1997 to improve the integrity of the income tax law by modifying the thin capitalisation rules to prevent double gearing structures.

2.2 All references in this Chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

2.3 The thin capitalisation rules (Division 820) apply to foreign controlled Australian entities, Australian entities that operate internationally and foreign entities that operate in Australia. In the case of an entity that is not an ADI, the rules operate to, broadly, deny deductions for debt financing expenses if the entity's debt exceeds certain limits (and the entity is therefore thinly capitalised). These limits are determined by reference to the greater of a 'safe harbour' debt amount, a 'worldwide gearing' debt amount and an 'arm's length' debt amount.

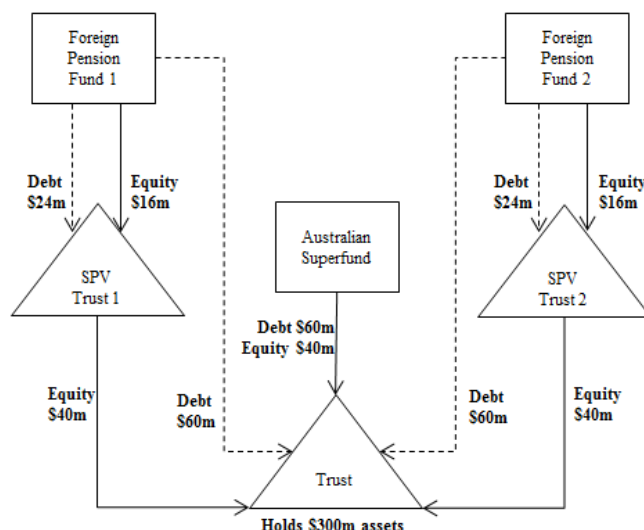
2.4 Foreign investors are increasingly entering into 'double gearing' structures that allow them to convert more of their active business income to interest income that is subject to interest withholding tax of 10 per cent, or less in certain circumstances.

2.5 Double gearing structures involve multiple layers of flow-through holding entities (trusts or partnerships) that each issue debt against the same underlying asset. This allows investors to provide a greater proportion of their capital as investor debt and gear higher than the thin capitalisation limits allow. As a result, investors are able to maintain and deduct higher levels of debt financing expenditure.

2.6 The 'associate entity' provisions in Subdivision 820-I are intended to prevent double gearing by requiring grouping of associate entities (essentially where there is a controlling interest of 50 per cent or more) when working out each entity's debt limits under the thin capitalisation rules, including its limit under the safe harbour debt amount. Broadly, these rules look to the underlying assets of the entity and under the safe harbour debt amount, allow gearing of up to 60 per cent of those underlying assets, effectively preventing re-gearing of the same underlying assets using layers of entities (that is, cascading equity).

2.7 It is common in some sectors for consortiums to provide funding through a combination of equity and debt. These investors typically have controlling interests of 20 per cent to 40 per cent and therefore fall below the 50 per cent threshold. Consequently, these investors are able to minimise tax through double gearing.

Example 2.1: Double gearing in relation to the safe harbour debt amount



SPV Trust 1, SPV Trust 2 and Trust are subject to the thin capitalisation rules. All monetary values reflect the values of the relevant assets, debt and equity at each measurement day in a period in accordance with Subdivision 820-G.

Trust holds \$300 million of assets (that are not interests in other entities). Therefore, the safe harbour debt amount should be \$180 million (60 per cent of \$300 million).

SPV Trust 1 and SPV Trust 2 have direct control interests in Trust of 33.33 per cent each. This is below the 50 per cent or more threshold for Trust to constitute an associate entity for SPV Trust 1 and SPV Trust 2. Therefore, the interests held by SPV Trust 1 and SPV Trust 2 in Trust do not give rise to associate entity equity.

Consequently, the safe harbour debt amount for both SPV Trust 1 and SPV Trust 2 is \$24 million (60 per cent of \$40 million).

Through the insertion of the SPV Trusts, the Foreign Pension Funds are able to inject an additional \$48 million of debt into the structure, and claim interest deductions for that debt (because the debt levels in SPV Trust 1, SPV Trust 2 and Trust are within their respective safe harbour debt amounts). This is despite no change in the level of the underlying assets (that are not interests in other entities).

2.8 To address this concern, the Government is improving the integrity of the income tax law by lowering the associate entity threshold under the thin capitalisation rules from 50 per cent or more to 10 per cent or more (where they apply to determine associate entity debt, associate entity equity and the associate entity excess amount) for interests in trusts and partnerships. This will prevent foreign investors from using multiple layers of flow-through entities to convert trading income into favourably taxed interest income.

Summary of new law

2.9 Schedule 2 to this Exposure Draft Bill amends the ITAA 1997 to improve the integrity of the income tax law by modifying the thin capitalisation rules to prevent double gearing structures.

2.10 For the purposes of determining associate entity debt, associate entity equity and the associate entity excess amount under the thin capitalisation provisions, a trust (other than a public trading trust) or partnership will be an associate entity of another entity if that other entity holds an associate interest of 10 per cent or more in that trust or partnership.

2.11 In addition, in determining the arm's length debt amount, an entity must consider the debt to equity ratios in entities that are relevant to the considerations of an independent lender or borrower.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
For the purposes of determining associate entity debt, associate entity equity and the associate entity excess amount under the thin capitalisation provisions, a trust (other than a public trading trust) or partnership will be an associate entity of another entity if that other entity holds an associate interest of 10 per cent or more in that trust or partnership.	For the purposes of determining associate entity debt, associate entity equity and the associate entity excess amount under the thin capitalisation provisions, a trust or partnership is an associate entity of another entity if that other entity holds an associate interest of 50 per cent or more in that trust or partnership.
In determining the arm's length debt amount, an entity must consider the debt to equity ratios in entities that are relevant to the considerations of an independent lender or borrower.	No equivalent.

Detailed explanation of new law

2.12 Schedule 2 to this Exposure Draft Bill amends the ITAA 1997 to improve the integrity of the income tax law by modifying the thin capitalisation rules to prevent double gearing structures.

2.13 To achieve this, the amendments modify the operation of the thin capitalisation associate entity test (section 820-905) for the purposes of determining:

- associate entity debt (section 820-910);
- associate entity equity (section 820-915); and
- the associate entity excess amount (section 820-920).

[Schedule 2, item 3, subsection 820-905(2B)]

2.14 The modifications apply if the first entity mentioned in paragraph 820-905(1)(a) or (2A)(a) is a trust (other than a public trading trust) or a partnership. *[Schedule 2, item 3, subsection 820-905(2B)]*

2.15 The amendments do not affect the operation of the thin capitalisation associate entity test for corporate limited partnerships (because of section 94K of the ITAA 1936).

2.16 The effect of the modifications is to:

- lower the thin capitalisation associate entity test from 50 per cent or more to 10 per cent or more; and
- ensure that subsection 318(5) of the ITAA 1936 is disregarded — as a result, a public unit trust (other than a public trading trust) will be taken to be a trust for the purposes of applying the thin capitalisation associate entity test.

[Schedule 2, item 3, paragraphs 820-905(2B)(a) and (c)]

2.17 In addition, as an integrity measure, the other entity mentioned in paragraph 820-905(1)(a) or (2A)(a) is taken as holding an associate interest in the first entity of 10 per cent or more if:

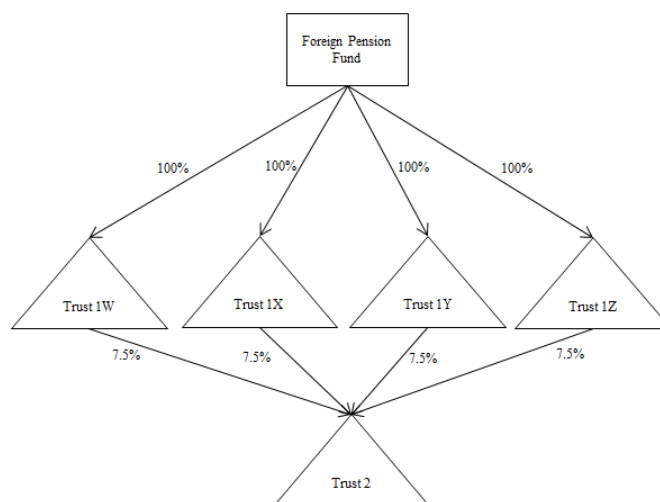
- that other entity actually holds an associate interest in the first entity of less than 10 per cent; and
- it is reasonable to conclude that an entity created this circumstance for the principal purpose of, or for more than one principal purpose that included the purpose of, ensuring that the first entity will not be an associate entity of the other entity.

[Schedule 2, item 3, paragraph 820-905(2B)(b) and subsection 820-905(2C)]

2.18 The principal purpose of an entity is one of the main purposes of the entity having regard to all the facts and circumstances. This recognises that an entity can have a number of purposes when entering into an arrangement, some or all of which are principal purposes.

2.19 Therefore, where there is a principal purpose of ensuring that the first entity will not be an associate entity of the other entity and a principal purpose of achieving a particular commercial objective, the principal purpose test would be met.

Example 2.2: An entity that is treated as holding an associate interest of 10 per cent or more



Foreign Pension Fund wishes to acquire an investment in Trust 2 in Australia, alongside other investors. The investment is set up such that Foreign Pension Fund has a 100 per cent direct control interest in each of Trusts 1W, 1X, 1Y and 1Z.

Each of those trusts have a 7.5 per cent direct control interest in Trust 2 and are subject to the thin capitalisation rules.

One of the principal purposes of setting up the investment in this way is to ensure that Trust 2 will not be an associate entity of Trusts 1W, 1X, 1Y and 1Z (as they each have a direct control interest below the 10 per cent threshold).

In this situation, paragraph 820-905(2B)(b) and subsection 820-905(2C) would apply so that Trust 2 is deemed to be an associate entity of Trusts 1W, 1X, 1Y and 1Z for the purposes of determining associate entity debt, associate entity equity and the associate entity excess amount.

2.20 Finally, if a trust (other than a public trading trust) is a partner in a partnership and another entity (the benefiting entity) benefits under the trust (as determined under paragraph 318(6)(a) of the ITAA 1936), then in

determining whether two entities are associates of each other, the benefiting entity is taken to be a partner in the partnership. *[Schedule 2, item 3, paragraph 820-905(2B)(d) and subsection 820-905(2D)]*

Example 2.3: Impact of the amendments on double gearing in relation to the safe harbour debt amount

Assume the facts are the same as for Example 2.1.

Subsection 820-905(2B) ensures that the direct control interests of 33.33 per cent held by each of SPV Trust 1 and SPV Trust 2 in Trust will give rise to associate entity equity.

SPV Trust 1 and SPV Trust 2 will need to reduce the average value of their assets by the average value of the associate entity equity. This means the safe harbour debt amounts for both SPV Trust 1 and SPV Trust 2 are nil.

The safe harbour debt amount for Trust remains \$180 million.

2.21 In response to the changes to the thin capitalisation associate entity provisions, investors may attempt to double gear by calculating a thin capitalisation arm's length debt amount (section 820-105 for an outward investing entity that is not an ADI and section 820-215 for an inward investing entity that is not an ADI).

2.22 For the purposes of determining the arm's length debt amount, regard must be had to the factors specified in subsections 820-105(3) and 820-215(3).

2.23 To safeguard against investors attempting to double gear in this way, the amendments clarify that, for the purposes of determining the arm's length debt amount, the debt to equity ratios of any entities in which the entity has a direct or indirect interest is a factor that must also be taken into account, to the extent the interest is relevant and material to the considerations of both a prudent independent borrower and a prudent independent lender. *[Schedule 2, items 1 and 2, subparagraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv)]*

2.24 Under this factor, the ability of relevant investments of the entity to act as security (or asset backing) to support the entity's debt is determined taking into account the burden of any debt claims the investments already have against their underlying assets (whether held directly or indirectly through further interposed entities). This would be customary in third party lending due diligence assessments.

2.25 All of the relevant factors specified in subsections 820-105(3) and 820-215(3) must be taken into account in determining the arm's length debt amount. However, this does not mean that every single factor will have a material impact on the quantum of the arm's length debt amount. Therefore, subparagraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv) do not require an assessment of direct and indirect

interests that are irrelevant or immaterial to a prudent independent borrower and lender.

2.26 The interests to be taken into account would need to be of material consideration to the borrower and lender in the context of the entity's portfolio of assets. Whether an interest is relevant in particular circumstances would depend on:

- the characteristics of the interest — that is, for example, whether the interest is a legal interest, an equitable interest, a contractual interest or an interest in possession; and
- the relative size, quality, value, significance and importance of the interest in context.

2.27 The indicators of relevance include, but are not limited to, whether:

- the interest constitutes the sole or predominate asset of the entity that secures and services the entity's debt; or
- the interest is one of many other assets of the entity but is highly valuable.

2.28 The inclusion of the new factor in paragraphs 820-105(3)(g) and 820-215(3)(g) does not affect the interpretation of the other factors that must be taken into account in determining the arm's length debt amount, but needs to be taken into account with the other factors.

Example 2.4: Consideration of the factor in subparagraph 820-215(3)(g)(iv)

Assume the facts are the same as for Example 2.1, except that SPV Trust 1 holds a range of interests in other entities and the investment in Trust is material to SPV Trust 1.

SPV Trust 1 calculates an arm's length debt amount under section 820-215. The factual assumptions under subsection 820-215(2) are applied. All the factors under subsection 820-215(3) are taken into account, including the factor in subparagraph 820-215(3)(g)(iv).

When considering the factor in subparagraph 820-215(3)(g)(iv), it is recognised that SPV Trust 1's interest in Trust is relevant to the considerations of a prudent independent borrower and a prudent independent lender in the context of the range of interests that SPV Trust 1 holds. This is because of the characteristics, size, quality, value, significance and importance of the interest in the context of SPV Trust 1's portfolio of assets.

The impact of the debt to equity ratio of Trust is taken into account. That is, the amount of debt that SPV Trust 1 can support involves looking to the level of debt held by Trust. This is because the debt held against the underlying assets impacts the inherent value and quality of SPV Trust 1's asset base that can act as security for its own debt.

This is also considered along with all the other factors in subsection 820-215(3).

Application and transitional provisions

2.29 The amendments to prevent double gearing structures through the thin capitalisation rules apply to income years starting on or after 1 July 2018. *[Schedule 2, item 4]*

Chapter 3

Superannuation funds for foreign residents withholding tax exemption

Outline of chapter

3.1 Schedule 3 to this Exposure Draft Bill amends the ITAA 1936 to improve the integrity of the income tax law to limit access to tax concessions for foreign investors by limiting the withholding tax exemption for superannuation funds for foreign residents.

3.2 All references in this Chapter are to the ITAA 1936 unless otherwise stated.

Context of amendments

3.3 A foreign resident that derives dividends or interest that is paid by an Australian resident generally has a liability to withholding tax in respect of the payment (section 128B). However, a withholding tax liability does not arise if the foreign resident is a superannuation fund for foreign residents where the income of the fund is exempt from income tax in the country in which it resides (paragraph 128B(3)(jb)). Generally, the dividends or interest are also NANE income of the superannuation fund (section 128D).

3.4 The exemption from dividend and interest withholding tax makes it very attractive for these superannuation funds to gear their Australian equity investments using investor debt to lower their overall Australian tax on the investments. Combined with a stapled structure, this exemption can result in these superannuation funds paying little Australian tax on Australian business activities.

3.5 In addition, the broad exemption from dividend and interest withholding tax puts these superannuation funds in a better financial position than other investors. For example:

- foreign corporate entities typically pay 10 per cent interest withholding tax on interest income; and
- Australian investors pay tax on interest income at their marginal tax rates.

3.6 To address these concerns, the Government has decided to limit the withholding tax exemption for superannuation funds for foreign residents to portfolio-like investments only. As a result, interest and

dividend income derived by superannuation funds for foreign residents from non-portfolio investments will be taxed.

Summary of new law

3.7 Schedule 3 to this Exposure Draft Bill amends the ITAA 1936 to improve the integrity of the income tax law to limit access to tax concessions for foreign investors by limiting the withholding tax exemption for superannuation funds for foreign residents.

3.8 Therefore, a superannuation fund for foreign residents will be liable to withholding tax on amounts of interest, dividends and non-share dividends it receives if the fund has a non-portfolio-like interest in the entity that pays the interest, dividends or non-share dividends to it.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>A superannuation fund for foreign residents will not be liable to withholding tax on amounts of interest, dividends or non-share dividends it receives from an Australian entity if:</p> <ul style="list-style-type: none"> • the income of the fund is exempt from income tax in the country in which it resides; and • the fund has a portfolio-like interest in the entity that pays the interest, dividends or non-share dividends to it. 	<p>A superannuation fund for foreign residents is not liable to withholding tax on amounts of interest, dividends or non-share dividends it receives from an Australian entity if the income of the fund is exempt from income tax in the country in which it resides.</p>

Detailed explanation of new law

3.9 Schedule 3 to this Exposure Draft Bill amends the ITAA 1936 to improve the integrity of the income tax law to limit access to tax concessions for foreign investors by limiting the withholding tax exemption for superannuation funds for foreign residents.

3.10 A *superannuation fund for foreign residents* (as defined in section 118-520 of the ITAA 1997) is, broadly, a fund that:

- is a provident, benefit, superannuation or retirement fund that is indefinitely continuing;
- is established in a foreign country;
- is established and maintained for foreign residents; and
- has its central management and control carried on outside Australia by entities that are foreign residents.

3.11 The withholding tax exemption for superannuation funds for foreign residents will be limited to interest and dividend income derived from an entity in which a superannuation fund has a portfolio-like interest – that is, where the superannuation fund does not hold an equity interest of 10 per cent or more and does not have influence in relation to the entity’s key decision making.

3.12 Consequently, a superannuation fund for foreign residents will be exempt from withholding tax on interest and dividends paid by an entity (the paying entity) under paragraph 128B(3)(jb) only if the superannuation fund:

- satisfies the portfolio interest test in subsection 128B(3CB) in relation to the paying entity:
 - at the time the payment is made; and
 - throughout any 12 month period that began no earlier than 24 months before that time and ended no later than that time; and
- does not have influence of the kind described in subsection 128B(3CC) in relation to the paying entity at the time the payment is made.

[Schedule 3, items 1 and 2, subsection 128B(3CA)]

The portfolio interest test

3.13 A superannuation fund satisfies the portfolio interest test in subsection 128B(3CB) in relation to the paying entity if the sum of the total participation interests (as defined in section 960-180 of the ITAA 1997) the superannuation fund holds in the paying entity:

- is less than 10 per cent; and
- for any non-share equity interests, would be less than 10 per cent if, in working out the direct participation interest (under section 960-190 of the ITAA 1997) that any entity holds in a company, both:
 - an equity holder were treated as a shareholder; and

- the total amount contributed to the company in respect of non-share equity interests were included in the total paid-up share capital of the company.

[Schedule 3, items 1 and 2, subsection 128B(3CB)]

3.14 This modified application of the total participation interest test ensures that, for the purpose of determining whether a superannuation fund satisfies the portfolio interest test, non-share equity interests are treated like shares in a company.

3.15 A superannuation fund for foreign residents must apply the portfolio interest test in respect of the interest it holds in the paying entity. The paying entity is the entity that makes the payment of interest or dividends to the superannuation fund — that is, it is the entity in which the superannuation fund holds the first level of its investment into Australia. Consequently, where a superannuation fund for foreign residents invests through an Australian trust, an assessment must be made of the superannuation fund’s level of interest in that trust.

The influence test

3.16 A superannuation fund has influence of the kind described in subsection 128B(3CC) in relation to the paying entity if:

- the superannuation fund, acting alone or in concert with others, is directly or indirectly able to determine the identity of at least one of the persons who, individually or together with others, make (or might reasonably be expected to make) the decisions that comprise the control and direction of the paying entity’s operations; and/or
- at least one of those persons is accustomed or obliged to act, or might reasonably be expected to act, in accordance with the directions, instructions or wishes of the superannuation fund (whether those directions, instructions or wishes are expressed directly or indirectly, or through the superannuation fund acting in concert with others).

[Schedule 3, item 2, subsection 128B(3CC)]

3.17 A superannuation fund for foreign residents must apply the influence test in respect of the influence it has in relation to the paying entity. The paying entity is the entity that makes the payment of interest or dividends to the superannuation fund — that is, the entity in which the superannuation fund holds the first level of its investment into Australia.

3.18 A superannuation fund will indirectly have influence of the kind described in the influence test where, for example, the influence or ability

to influence the tested entity is held by an Australian resident entity that is controlled by the superannuation fund.

Example 3.1: Dividend withholding tax exemption applies

FSF is a superannuation fund for foreign residents. FSF holds 8 per cent of the ordinary share capital of Aus Co.

The rights attached to the ordinary shares acquired by FSF are identical to the rights of all other ordinary shareholders in Aus Co. FSF has no capacity to influence (either directly or indirectly) Aus Co in any way outside of its basic rights as a minority holder of ordinary shares.

There are no other factors present which indicate FSF can influence Aus Co in any way.

FSF holds a total participation interest in Aus Co of less than 10 per cent and does not have influence in relation to Aus Co of the kind described in the influence test.

Therefore, any dividends paid by Aus Co to FSF will be exempt from dividend withholding tax under paragraph 128B(3)(jb).

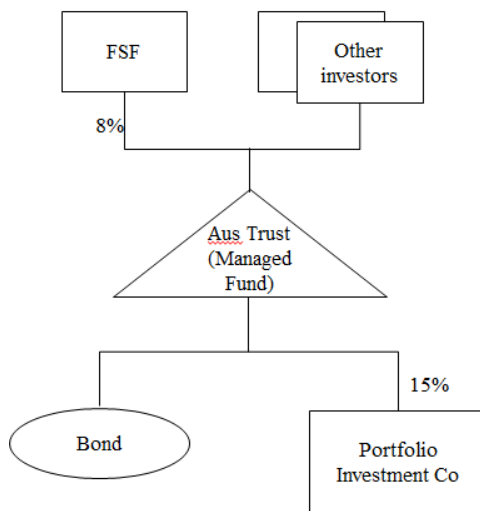
Example 3.2: Dividend income subject to withholding tax

FSF is a superannuation fund for foreign residents. FSF holds 15 per cent of the ordinary share capital of Aus Co.

FSF holds a total participation interest in Aus Co of more than 10 per cent.

Therefore, any dividends paid by Aus Co to FSF will not be exempt from dividend withholding tax under paragraph 128B(3)(jb).

Example 3.3: Dividend and interest withholding tax exemption applies



FSF is a superannuation fund for foreign residents. FSF holds 8 per cent of the issued units of Aus Trust.

The rights attached to the units acquired by FSF are identical to the rights of all other unitholders in Aus Trust. FSF has no capacity to influence (either directly or indirectly) Aus Trust in any way outside of its basic rights as a minority holder of units.

Aus Trust is a managed fund which holds two investments:

- 15 per cent of the ordinary shares in Portfolio Investment Co; and
- a bond.

There are no other factors present which indicate FSF can influence Aus Trust in any way.

FSF holds a total participation interest in Aus Trust of less than 10 per cent and does not have influence in relation to Aus Trust of the kind described in the influence test.

Therefore, any dividends (on the shares held in Portfolio Investment Co) or interest (on the bond) that flows to FSF through Aus Trust will be exempt from dividend and interest withholding tax under paragraph 128B(3)(jb).

Example 3.4: Dividend income subject to withholding tax

FSF is a superannuation fund for foreign residents. FSF holds 8 per cent of the ordinary share capital of Aus Co.

Under Aus Co's constitution, any investor with an equity interest of 8 per cent or more is entitled to appoint an individual to an Advisory Board of Aus Co. The Board of Directors of Aus Co cannot make certain decisions in relation to the control and direction of Aus Co's operations without the Advisory Board's approval.

In these circumstances, FSF has influence in relation to Aus Co of the kind described in the influence test.

Therefore, any dividends paid by Aus Co to FSF will not be entitled to a dividend withholding tax exemption under paragraph 128B(3)(jb).

Application and transitional provisions

3.19 The amendments to limit the withholding tax exemption for superannuation funds for foreign residents apply to interest, dividends and non-share dividends that are derived by a superannuation fund on or after 1 July 2019. [*Schedule 3, item 3, subitem (1)*]

3.20 A seven year transitional rule applies to assets acquired by a superannuation fund for foreign residents on or before 27 March 2018. In these circumstances, the amendments apply to interest, dividends and

non-share dividends derived from such assets on or after 1 July 2026.

[Schedule 3, item 3, subitem (2)]

Chapter 4

Sovereign immunity

Outline of chapter

4.1 Schedule 4 to this Exposure Draft Bill amends the ITAA 1936 and the ITAA 1997 to improve the integrity of the income tax law to limit access to tax concessions for foreign investors by codifying and limiting the scope of the sovereign immunity tax exemption.

4.2 All references in this Chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

4.3 Broadly, certain income and gains from Australian investments are currently exempt from Australian income tax if they are derived by a foreign government, or by a foreign entity that is wholly-owned by a foreign government (commonly known as a sovereign wealth fund).

4.4 The exemption is based on the international law doctrine of sovereign immunity (see *I Congreso del Partido* (1981) 2 All ER 1064). This international law doctrine is unclear in its application and different countries take different approaches to how the immunity is implemented in practice.

4.5 In ATO ID 2002/45, the Commissioner states that:

Certain income derived from within Australia by foreign governments is exempt from Australian tax under the international law doctrine of sovereign immunity. In accordance with that doctrine, Australia accepts that any income derived by a foreign government from the performance of governmental functions within Australia is exempt from Australian tax. An activity undertaken by a foreign Government Agency will generally be accepted as the performance of governmental functions provided that it is functions of government, provided that the agency is owned and controlled by the government and does not engage in commercial activities.

4.6 In practice, the Commissioner exempts investment income and gains derived by foreign governments and foreign government agencies from tax where:

- the monies invested are and will remain government monies; and
- the income is derived from a non-commercial activity.

4.7 In determining whether an investment in an entity is a commercial activity the Commissioner takes into account the size of the direct and indirect investment and the actual or potential influence that may be exercised in respect of the entity’s financial, operating and policy decisions.

4.8 Where the sovereign immunity tax exemption applies, the Commissioner accepts that the sovereign entity will be exempt from income tax and withholding tax.

4.9 The Government has decided to create a legislative framework for the existing tax concession for foreign governments (including sovereign wealth funds) and, among other things, limit the exemption to portfolio-like investments in certain assets.

4.10 In addition, income flowing through Australian trusts will only be able to access the sovereign immunity tax exemption if the paying trust is a MIT and the income is *not* non-concessional MIT income.

Summary of new law

4.11 Schedule 4 to this Exposure Draft Bill amends the ITAA 1936 and the ITAA 1997 to improve the integrity of the income tax law to limit access to tax concessions for foreign investors by codifying and limiting the scope of the sovereign immunity tax exemption.

4.12 An amount derived, received or made by a sovereign entity will be NANE income if, broadly:

- the amount is derived, received or made by the sovereign entity because it holds a portfolio-like membership interest, debt interest or non-share equity interest in the Australian company or MIT; and
- the sovereign entity does not have influence (either directly or indirectly) over decisions that comprise the control and direction of the operations of the Australian company or MIT.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
An amount derived, received or made by the sovereign entity will be NANE income if, broadly:	No equivalent.

- | | |
|--|--|
| <ul style="list-style-type: none"> • the amount is derived, received or made by the sovereign entity because it holds a portfolio like membership interest, debt interest or non-share equity interest in the Australian company or MIT; and • the sovereign entity does not have influence (either directly or indirectly) over decisions that comprise the control and direction of the operations of the Australian company or MIT. | |
|--|--|

Detailed explanation of new law

4.13 Schedule 4 to this Exposure Draft Bill amends the ITAA 1936 and the ITAA 1997 to codify and limit the scope of the sovereign immunity tax exemption.

What is a sovereign entity?

4.14 A sovereign entity is any entity that is:

- a body politic of a foreign country or a part of a foreign country;
- a foreign government agency; or
- a foreign resident entity in which a body politic of a foreign country or a part of a foreign country, or a foreign government agency, holds a total participation interest of 100 per cent.

[Schedule 4, items 5 and 9, section 880-15, and the definition of ‘sovereign entity’ in subsection 995-1(1)]

4.15 A *foreign government agency* is defined in subsection 995-1(1) to mean:

- the government of a foreign country or a part of a foreign country;
- an authority of the government of a foreign country; or
- an authority of the government of part of a foreign country.

4.16 A sovereign entity is liable to pay tax on its taxable income.
[Schedule 4, item 5, section 880-55]

4.17 For the purposes of applying the income tax law, a body politic of a foreign country or a part of a foreign country, or a foreign

government agency of a foreign country or a part of a foreign country, is taken to be:

- a foreign resident; and
- a resident of the foreign country.

[Schedule 4, item 5, section 880-60]

4.18 The rate of income tax payable by a sovereign entity on its taxable income is equal to the top corporate tax rate — currently 30 per cent.

What is a covered sovereign entity?

4.19 Certain income of a sovereign entity that is covered by section 880-120 (a ‘covered sovereign entity’) will be NANE income. A sovereign entity is a covered sovereign entity if:

- the sovereign entity is funded only by public monies;
- the sovereign entity is not a superannuation fund for foreign residents or a foreign superannuation fund;
- the sovereign entity is not a partnership; and
- the sovereign entity is not:
 - a public non-financial entity; or
 - a public financial entity (other than a public financial entity that only carries on central banking activities).

[Schedule 4, item 5, subsection 880-120(1)]

4.20 A *superannuation fund for foreign residents* is defined in section 118-520 to mean, broadly, a fund that:

- is a provident, benefit, superannuation or retirement fund that is indefinitely continuing;
- is established in a foreign country;
- is established and maintained for foreign residents; and
- has its central management and control carried on outside Australia by entities that are foreign residents.

4.21 A *foreign superannuation fund* is defined in subsection 995-1(1) to mean, broadly, a superannuation fund that is not an Australian superannuation fund.

4.22 A sovereign entity is a **public non-financial entity** if its principal activity is:

- producing or trading non-financial goods; and/or

- providing services that are not financial services.

[Schedule 4, items 5 and 9, subsection 880-125(2) and the definition of ‘public non-financial entity’ in subsection 995-1(1)]

4.23 A sovereign entity is a **public financial entity** if:

- the entity trades in financial assets;
- the entity operates commercially in the financial markets; and/or
- the principal activities of the entity include providing any of the following financial services:
 - financial intermediary services, including deposit-taking and insurance services;
 - financial auxiliary services, including brokerage, foreign exchange and investment management services; and/or
 - capital financial institution services, including financial services in relation to assets or liabilities that are not available on open financial markets.

[Schedule 4, items 5 and 9, paragraphs 880-125(3)(a) to (c) and the definition of ‘public financial entity’ in subsection 995-1(1)]

4.24 However, a central bank is *not* a public financial entity. Therefore, a central bank could qualify as a sovereign entity if the other conditions are satisfied. *[Schedule 4, item 5, paragraph 880-125(3)(d)]*

4.25 The definitions of public non-financial entity and public financial entity are based on concepts in the International Monetary Fund Government Finance Statistics Manual 2014.

4.26 Public non-financial entities include entities such as airline corporations, postal authorities, state water corporations and port authorities. They also include public non-profit institutions engaging in market production (such as hospitals, schools, or colleges) if they are separate institutional units and charge economically significant prices.

4.27 Public financial entities include deposit-taking corporations, financial intermediaries, financial auxiliaries and captive financial institutions.

NANE income of a covered sovereign entity — income from holding certain interests

4.28 If a sovereign entity is a covered sovereign entity, an amount of its ordinary income or statutory income is NANE income if:

- the amount is derived, received or made by the sovereign entity from an entity (the paying entity) that is either:

- an Australian resident company; or
- an Australian resident trust that is a MIT;
- the sovereign entity derives, receives or makes the amount because it holds a membership interest, a debt interest or a non-share equity interest in the paying entity;
- the sovereign entity group of which the sovereign entity is a member passes the portfolio interest test in subsection 880-105(3) in relation to the paying entity:
 - at the time the amount is derived, received or made; and
 - throughout any 12 month period that began no earlier than 24 months before that time and ended no later than that time; and
- the sovereign entity group of which the sovereign entity is a member does not have influence of the kind described in subsection 880-105(5) in relation to the paying entity at the time the amount is derived, received or made.

[Schedule 4, item 5, subsection 880-105(1)]

4.29 However, if the paying entity is a MIT in relation to the income year in which the amount is derived, received or made, the amount of ordinary income or statutory income will *not* be NANE income to the extent that:

- the amount is attributable to a fund payment; and
- the fund payment is attributable to non-concessional MIT income (including MIT cross staple arrangement income that is disregarded because of the de minimis exception, the approved economic infrastructure facility exception or the application of a non-concessional MIT income transitional rule).

[Schedule 4, item 5, subsection 880-105(2)]

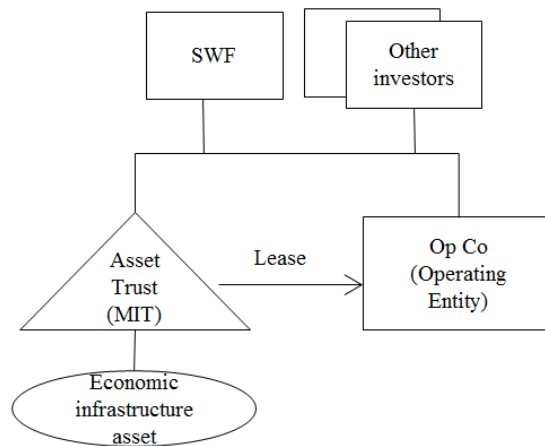
4.30 A capital gain or a gain on a revenue asset made by a covered sovereign entity will be ordinary income or statutory income that is NANE income under section 880-105 if the capital gain or revenue gain arises because the covered sovereign entity disposes of an interest in the paying entity. *[Schedule 4, item 5, section 880-115]*

4.31 Section 880-105 specifies income derived, received or made by a covered sovereign entity from qualifying investments that is treated as NANE income (and therefore exempt from withholding tax).

4.32 Broadly, the following types of ordinary income or statutory income of a covered sovereign entity may be NANE income (and therefore exempt from withholding tax):

- dividends — including non-share dividends and dividends that pass through a MIT;
- interest — including interest that passes through a MIT;
- fund payments made by a MIT (other than fund payments that are attributable to non-concessional MIT income); and
- capital gains and revenue gains made on the disposal of an interest in the paying entity — including gains that pass through a MIT.

Example 4.1: Sovereign wealth fund acquires an interest in a stapled structure



SWF is a covered sovereign entity that holds a portfolio (5 per cent) interest in:

- ordinary units in Asset Trust (which is a MIT); and
- ordinary shares in Op Co.

Asset Trust and Op Co are stapled entities that entered a cross staple arrangement in respect of an economic infrastructure facility. SWF (or other members in its sovereign entity group) have no other rights in respect of the stapled entities.

Because of the operation of the transitional rules that apply to cross stapled arrangements, the cross staple lease payments are not MIT cross staple arrangement income of Asset Trust until 1 July 2034.

SWF:

- acquired its interest in the stapled entities on 1 July 2018; and
- satisfies the portfolio interest test and the influence test in section 880-105.

Therefore, any dividends or other distributions that SWF receives on the shares it holds in Op Co will be NANE income.

In addition, any distributions that SWF receives on the units it holds in Asset Trust will be NANE income if they are not fund payments attributable to non-concessional MIT income (or MIT cross staple arrangement income that is disregarded in certain circumstances).

In this regard, the cross staple rental payments from Op Co to Asset Trust are not non-concessional MIT income until 1 July 2034 because of the MIT cross staple arrangement income transitional rule available to staples with an economic infrastructure facility (see item 10 of Schedule 1).

However, ignoring those transitional provisions, these amounts would be MIT cross staple arrangement income from 1 July 2019. Therefore, any fund payments from Asset Trust to SWF made on or after 1 July 2019 that are attributable to this cross staple rental arrangement will not be NANE income under Division 880.

Sovereign entity groups

4.33 In determining whether a covered sovereign entity can access the sovereign immunity tax exemption, the entity must consider the total level of interest and influence that it, together with its sovereign entity group, has in the investment asset.

4.34 A sovereign entity group consists of each entity that is a part of the sovereign entity group. *[Schedule 4, items 5 and 9, section 880-20 and the definition of 'sovereign entity group' in subsection 995-1(1)]*

4.35 Sovereign entities of the same foreign government will be members of the same sovereign entity group. *[Schedule 4, items 5 and 8, subsection 880-20(1) and the definition of 'member' in subsection 995-1(1)]*

4.36 Sovereign entities of the same part of a foreign government will be members of the same sovereign entity group. *[Schedule 4, items 5 and 8, subsection 880-20(2) and the definition of 'member' in subsection 995-1(1)]*

4.37 Therefore, for countries with different levels of government (such as federal and state governments, or federal, state and provincial governments):

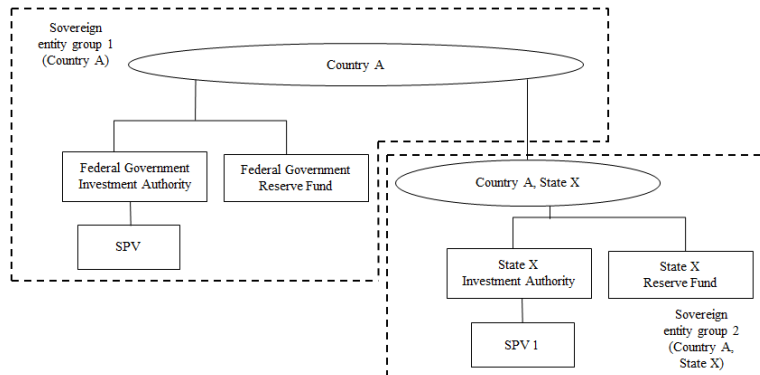
- the federal government would be considered the foreign government under subsection 880-20(1); and

- the state and provincial governments would respectively be considered separate parts of that foreign country under subsection 880-20(2).

4.38 Consequently, the grouping of the sovereign entities occurs at:

- the federal level for federal entities; and
- the state or provincial level respectively for entities that are part of the state or provisional level government.

Example 4.2: Sovereign entity groups for multiple levels of government



Country A is a country that has a federalist system of government. State X is a state of Country A.

Federal Government Investment Authority and Federal Government Reserve Fund are agencies of Country A's federal government that satisfy the requirements to be a sovereign entity.

SPV is a wholly owned entity of Federal Government Investment Authority and also satisfies the requirements to be a sovereign entity.

State X Investment Authority and State X Reserve Fund are agencies of State X of Country A that satisfy the requirements to be a sovereign entity.

SPV 1 is a wholly owned entity of State X Investment Authority and also satisfies the requirements to be a sovereign entity.

For the purposes of Division 880, there are two sovereign entity groups.

Both the Federal Government and the State Government have their own sovereign entity group.

Under subsection 880-20(1), one sovereign entity group consists of:

- the Federal Government Investment Authority;
- the Federal Government Reserve Fund; and

- SPV.

Under subsection 880-20(2), another sovereign entity group consists of:

- the State X Investment Authority;
- the State X Reserve Fund; and
- SPV 1.

Portfolio interest test

4.39 A sovereign entity group satisfies the portfolio interest test in subsection 880-105(3) in relation to the paying entity if the sum of the total participation interests (as defined in section 960-180) that each member of the sovereign entity group holds in the paying entity:

- is less than 10 per cent; and
- would be less than 10 per cent if, in working out the direct participation interest (under section 960-190) that any entity holds in a company:
 - an equity holder were treated as a shareholder; and
 - for any non-share equity interests, the total amount contributed to the company in respect of non-share equity interests were included in the total paid-up share capital of the company.

[Schedule 3, item 5, subsection 880-105(3)]

4.40 This modified application of the total participation interest test ensures that, for the purpose of determining whether a sovereign entity group satisfies the portfolio interest test, non-share equity interests are treated like shares in a company.

4.41 In working out the sum of the total participation interests held by each member of the group in the paying entity, a particular direct or indirect participation interest held in the paying entity is taken into account only once. ***[Schedule 4, item 5, subsection 880-105(4)]***

4.42 A sovereign entity group must apply the portfolio interest test in respect of the interest it holds in the paying entity. The paying entity is the entity from which the sovereign entity group derives, receives or makes an amount of ordinary income or statutory income — that is, it is the entity in which the sovereign entity group holds the first level of its investment into Australia. Consequently, where a sovereign entity invests through an Australian trust, an assessment must be made of the sovereign entity group's level of interest in that trust.

The influence test

4.43 A sovereign entity group has influence of the kind described in subsection 880-105(5) in relation to a paying entity at a time if, at that time:

- a member of the sovereign entity group, acting alone or in concert with others, is directly or indirectly able to determine the identity of at least one of the persons who, individually or together with others, make (or might reasonably be expected to make) the decisions that comprise the control and direction of the paying entity's operations; and/or
- at least one of those persons is accustomed or obliged to act, or might reasonably be expected to act, in accordance with the directions, instructions or wishes of a member of the sovereign entity group (whether those directions, instructions or wishes are expressed directly or indirectly, or through the member of the sovereign entity group acting in concert with others).

[Schedule 4, item 5, subsection 880-105(5)]

4.44 For the purposes of applying the influence test in subsection 880-105(5) in relation to a paying entity, an entity is taken to be a member of the sovereign entity group if it is a foreign resident entity in which the relevant body politic or foreign government agency holds a total participation interest of 50 per cent or more. *[Schedule 4, item 5, subsection 880-105(6)]*

4.45 A sovereign entity group will indirectly have influence of the kind described in the influence test where, for example, the influence or ability to influence the tested entity is held by an Australian resident entity that is controlled by the sovereign entity group.

4.46 A sovereign entity group must apply the influence test in respect of the influence it has in relation to the paying entity. The paying entity is the entity from which the sovereign entity group derives, receives or makes an amount of ordinary income or statutory income — that is, it is the entity in which the sovereign entity group holds the first level of its investment into Australia.

Example 4.3: Portfolio interest test satisfied

SWF is a corporate entity which is wholly-owned by a foreign government. SWF is fully funded by general tax revenue raised by the foreign government. SWF will ultimately distribute all profits made to the foreign government as dividends. SWF is a foreign resident for income tax purposes.

As part of its portfolio investments, SWF has acquired less than 1 per cent of the ordinary share capital of Listed Company. Listed

Company is an Australian resident company listed on the Australian Securities Exchange.

The rights attached to the ordinary shares acquired by SWF are identical to the rights of all other ordinary shareholders in Listed Company. SWF has no capacity to influence (either directly or indirectly) Listed Company in any way outside of its basic rights as a minority holder of ordinary shares.

SWF holds a total participation interest in Listed Company of less than 10 per cent and does not have influence in relation to Listed Company of the kind described in the influence test.

Therefore, any dividends paid by Listed Company to SWF will be NANE income under Division 880.

Example 4.4: Portfolio interest test not satisfied

SWF 1 and SWF 2 are corporate entities which are wholly-owned by the same foreign government. Both SWF 1 and SWF 2 are fully funded by general tax revenue raised by the foreign government. Both SWF 1 and SWF 2 will ultimately distribute all profits made to the foreign government as dividends. Both SWF 1 and SWF 2 are foreign residents for income tax purposes.

SWF 1 has acquired 7 per cent of the ordinary share capital of ABC Pty Ltd. SWF 2 has acquired 8 per cent of the ordinary share capital of ABC Pty Ltd.

As SWF 1 and SWF 2 are both wholly-owned by the same foreign government, they are members of the same sovereign entity group. Consequently, the total participation interest of the sovereign entity group in ABC Pty Ltd is 15 per cent.

Therefore, any dividends paid by ABC Pty Ltd to SWF 1 and SWF 2 will not be NANE income under Division 880.

Example 4.5: Portfolio interest test not satisfied

SWF is a covered sovereign entity that owns 5 per cent of the ordinary shares in Portfolio Company, an Australian resident company.

Portfolio Company has \$100 of paid-up ordinary share capital. It does not have any other classes of share on issue.

SWF holds a profit participating loan issued by Portfolio Company. The profit participating loan is non-share equity for Australian tax purposes under Division 974. The subscription amount for the profit participating note was \$20.

Other than the profit participating loan held by SWF, there are no other non-share equity interests issued by Portfolio Company.

To determine whether SWF satisfies the portfolio interest test for the purposes of Division 880, it must work out its total participation interests in Portfolio Company assuming that the total amount

contributed to the company in respect of non-share equity interests were included in the total paid-up share capital of the company.

SWF would have a total participation interest of (at least) 20 per cent by virtue of its rights to the capital in the company (taking into account the modifications in paragraph 880-105(3)(b)). That is, SWF holds \$25 of the total capital of \$120.

Therefore, SWF fails the portfolio interest test and distributions on the PPL and the ordinary shares will not be NANE income under Division 880.

Example 4.6: Influence test not satisfied

SWF is a corporate entity which is wholly-owned by a foreign government. SWF is fully funded by general tax revenue raised by the foreign government. SWF will ultimately distribute all profits made to the foreign government as dividends. SWF is a foreign resident for income tax purposes.

SWF has acquired 9.95 per cent of the equity interests in ABC Unit Trust. ABC Unit Trust is an Australian resident MIT with a small number of investors.

Under the constituent documents of ABC Unit Trust, any investor with an equity interest of 5 per cent or more is entitled to appoint an individual to an Advisory Board of ABC Unit Trust. The Board of Directors of ABC Unit Trust cannot make certain decisions in relation to the control and direction of the Trust's operations without the Advisory Board's approval.

In these circumstances, SWF has influence in relation to the ABC Unit Trust of the kind described in the influence test.

Therefore, any payments made by ABC Unit Trust to SWF will not be NANE income under Division 880.

NANE income of a covered sovereign entity — income from consular functions

4.47 If a sovereign entity is a covered sovereign entity, an amount of its ordinary income or statutory income is NANE income if that income arises from the entity's consular functions. *[Schedule 4, item 5, section 880-110]*

Liability to withholding tax

4.48 A foreign resident that derives dividends or interest that is paid by an Australian resident generally has a liability to withholding tax in respect of the payment (section 128B of the ITAA 1936). However, a withholding tax liability does not arise in relation to income that is excluded under subsection 128B(3) of the ITAA 1936.

4.49 Therefore, subsection 128B(3) of the ITAA 1936 is amended to ensure that dividend and interest income derived by a sovereign entity that

is NANE income under section 880-105 is exempt from withholding tax. *[Schedule 4, item 1, paragraph 128(3)(n) of the ITAA 1936]*

4.50 A sovereign entity may still be subject to withholding tax on dividend and interest income (at the relevant dividend or interest withholding tax rate) that is not NANE income under section 880-105. In this event, income which is subject to withholding tax will be NANE income under section 128D of the ITAA 1936.

4.51 A foreign resident that receives a fund payment from an Australian MIT is liable to MIT withholding tax in respect of the payment (section 840-805). A fund payment that is made to a sovereign entity that is NANE income under section 880-105 is not subject to MIT withholding tax. *[Schedule 4, item 4, subsection 840-805(9)]*

4.52 A sovereign entity will be subject to MIT withholding tax on a fund payment that is not NANE income under section 880-105. In this event, section 840-815 will apply so that the income which is subject to withholding tax is NANE income – as a result, tax will be payable on these amounts at the fund payment withholding tax rates rather than the corporate tax rate.

Consequential amendments

4.53 Consequential amendments are made to:

- modify the table in section 9-1 of the ITAA 1997 to add a reference to a sovereign entity — that table lists entities that must pay income tax; and
- modify the table in section 11-55 of the ITAA 1997 to add a reference to sovereign entities — that table lists provisions in the income tax law that make amounts NANE income.

[Schedule 4, items 2 and 3, sections 9-1 and 11-55]

Application and transitional provisions

4.54 The amendments to specify the boundaries for the sovereign immunity tax exemption apply to the 2019-20 income year and to later income years. *[Schedule 4, item 6, subitem (1)]*

Transitional rules to protect existing investments

4.55 Transitional rules apply to protect income and gains from existing investments of a sovereign entity for which the Commissioner provides a tax exemption under the doctrine of sovereign immunity.

4.56 To access the transitional rules, the sovereign entity must hold a positive ruling from the Commissioner in respect of an investment asset, which applies at any time between the announcement of the policy (27 March 2018) and the end of the transitional period (1 July 2026).

4.57 In addition, the circumstances of the investment asset must not materially change during the transition period. For example, if an existing investment asset (such as a loan) qualifies for the transitional rules is rolled over before 1 July 2026, the transition period would not cease to apply if all other features of the loan remain the same.

4.58 The transitional rules apply in relation to an amount of ordinary income or statutory income of a sovereign entity if:

- the amount is derived, received or made in respect of an investment asset;
- the sovereign entity acquired the investment asset on or before 27 March 2018;
- on or before that date, the sovereign entity applied for a private ruling in relation to the investment asset;
- before 1 July 2026, the Commissioner gave the sovereign entity a private ruling confirming that the investment asset was not subject to income tax or withholding tax because of the doctrine of sovereign immunity;
- the private ruling applied during at least part of the period starting on 27 March 2018 and ending before 1 July 2026 (regardless of whether the private ruling started to apply before 27 March 2018, or ceased to apply before 1 July 2026); and
- the scheme carried out is not materially different to the scheme specified in the private ruling.

[Schedule 4, item 6, paragraphs (2)(a) to (f)]

4.59 In these circumstances, the amendments will not apply in relation to that investment asset until the later of:

- the 2025-26 income year; and
- if the last income year to which the private ruling applies is a later income year than the 2025-26 income year — that later income year.

[Schedule 4, item 6, paragraph (2)(g)]

Transitional rule to reset the tax costs of assets

4.60 A transitional rule applies to reset the tax costs of assets held by a sovereign entity that currently qualify for sovereign immunity. The transitional rule applies if:

- a sovereign entity acquired an asset (other than money) on or before 27 March 2018;
- on or before that date, the sovereign entity applied for a private ruling in relation to the asset;
- before 1 July 2026, the Commissioner gave the sovereign entity a private ruling confirming that the income and gains from the asset was not subject to income tax or withholding tax because of the doctrine of sovereign immunity;
- the private ruling applied to income and gains during at least part of the period starting on 27 March 2018 and ending before 1 July 2026 (regardless of whether the private ruling started to apply before 27 March 2018, or ceased to apply before 1 July 2026);
- the sovereign entity holds the asset on the day that is the later of:
 - 1 July 2026; and
 - the day before the private ruling ceases to apply; and
- the scheme carried out is not materially different to the scheme specified in the private ruling.

[Schedule 4, item 7, subitems (1) and (5)]

4.61 If the transitional rule applies to an asset, then the sovereign entity is taken to have disposed of and re-acquired the asset, for consideration equal to the higher of its market value or cost base immediately before that sale, on the day that is the later of:

- 1 July 2026; and
- the day before the private ruling ceases to apply.

[Schedule 4, item 7, subitems (2) and (5)]

4.62 The reset tax cost for an asset may apply, for example, for the purposes of:

- working out the amount of a capital gain or capital loss that arises when a CGT event happens to the asset; or

- if the asset is a revenue asset, working out the amount that is included in, or can be deducted from, the assessable income of the sovereign entity.

[Schedule 4, item 7, subitem (3)]

4.63 In addition, if the transitional rule applies to an asset, any capital gain or capital loss, or any revenue gain or revenue loss, that is made because of the deemed disposal is disregarded. *[Schedule 4, item 7, subitem (4)]*