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PROPOSED AMENDMENTS TO DEBT/EQUITY RULES – TAX AND SUPERANNUATION LAWS AMENDMENT (DEBT AND EQUITY SCHEME INTEGRITY RULES) BILL

Thank you for the opportunity to comment on the proposed debt/equity amendments contained in the Exposure Draft (**ED**) legislation referred to above in respect of the debt / equity integrity rules, together with the associated Exposure Draft Explanatory Memorandum (**EDEM**) and the Income Tax Assessment (Debt and Equity Examples) Declaration 2016 (**ED Examples**) (together the **ED Materials**).

The Property Council is the peak body representing the interests of owners and investors in Australia's \$670 Billion property investment industry. The Property Council represents members across all four quadrants of property investment, debt, equity, public and private.

The Property Council welcomes the proposed amendments and the specific aim of addressing the uncertainty around the operation of the related scheme and section 974-80 provisions through their repeal and replacement that incorporates a new principles based provision. However, the ED Examples create new uncertainty for the property sector.

ED Examples – Part 7 and Part 8

The utility of these two examples is in question due to the facts posed in both cases.

These examples do not address the position where a stapled structure has been adopted and management is "internalised". This is the most common structure for ASX Listed real estate trusts, and is the business model that most listed property groups have adopted.

It is also common for unlisted property groups to adopt a stapled structure, but typically unlisted groups are not internally managed. These ED Examples make it unclear as to whether an internalised management structure is of itself a problem, or not. This creates undue uncertainty for the majority of the listed property trust sector, but seems to address the position for many unlisted property trusts, in circumstances where it is the listed groups that are subject to the highest level of regulation (ASX, ASIC etc).

In order to clarify the examples they need to be amended to take into account internally managed groups, and also to remove references to concepts that are both vague and irrelevant to the analysis (eg. whether rent or fees are set at arm's length).

Common features of the "internalised" management stapled structure are:

- The Company and Property Trust are stapled, and securities in the stapled group are listed and traded on the ASX;
- The trustee, also known as the Responsible Entity (**RE**), of the Property Trust is a company that holds an AFSL;
- The RE is a wholly owned subsidiary of the Company;
- The composition of the board of Directors of the Company and the RE are identical;
- Other statutory positions such as the Company Secretary and Public Officer (for tax purposes) of the Company and RE are also identical;

- Board meetings of the Company and RE are held in conjunction with each other; and
- Annual General Meetings of securityholders are also held in conjunction with each other.

This “internalised” management structure displays these features in the interests of commercial efficiency while also displaying the highest degree of good Corporate Governance. It is a typical feature that management fees charged by the Company to the Property Trust are set with a small or even no margin over cost, resulting in fees that are below the arm’s length rate that an external manager would otherwise charge.

An outcome of this structure is that the Company can control the composition of the Board of Directors of the RE.

Given that most internally managed staples are listed, the Property Trust is a registered Managed Investment Scheme (under the Corporations Act). The securityholders in exercising their rights as unitholders cannot appoint the Directors of the RE, but can exercise their vote for the removal of the RE (and the appointment of a replacement Responsible Entity).

The same securityholders, when exercising their voting rights in their capacity as shareholders in the Company, have the ability to appoint and remove Directors of the Company. Whenever there is a change in the composition of the Board of the Company the Company will typically cause there to be a corresponding change to the Board of the RE (the RE being wholly owned and therefore controlled by the Company).

The RE, nonetheless, in conducting its duties and responsibilities in its capacity as the trustee / responsible entity of the Property Trust does so in accordance with the Property Trust Constitution, Trust Law and the Managed Investment Scheme provisions of the Corporations Act always for the best interests of the Property Trust and its unitholders.

So although the Company in fact controls RE, when RE is acting in the discharge of its duties and responsibilities to Property Trust (and in turn its unitholders) it does so in satisfaction of its appointed role as RE.

Having regard to the features of an “internalised” management structure and the prevalence of this structure in the ASX Listed property trust sector, the ED Examples in Part 7 and Part 8 should be amended. We note that Part 9 would also need to be amended to ensure that comments regarding control are not inconsistent with the amended property trust examples.

Furthermore, whilst Part 9 is not a typical structure utilised in the property sector, the Property Council is concerned about understanding the weighting of the various factors and is unsure how the end conclusion is reached.

We attach a mark-up of amendments that we trust will be of assistance.

We look forward to discussing this further with you after you have had a chance to consider the submission.

Yours sincerely



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APPENDIX: TECHNICAL SUBMISSION

Appendix: Technical Submission

Part 7—Debt raised by a property trust: no aggregation

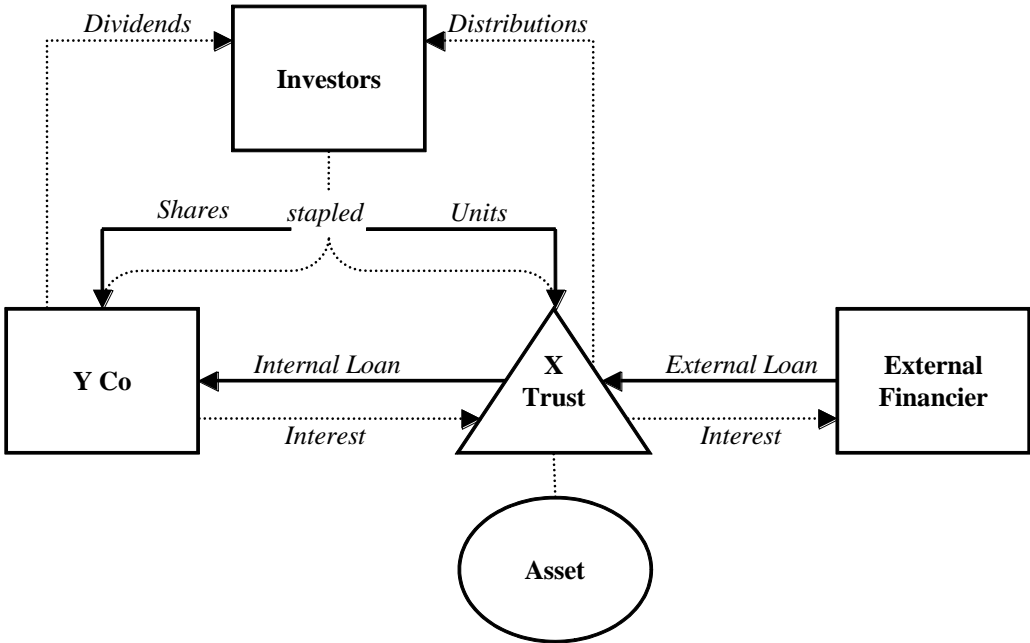
Division 1—Object, explanation of facts and assumptions

38 Object

This example focuses on the operation of the interdependence test and the design test.

39 Diagram

A diagram explaining the facts for this example is as follows:



40 X Trust

- (1) A property trust (*X Trust*) holds Australian commercial properties having a total market value of \$500 million. Units in X Trust are listed on the Australian Securities Exchange (the *ASX*).
- (2) X Trust derives rental income from leasing these properties to third parties.
- (3) ~~Under the deed constituting X trust (*X Trust's deed*), the trustee may, in its absolute discretion, distribute income or capital to some or all of X Trust's unit holders.~~
- (4) X Trust is not taxed under Division 6C of Part III of the *Income Tax Assessment Act 1936*.

41 Y Co

- (1) It is assumed for the purposes of this example, that theA company (*Y Co*) is an associated entity of X Trust.

- (2) Y Co is responsible for managing the properties held by X Trust, and for developing those properties.
- (3) X Trust pays a service fee to Y Co ~~at a market rate~~ for this property management and development.
- (4) Y Co ~~owns~~~~has no control over~~ the trustee of X Trust, and ~~no~~~~has~~ rights relating to the appointment of directors of that trustee (assuming the trustee is a body corporate).

42 The stapling agreement

- (1) The shares in Y Co are stapled to the units in X Trust under a stapling agreement.
- (2) Under the stapling agreement:
 - (a) the stapling agreement takes precedence over X Trust's deed and Y Co's constitution; and
 - (b) X Trust must not consolidate, subdivide, buy-back, cancel or otherwise reorganise its units unless there is a corresponding transaction with the shares in Y Co; and
 - (c) Y Co must not consolidate, subdivide, buy-back, cancel or otherwise reorganise its shares unless there is a corresponding transaction with the units in X Trust.
- (3) The stapling agreement and X Trust's deed are subject to the ASX's listing rules (within the meaning of Chapter 7 of the *Corporations Act 2001*).

43 Offer of stapled securities

- (1) The stapled securities are listed on the ASX and offered to investors by way of a prospectus.
- (2) Funds totalling \$50 million are raised on the issue of stapled securities.
- (3) These funds are allocated to Y Co and X Trust ~~on a reasonable basis~~~~having regard to the overall value of the 2 entities. As a result, \$30 million is allocated to X Trust and \$20 million to Y Co.~~

44 The external loan

X Trust and an independent third party (the *external financier*) enter into arrangements (the *external loan*) under which:

- (a) the external financier lends an additional \$50 million to X Trust; and
- (b) this principal of \$50 million is repayable at the end of 9 years; and
- (c) financial benefits in the form of loan interest accrue during that 9-year loan period and are payable by X Trust to the external financier at the end of that period.

45 The internal loan

X Trust and Y Co enter into an arrangement (the *internal loan*) under which:

- (a) X Trust lends \$80 million to Y Co; and
- (b) this principal of \$80 million:
 - (i) is made up of the \$30 million raised on the issue of the stapled securities and the \$50 million raised from the external loan; and
 - (ii) is repayable at the end of 9 years; and

- (c) financial benefits in the form of loan interest accrue, at a mark up on the interest rate on the external loan, during that 9-year loan period and are payable by Y Co to X Trust at the end of that period.

46 Assumptions—separate schemes exist if the aggregation rule is disregarded

- (1) Assume that, under Division 974 of the Act:
 - (a) the issuing of the shares in Y Co (as part of the stapled securities) is a scheme (the *share scheme*) that gives rise to equity interests in Y Co; and
 - (b) the issuing of the units in X Trust (as part of the stapled securities) is a separate scheme (the *unit scheme*) that does not give rise to equity interests or debt interests; and
 - (c) the external loan is a separate scheme (the *external loan scheme*) that gives rise to a debt interest in X Trust; and
 - (d) the internal loan is a separate scheme (the *internal loan scheme*) that gives rise to a debt interest in Y Co.
- (2) Disregard the aggregation rule for the purposes of these assumptions.

Division 2—Applying the aggregation rule to the schemes

47 Applying the interdependence test to the internal loan scheme, the unit scheme and the share scheme

- (1) The interdependence test is not satisfied in relation to the internal loan scheme, the unit scheme and the share scheme because the pricing, terms and conditions of one or more of these schemes:
 - (a) are not dependent on, or linked to; and
 - (b) do not operate to change the economic consequences of; the pricing, terms and conditions of any of the other schemes.

Unit scheme and the share scheme

- (2) This is the case for the unit scheme and the share scheme because \therefore

~~(a) the stapling exception in subparagraph 974-155(2)(a)(ii) of the Act will apply \therefore and~~

~~(b) Y Co does not control the trustee of X Trust (unlike the example in Part 9).~~

Internal loan scheme and the share scheme

- (3) This is the case for the internal loan scheme and the share scheme because Y Co must perform its obligations under the internal loan regardless of anything to do with the shares in Y Co (for example, repaying the internal loan is not legally contingent on whether dividends are paid on those shares).

Internal loan scheme and the unit scheme

- (4) This is the case for the internal loan scheme and the unit scheme because:
 - (a) the power of X Trust's trustee to return capital is exercisable in respect of X Trust's funds remaining after repaying X Trust's liabilities, including the external loan; and

- (b) unlike the example in Part 9, X Trust's trustee can return invested capital to X Trust's unit holders independently of any actions of Y Co.

48 Applying the interdependence test to the 4 schemes

- (1) The interdependence test is not satisfied in relation to the external loan scheme, the internal loan scheme, the unit scheme and the share scheme because the pricing, terms and conditions of one or more of these schemes:
 - (a) are not dependent on, or linked to; and
 - (b) do not operate to change the economic consequences of; the pricing, terms and conditions of any of the other schemes.
- (2) This is because X Trust must perform its obligations under the external loan regardless of:
 - (a) anything to do with the units in X Trust; and
 - (b) whether Y Co meets its obligations under the internal loan; and
 - (c) anything in the stapling agreement.

49 Applying the design test to these combinations of the schemes

- (1) The design test is not satisfied in relation to either of these combinations of the schemes:
 - (a) the internal loan scheme, the unit scheme and the share scheme; or
 - (b) the external loan scheme, the internal loan scheme, the unit scheme and the share scheme.
- (2) This is because, having regard to:
 - ~~(a) the absence of any evidence that either of these combinations of the schemes was entered into or carried out in a holistic way, with each component scheme being part of a unified whole; and~~
 - (a) the commercial manner in which the schemes were entered into; and
 - (b) normal commercial understandings and practices; and
 - (c) in the case of the combination of schemes referred to in paragraph (1)(b)—the independence of the external financier;

it would not be concluded that either of the combinations of schemes was designed to operate together to produce their combined economic effect.

Example: Normal commercial understandings and practices would treat the internal loan scheme, the unit scheme and the share scheme as separate schemes because the internal loan was only one of X Trust's many assets. So, returns of trust capital would reflect X Trust's entire net asset position, not just the value of the internal loan.

50 Conclusion

As neither the interdependence test nor the design test is satisfied, the aggregation rule does not apply to treat either of these combinations of the schemes as a single aggregate scheme:

- (a) the internal loan scheme, the unit scheme and the share scheme; or
- (b) the external loan scheme, the internal loan scheme, the unit scheme and the share scheme.

Division 3—Effect of changes to the facts

51 Changes to the facts that would not cause the aggregation rule to apply

- (1) The aggregation rule still would not apply to the internal loan scheme, the unit scheme and the share scheme if the capital funding were instead by way of a capital distribution on the shares in Y Co that:
 - (a) is compulsorily applied as an additional capital contribution to the units in X Trust held by shareholders of those shares; and
 - (b) subject to the approval of each of those shareholders.
- (2) The interdependence test would not be satisfied in relation to these 3 schemes because the pricing, terms and conditions of one or more of the schemes:
 - (a) would not be dependent on, or linked to; and
 - (b) would not operate to change the economic consequences of; the pricing, terms and conditions of any of the other schemes.
- (3) As the interdependence test would not be satisfied, it is not necessary to consider whether the design test would be satisfied in relation to these 3 schemes.
- (4) As the interdependence test would not be satisfied, the aggregation rule would not apply to treat these 3 schemes as a single aggregate scheme.

(5) The aggregation rule still would not apply to the internal loan scheme if there was no mark up on the interest rate charged on the internal loan.

(6) The aggregation rule still would not apply to the internal loan scheme if Y Co did not own the trustee of X Trust.

(7) The aggregation rule still would not apply to the internal loan scheme if Y Co has no control over the trustee of X Trust, and no rights relating to the appointment of directors of that trustee (assuming the trustee is a body corporate).

Part 8—Trust and company staple: no aggregation

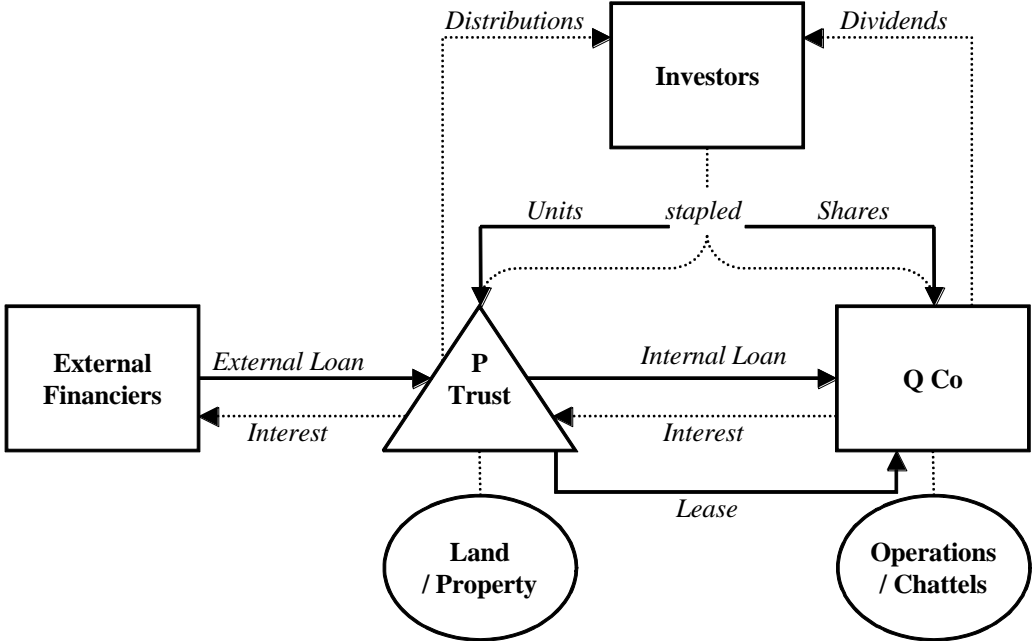
Division 1—Object, explanation of facts and assumptions

52 Object

This example focuses on the operation of the interdependence test and the design test.

53 Diagram

A diagram explaining the facts for this example is as follows:



Note 1: This example is based on project financed single-project economic infrastructure ownership models that can apply to assets such as toll roads, ports, airports and electricity generation assets.

Note 2: Shares in P Trust’s trustee company could also be included in the stapled securities, but this is not done in this example for simplicity.

54 P Trust and Q Co

- (1) A unit trust (*P Trust*), that is not a public trading trust, holds real property (with affixed improvements).
- (2) A company (*Q Co*) is formed to perform a number of operations.

Note: Q Co’s operations need not be limited to the arrangement to which this Division relates.

- (3) A wholly owned subsidiary of Q Co has no control over theis the Responsible Entity trustee of P Trust, and no rights relating to the appointment of directors of that trustee (assuming the trustee is a body corporate).

55 The stapling agreement

- (1) The shares in Q Co are stapled to the units in P Trust under a stapling agreement.
- (2) Under the stapling agreement:

- (a) the stapling agreement takes precedence over the deed constituting P Trust and Q Co's constitution; and
- (b) P Trust must not consolidate, subdivide, buy-back, cancel or otherwise reorganise any units unless there is a corresponding transaction with the shares in Q Co; and
- (c) Q Co must not consolidate, subdivide, buy-back, cancel or otherwise reorganise its shares unless there is a corresponding transaction with the units in P Trust.

56 The external loan

P Trust, Q Co and the trustee for a syndicate of independent external financiers enter into arrangements (the *external loan*) under which:

- (a) the external financiers lend \$60 million to P Trust; and
- (b) financial benefits in the form of loan interest, worked out using an arm's length interest rate, are payable periodically by P Trust to the external financiers; and
- (c) Q Co agrees not to pay dividends, or to do so only in accordance with the external loan; and
- (d) Q Co guarantees the performance of P Trust to the external financiers by Q Co providing the security and guarantees required to support its obligations to P Trust under the lease and internal loan referred to in section 57; and
- (e) the trustee for the syndicate holds the following security to support P Trust:
 - (i) unit and share mortgages over the units in the P Trust and the shares in Q Co;
 - (ii) a fixed and floating charge over all P Trust's assets and Q Co's assets.

Note 1: This means P Trust is funded by:

- (a) its units issued as part of the stapled securities; and
- (b) the \$60 million under the external loan.

Note 2: For paragraph (c), the external loan could, for example, permit paying dividends out of available post-debt service cash flows.

57 The real property lease and internal loan

- (1) P Trust and Q Co enter into a lease agreement (the *real property lease*) under which P Trust leases its real property to Q Co ~~for an arm's length rental amount.~~
- (2) P Trust and Q Co enter into a loan agreement (the *internal loan*) under which:
 - (a) P Trust lends \$20 million to Q Co; and
 - (b) this principal of \$20 million is repayable at the end of 9 years; and
 - (c) financial benefits in the form of loan interest, at a rate of 8% per annum, accrue during that 9-year loan period and are payable by Q Co to P Trust at the end of that period.

Note: This means P Trust has 2 investments:

- (a) the real property it has leased to Q Co; and
- (b) the internal loan.

58 Assumptions—separate schemes exist if the aggregation rule is disregarded

- (1) Assume that, under Division 974 of the Act:
 - (a) the issuing of the shares in Q Co (as part of the stapled securities) is a scheme (the *share scheme*) that gives rise to equity interests in Q Co; and

- (b) the issuing of the units in P Trust (as part of the stapled securities) is a separate scheme (the *unit scheme*) that does not give rise to equity interests or debt interests; and
 - (c) the external loan is a separate scheme (the *external loan scheme*) that gives rise to a debt interest in P Trust; and
 - (d) the internal loan is a separate scheme (the *internal loan scheme*) that gives rise to a debt interest in Q Co; and
 - (e) the real property lease is a separate scheme (the *lease scheme*) that does not give rise to equity interests or debt interests.
- (2) Disregard the aggregation rule for the purposes of these assumptions.

Division 2—Applying the aggregation rule to the schemes

59 Applying the interdependence test to the internal loan scheme, the unit scheme, the share scheme and the lease scheme

- (1) The interdependence test is not satisfied in relation to the internal loan scheme, the unit scheme, the share scheme and the lease scheme because the pricing, terms and conditions of one or more of these schemes:
- (a) are not dependent on, or linked to; and
 - (b) do not operate to change the economic consequences of; the pricing, terms and conditions of any of the other schemes.

Unit scheme and the share scheme

- (2) This is the case for the unit scheme and the share scheme because:

- ~~(a) the stapling exception in subparagraph 974-155(2)(a)(ii) of the Act will apply; and~~
- ~~(b) Q Co does not control the trustee of P Trust (unlike the example in Part 9).~~

Internal loan scheme and the share scheme

- (3) This is the case for the internal loan scheme and the share scheme because Q Co must perform its obligations under the internal loan regardless of anything to do with the shares in Q Co (for example, repaying the internal loan is not legally contingent on whether dividends are payable on those shares).

Note: The agreement referred to in paragraph 56(c) about not paying dividends is part of the external loan scheme, not the internal loan scheme.

Internal loan scheme and the unit scheme

- (4) This is the case for the internal loan scheme and the unit scheme because the funding exception in subparagraph 974-155(2)(a)(i) of the Act will apply. While P Trust's return on the internal loan will fund P Trust's distributions on the units in P Trust:
- (a) those distributions are not legally contingent on that return; and
 - (b) ~~such~~ a legal contingency does not form part of the terms and conditions of either the internal loan scheme or the unit scheme.

Internal loan scheme and the lease scheme

- (5) This is the case for the internal loan scheme and the lease scheme because Q Co must perform its obligations under the internal loan regardless of anything to do with the real property lease (for example, repaying the internal loan is not legally contingent on whether payments are made under the lease).

60 Applying the interdependence test to the external loan scheme and the unit scheme

- (1) The interdependence test is not satisfied in relation to the external loan scheme and the unit scheme because the pricing, terms and conditions of either of these schemes:
- (a) are not dependent on, or linked to; and
 - (b) do not operate to change the economic consequences of; the pricing, terms and conditions of the other scheme.
- (2) This is because P Trust must perform its obligations under the external loan regardless of:
- (a) anything to do with the units in P Trust; and
 - (b) whether Q Co meets its obligations under the internal loan; and
 - (c) anything in the stapling agreement.

61 Applying the interdependence and design tests to the external loan scheme and the internal loan scheme

- (1) The interdependence test is not satisfied in relation to the external loan scheme and the internal loan scheme for the reasons set out in subsections (2) and (3).
- (2) The pricing, terms and conditions of the external loan scheme:
- (a) are dependent on, or linked to; and
 - (b) operate to change the economic consequences of;
- the pricing, terms and conditions of the internal loan scheme because commitments given by Q Co under the external loan are necessary for P Trust's ability to source funds to on-lend to Q Co under the internal loan.

Note 1: The most relevant of these commitments is the agreement referred to in paragraph 56(c) about not paying dividends.

Note 2: These commitments are more than a mere taking of security, and would not fall within the exception in subparagraph 974-155(2)(a)(iv) of the Act.

- (3) However, this dependence, link or operation would not cause the schemes (if they were treated as a single aggregate scheme) to change whether Division 974 of the Act treats an interest as a debt interest or an equity interest.

Note: The single scheme would continue to give rise to debt interests in P Trust and Q Co.

- (4) The design test is not satisfied in relation to the external loan scheme and the internal loan scheme because, having regard to the following:
- (a) the independence of the external financiers;
 - (b) the commercial manner in which the schemes were entered into;
 - (c) normal commercial understandings and practices;
- it would not be concluded that the schemes were designed to operate together to produce their combined economic effect.

- (5) In applying the design test to these schemes, normal commercial understandings and practices outweigh the common involvement of the parties to the schemes.

62 Conclusion

As neither the interdependence test nor the design test is satisfied, the aggregation rule does not apply to treat any combination of these 5 schemes as a single aggregate scheme.

Part 9—Finance trust and company staple: aggregation

Please refer to general comments made in our cover letter.