
TREASURY LAWS AMENDMENT (MAKING SURE FOREIGNERS PAY THEIR
FAIR SHARE OF TAX AND OTHER MEASURES) BILL 2018: INTEGRITY
MEASURES

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>
AMIT	attribution managed investment trust
Commissioner	Commissioner of Taxation
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MIT	managed investment trust
TAA 1953	<i>Taxation Administration Act 1953</i>

Chapter 1

Non-concessional MIT income

Outline of chapter

1.1 This Exposure Draft legislation contains integrity rules that will be inserted into Schedule 1 of the Exposure Draft for Treasury Laws Amendment (Making Sure Foreigners Pay Their Fair Share of Tax and Other Measures) Bill 2018.

1.2 Schedule 1 to the Exposure Draft for Treasury Laws Amendment (Making Sure Foreigners Pay Their Fair Share of Tax and Other Measures) Bill 2018 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.

1.3 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.

1.4 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

1.5 The Exposure Draft for Treasury Laws Amendment (Making Sure Foreigners Pay Their Fair Share of Tax and Other Measures) Bill 2018 was released on 26 July 2018.

1.6 Schedule 1 to that 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.

1.7 An amount of a fund payment will be non-concessional MIT income if it is attributable to, among other things, MIT cross staple arrangement income. However, the existing 15 per cent MIT withholding rate will continue to apply to MIT cross staple arrangement income for specified periods of time if:

- the approved economic infrastructure facility exception applies (see section 12-450 in item 7 of Schedule 1 to the Exposure Draft Bill); or
- the MIT cross staple arrangement income transitional rule applies (see item 10 of Schedule 1 to the Exposure Draft Bill).

1.8 On 28 June 2018, the Treasurer released a public consultation paper outlining proposed integrity rules that are needed to safeguard against aggressive cross staple pricing arrangements during the period that the approved economic infrastructure facility exception or the MIT cross staple arrangement income transitional rule applies.

1.9 As the consultation period on that proposal paper closed on 12 July 2018, legislation to implement the integrity rules was not available to be included in the Exposure Draft for Treasury Laws Amendment (Making Sure Foreigners Pay Their Fair Share of Tax and Other Measures) Bill 2018 that was released on 26 July 2018.

1.10 Therefore, this Exposure Draft legislation contains the integrity rules that will be inserted into Schedule 1 of the Exposure Draft for Treasury Laws Amendment (Making Sure Foreigners Pay Their Fair Share of Tax and Other Measures) Bill 2018.

Detailed explanation of new law

1.11 The following material will be inserted into Chapter 1 of the Explanatory Materials for Treasury Laws Amendment (Making Sure Foreigners Pay Their Fair Share of Tax and Other Measures) Bill 2018.

Integrity rules apply when a MIT has excepted MIT CSA income

1.12 Integrity rules apply if a MIT derives, receives or makes an amount (directly or indirectly) that is excepted MIT CSA income.

1.13 An amount is *excepted MIT CSA income* of a MIT in relation to an income year if the amount would be MIT cross staple arrangement income of the MIT but for:

- the approved economic infrastructure facility exception (see section 12-450 in item 7 of Schedule 1 to the Exposure Draft Bill); or
- the MIT cross staple arrangement income transitional rule (see item 10, subitem (3) of Schedule 1 to the Exposure Draft Bill).

[Schedule 1, items 3 and 4, subsection 12-451(4) of Schedule 1 to the TAA 1953 and the definition of 'excepted MIT CSA income in subsection 995-1(1) of the ITAA 1997]

1.14 The integrity rules will:

- extend the scope of the non-arm's length income rule; and
- introduce a concessional cross staple rent cap.

1.15 If the facility that gives rise to the excepted MIT CSA income is not an economic infrastructure facility (and therefore benefits from the seven year MIT cross staple arrangement income transitional rule), only the non-arm's length income rule will apply to the facility.

1.16 If the facility that gives rise to the excepted MIT CSA income is an economic infrastructure facility (and therefore benefits from the approved economic infrastructure facility exception or the 15 year MIT cross staple arrangement income transitional rule), both the non-arm's length income rule and the concessional cross staple rent cap will apply to the facility.

Integrity rule: Non-arm's length income rule

1.17 The non-arm's length income rule in section 275-610 of the ITAA 1997 operates to treat an amount of income of a MIT as non-arm's length income if:

- the amount is derived from a scheme where the parties were not dealing with each other at arm's length;
- the amount exceeds the amount the entity might have derived if those parties had been dealing with each other at arm's length; and
- the amount is not a particular type of distribution.

1.18 The Commissioner must make a determination that an amount is non-arm's length income. If a determination is made, the trustee of the MIT is liable to pay tax on the amount at the top corporate tax rate (currently 30 per cent).

1.19 The non-arm's length income rule provides an appropriate safeguard against aggressive cross staple rent pricing for sectors that have readily available data on comparable Australian third party market transactions.

1.20 Therefore, the Commissioner will be able to make a determination to apply the non-arm's length income rule to a MIT that derives excepted MIT CSA income regardless of whether or not the MIT is a party to the scheme that gave rise to the non-arm's length income. *[Schedule 1, item 1, subsection 275-615(1A) of the ITAA 1997]*

1.21 If the Commissioner makes a determination to apply the non-arm's length income rule to a MIT, then the trustee of the MIT is liable to pay tax on the amount at the top corporate tax rate, currently 30 per cent (subsection 275-605(2)).

1.22 In addition, the net income of the MIT, or the assessable income of a MIT that is an AMIT, is reduced by the amount of the non-arm's length income (subsections 275-605(3) to (5)). This ensures that the non-arm's length income is:

- not included in a fund payment made by the MIT that is subject to MIT withholding tax; and
- not included in the assessable income of Australian investors under Division 6 of Part III of the ITAA 1936.

Integrity rule: Concessional cross staple rent cap

1.23 The concessional cross staple rent cap will apply to a MIT only if:

- the MIT derives, receives or makes excepted MIT CSA income and the facility that gives rise to the excepted MIT CSA income is an economic infrastructure facility that benefits from:
 - the approved economic infrastructure facility exception; or
 - the 15 year MIT cross staple arrangement income transitional rule; and
- the amount of excepted MIT CSA income is, or is attributable to, rent from land investment under a cross staple lease entered by the asset entity and the operating entity that are parties to the cross staple arrangement.

[Schedule 1, item 4, subsection 12-451(1) of Schedule 1 to the TAA 1953]

1.24 The amount of the concessional cross staple rent cap will depend on whether or not, at the transition date (27 March 2018), the cross staple lease is an existing lease an established method for working out the amount of the rent (including a method that specifies an amount of rent).

1.25 If the relevant asset entity is not a MIT, then the relevant asset entity is taken to be a MIT for the purpose of working out whether its excepted MIT CSA income exceeds the amount of its concessional cross staple rent cap under section 12-451. *[Schedule 1, item 4, subsection 12-451(3) of Schedule 1 to the TAA 1953]*

1.26 This will ensure the cap is worked out at the asset entity level even where the asset entity is not a MIT (with the consequences of breaching the cap at the asset entity level flowing up to the MIT and its investors.

Amount of the cap — existing lease with an established rent method

1.27 An asset entity that has an existing lease arrangement in place with a method to determine the amount of the rent (including a method that specifies an amount of rent) agreed between the asset entity and operating entity can continue to charge rent under their existing arrangements for the duration of the transition period and remain compliant with the concessional cross staple rent cap.

1.28 The amount of the cap in relation to a cross staple lease is worked out based on the existing amount of rent, or an existing method for working out the amount of the rent, if:

- the amount is excepted MIT CSA income because the 15 year MIT cross staple arrangement income transitional rule applies;
- the cross staple lease was entered into before 27 March 2018;
- the cross staple lease, or any associated documents (such as a rental agreement) that existed before 27 March 2018 specified:
 - the amount of annual rent under the lease; or
 - a method for determining the amount of annual rent under the lease which is set out fully in the cross staple lease or in the associated documents.

[Schedule 1, item 4, subsection 12-452(1) of Schedule 1 to the TAA 1953]

1.29 If a method for determining the amount of annual rent under the lease is set out fully in the cross staple lease or in the associated documents, then the amount of the ***concessional cross staple rent cap*** for an income year of the MIT is the amount of annual rent determined for the income year in the method specified in the lease (including in the lease agreement and/or associated documents). *[Schedule 1, items 3 and 4, subsection 12-452(2) of Schedule 1 to the TAA 1953 and the definition of ‘concessional cross staple rent cap’ in subsection 995-1(1) of the ITAA 1997]*

1.30 In this regard, the cross staple lease or in the associated documents must fully set out the method for determining the amount of

annual rent in an objective manner and be in existence prior to 27 March 2018.

1.31 It is a question of fact as to whether a method existed that was fully documented and regard must be had to both the lease agreement and any other associated documents that support the calculation of rent under the lease.

1.32 It is not necessary for the method to be stipulated in the lease agreement itself. For example, the lease agreement may specify a fixed amount of rent but there may be other documents which evidence the method which is the basis for the calculation in the lease agreement.

1.33 In order to establish that there is a method that is fully set out in the documents, the method must be objective and be sufficiently prescriptive such that the calculation of the rental charge relies upon objectively discernible information, and produces a result that would be same for any reasonable person applying it.

1.34 Examples of circumstances where an objective method may exist in documentation prior to 27 March 2018 are as follows.

- The lease agreement (and/or associated documents) provided a formula for the calculation of rent based on a percentage of the regulated asset base. The method is the approach in the formula.
- The lease agreement (and/or associated documents) provided for rent to be charged as a percentage of the gross turnover of the operating entity. The method is the percentage of gross turnover that was specified.
- A lease agreement specifies that the rent will be set at a market rate of rent. At the commencement of the lease, the parties sought a transfer pricing report prepared by an independent expert on 1 July 2017. The report's conclusions are based on a comparison to rates of rental return on certain assets in the industrial property sector. The report provided a data set of comparables and a rent pricing range based on the data set concluding that the midpoint of the range is an appropriate rent yield to apply to the accounting book value of the leased assets. The asset entity and operating entity agree this will be the method by which market rent will be ascertained for that year. The method is the midpoint of the range determined in accordance with the approach adopted in the transfer pricing report to determine the arm's length rent.
- The lease agreement prescribes a method comprising five factors to which regard may be had in annual rent reviews.

Rent has always been calculated as a set per cent of gross revenue, pursuant to a sub-lease. The way in which the five factors in the sub-lease should be taken into account to determine the set percentage of the gross revenue is set out in the rent notice for the income year ended 30 June 2017. The method is based on the manner in which a range of set factors are applied to determine the amount of the rent.

- The lease agreement specifies rent to be calculated based on a percentage of gross turnover of the operating entity and provides for a market rent review every three years. Associated documents show that the method for determining the rent is based on a split of the profit between the asset entity and operating entity (that is, to ensure that both the asset entity and operating entity receive an equal rate of return on their investment) and that the percentage of turnover set in the lease as a proxy to achieve this outcome. The method is the profit split.

1.35 An objective method would not exist, for example, if the lease agreement provided for the rent to be determined at the discretion of the trustee or based on agreement between the trustee and the operating entity.

Example 1.1: Existing lease with method for calculating rent agreed to prior to 27 March 2018

Asset Trust and Op Co entered into a cross staple lease arrangement, with effect from 1 July 2015, over an economic infrastructure facility.

Asset Trust and Op Co are eligible to apply the 15 year MIT cross staple arrangement income transitional rule to the rent earned by Asset Trust on the economic infrastructure facility.

Before 27 March 2018, Asset Trust and Op Co had entered into a lease agreement setting out the terms of the lease. The lease agreement has a lease payment schedule covering the 2017-18 and 2018-19 income years (the covered income years). The payment schedule denotes a fixed dollar amount of lease payments in each of the covered income years.

There is documentary evidence that the method used to determine the rent in the payment schedule was to:

- adopt the rental yield in a transfer pricing report prepared by an independent expert on 1 July 2017, which concluded that the rent for the covered income years should be determined based on a midpoint of a range of comparable returns for certain leased assets in the industrial property sector; and
- apply that yield to the opening book value of the economic infrastructure facility (that is, the leased assets) for the year.

Because the amounts specified in the lease agreement were determined based on an objective method, Asset Trust would be able to use that objective method to determine its concessional cross staple rent cap.

Therefore, the concessional cross staple rent cap will be based on the midpoint of the range of current market returns on the assets in the industrial property sector and the opening accounting book value of the leased assets in the relevant year throughout the transition period.

1.36 If the cross staple lease and any associated documents specify the amount of annual rent under the lease but do not set out a method for determining that amount, then the amount of the ***concessional cross staple rent cap*** for an income year of the MIT is:

- for the first income year that ends after 27 March 2018 — the amount of annual rent specified in the lease for the first year of the lease that ends after 27 March 2018; or
- for a subsequent income year— that amount indexed annually by the All Groups Consumer Price Index (as set out in Subdivision 960-M of the ITAA 1997).

[Schedule 1, items 2 to 4, subsection 12-452(2) of Schedule 1 to the TAA 1953; section 960-265 and the definition of ‘concessional cross staple rent cap’ in subsection 995-1(1) of the ITAA 1997]

Example 1.2: Existing lease with specified amount of rent agreed to prior to 27 March 2018

Assume the facts are the same as Example 1.1, except that the lease agreement merely states that the parties will meet periodically to agree on a rental amount.

Prior to 27 March 2018, it was determined that, for the income year ending 30 June 2018, Op Co would pay rent of \$10 million to Asset Trust. There are no associated documents which outline an objective method which was used to determine the amount of the rent.

The concessional cross staple rent cap for income years starting on or after 1 July 2019 will be set at \$10 million (the rent for the income year ending 30 June 2018) and will be indexed annually by the All Groups Consumer Price Index (as set out in Subdivision 960-M of the ITAA 1997).

Amount of the cap — no existing lease with established rent method

1.37 The amount of the concessional cross staple rent cap is worked out differently if the amount is excepted MIT CSA income because:

- the approved economic infrastructure facility exception applies; or
- the 15 year MIT cross staple arrangement income transitional rule applies and section 12-452 of Schedule 1 to the

TAA 1953 does not apply — that is, broadly, the cross staple lease and any associated documents do not, before 27 March 2018, set out a method to determine the amount of the rent (including a method that specifies an amount of rent).

1.38 This method should generally apply to staples that are established, or leases that are entered into, on or after the transition date. However, this method will also apply to leases entered before 27 March 2018 where the rent had not been agreed by the parties (and therefore included in the lease or associated documents) before this date.

1.39 In these circumstances, a statutory concessional cross staple rent cap applies. The amount of the statutory cap broadly reflects the amount of rent that would be paid from the operating entity to the asset entity which would result in the asset entity having a current year net (taxable) income position equal to 80 per cent of the project’s notional current year taxable income.

1.40 The amount of the statutory concessional cross staple rent cap for an income year is worked out applying the steps in Table 1.1.

Table 1.1: Steps for working out the concessional cross staple rent cap

Step 1	<p>Work out a reasonable estimate of the following amount for the relevant asset entity for the income year:</p> <ul style="list-style-type: none"> • if the entity is a trust (other than an AMIT) — the amount of its net income or tax loss; • if the entity is an AMIT — the amount of its trust components with the character of assessable income or its tax loss; • if the entity is a partnership — the amount of its net income or partnership loss.
Step 2	<p>Work out a reasonable estimate of the following amount for the relevant operating entity for the income year:</p> <ul style="list-style-type: none"> • if the entity is a trust (other than an AMIT) — the amount of its net income or tax loss; • if the entity is a partnership — the amount of its net income or partnership loss; • otherwise — the amount of its taxable income or tax loss
Step 3	Add the results of step 1 and step 2
Step 4	Multiply the result of step 3 by 0.8
Step 5	Subtract the result of step 1 from the result of step 4
Step 6	Add the amount of excepted MIT CSA income to the result of step 5

1.41 If the result of step 6 is a positive number, then the *concessional cross staple rent cap* is that result. Otherwise, the concessional cross

staple rent cap is nil. [Schedule 1, items 3 and 4, section 12-453 of Schedule 1 to the TAA 1953 and the definition of ‘concessional cross staple rent cap’ in subsection 995-1(1) of the ITAA 1997]

1.42 For the purposes of steps 1 and 2 of Table 1.1:

- the amount of a tax loss, or a partnership loss, is treated as a negative number; and
- any prior year tax losses are disregarded.

[Schedule 1, item 4, subsection 12-453(3) of Schedule 1 to the TAA 1953]

Example 1.3: Existing staple arrangement with no agreed rent

Asset Trust and Op Co entered a cross staple lease arrangement, with effect from 1 July 2017, over an economic infrastructure facility.

Asset Trust and Op Co are eligible to apply the 15 year MIT cross staple arrangement income transitional rule to the rent earned by Asset Trust on the economic infrastructure facility.

Asset Trust and Op Co had not agreed the amount of rent to be charged under the lease before 27 March 2018. Therefore, the amount of the concessional cross staple rent cap for Asset Trust will be determined using the statutory method.

Asset Trust would need to determine the concessional cross staple rent cap for the 2019 20 income year by applying the steps in Table 1.1.

Step 1: Work out a reasonable estimate of Asset Trust’s net income

At 30 June 2020, a reasonable estimate of Asset Trust’s net income for the income year is as follows:

	<i>\$ million</i>
Cross staple rental income	85
Cross staple interest income	9
Depreciation	(20)
External interest expense	(9)
Prior year tax losses carried forward	(10)
Net income	55

The step 1 amount is a reasonable estimate of Asset Trust’s net income disregarding prior year tax losses — that is, \$65 million.

Step 2: Work out a reasonable estimate of Op Co's taxable income

At 30 June 2020, a reasonable estimate of Op Co's taxable income for the income year is as follows:

	<i>\$ million</i>
Third party income	105
Cross staple rent expense	(85)
Cross staple interest expense	(9)
Prior year tax losses carried forward	0
Taxable income	11

The step 2 amount is a reasonable estimate of Op Co's taxable income disregarding prior year tax losses — that is, \$11 million.

Step 3: Add the results of step 1 and step 2

The step 3 amount is a reasonable estimate of the notional current year taxable income for the project. This is worked out by adding the results of step 1 (\$65 million) and step 2 (\$11 million) — that is, \$76 million.

Step 4: Multiply the result of step 3 by 0.8

The step 4 amount is worked out by multiplying the notional project taxable income by 0.8. This represents the share of the project's taxable income that would be allocated to the trust if it received the maximum rent under the concessional rent cap. Therefore, the step 4 amount is:

$$\$76 \text{ million} \times 0.8 = \$61 \text{ million.}$$

Step 5: Subtract the result of step 1 from the result of step 4

The step 5 amount compares this notional taxable income cap and the actual taxable income of the trust to determine whether there is an excess of taxable income allocated to the Asset Trust. This is worked out by subtracting the result of step 1 from the result of step 4. Therefore, the step 5 amount is:

$$\$61 \text{ million} - \$65 \text{ million} = (\$4 \text{ million}).$$

The negative amount of \$4 million represents excess taxable income that is allocated to Asset Trust.

Step 6: Add the amount of excepted MIT CSA income to the result of step 5

The step 6 amount is worked out by adding the amount of excepted MIT CSA income to the result of step 5. The amount of excepted MIT CSA income is amount of the cross staple rent (\$85 million). Therefore, the step 6 amount is:

$$(\$4 \text{ million}) + \$85 \text{ million} = \$81 \text{ million.}$$

Therefore, the amount of Asset Trust's concessional cross staple rent cap is \$81 million.

Consequences of breaching the cap

1.43 If the amount of the relevant asset entity's excepted MIT CSA income exceeds the amount of its concessional cross staple rent cap for the income year, then the excess amount of excepted MIT CSA income will not benefit from the approved economic infrastructure facility exception or the 15 year MIT cross staple arrangement income transitional rule. *[Schedule 1, item 4, subsection 12-451(2) of Schedule 1 to the TAA 1953]*

1.44 As a result, the excess amount will be non-concessional MIT income that, to the extent it is reflected in a fund payment made to a foreign resident, is subject to MIT withholding at a rate equal to the top corporate tax rate, currently 30 per cent.

1.45 In addition, if, for the income year, the relevant asset entity is entitled to a deduction against assessable income that arises from rent for land investment and its excepted MIT CSA income exceeds the amount of its concessional cross staple rent cap, then:

- the amount must first be deducted against assessable income from that arrangement that is *not* MIT cross staple arrangement income;
- any remaining amount can be deducted against assessable income from that arrangement that is MIT cross staple arrangement income.

[Schedule 1, item 4, section 12-451(4) of Schedule 1 to the TAA 1953]

1.46 If the relevant asset entity is not a MIT, then the relevant asset entity is taken to be a MIT for the purpose of:

- working out whether its excepted MIT CSA income exceeds the amount of its concessional cross staple rent cap under section 12-451; and
- determining the amount of assessable income that is MIT cross staple arrangement income under section 12-454.

[Schedule 1, item 4, subsections 12-451(3) and 12-454(4) of Schedule 1 to the TAA 1953]

Example 1.4: Existing staple arrangement with no agreed rent

Assume the facts are the same as Example 1.1. In addition, assume that:

- Asset Entity is a MIT that (ignoring the application of the concessional cross staple rent cap and the expense allocation rule) had excepted MIT CSA income which is cross staple rent in relation to the economic infrastructure facility (Facility 1) of \$60 million;

- the concessional cross staple rent cap was \$55 million;
- Asset Entity had third party rental income in relation to a separate facility (Facility 2) it owned of \$50 million;
- Asset Entity had deductible expenses of \$20 million; and
- Asset Entity's net (taxable) income for the year was \$90 million.

When determining the amount of non-concessional MIT income resulting from the breach of the concessional cross staple rent cap, Asset Entity must have regard to the expense allocation rule in section 12-454.

Asset Entity had determined, based on the usual approach to the allocation of expenses, that expenses directly related to Facility 1 or Facility 2 are to be allocated directly against income from that Facility. Other indirect expenses are allocated on a pro-rata basis to the income. This allocation resulted in:

- \$12 million of expenses being allocated against the rental income from Facility 1; and
- \$8 million of expenses being allocated against the rental income from Facility 2.

Under the expense allocation rule, the expenses of \$12 million that relate to earning the rental income from Facility 1 of \$60 million must be first allocated to excepted MIT CSA income.

Therefore, if Asset Entity made a fund payment equal to its net income of \$90 million, it would have the following components:

- a fund payment attributable to cross staple rent of \$43 million (that is, \$55 million — \$12 million) — this amount is excepted MIT CSA income that is subject to 15 per cent MIT withholding;
- a fund payment attributable to cross staple rent that is in excess of the concessional cross staple rent cap of \$5 million (that is, \$60 million — \$55 million) — this amount is non-concessional MIT income that is subject to MIT withholding at the top corporate tax rate; and
- a fund payment attributable to third party rental income of \$42 million (that is, \$50 million — \$8 million) — this amount is subject to 15 per cent MIT withholding.