TREASURY LAWS AMENDMENT (STAPLED STRUCTURES 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.

Abbreviation	***Definition***
ADI	authorised deposit-taking institution
AMIT	attribution managed investment trust
CGT	capital gains tax
Commissioner	Commissioner of Taxation
GFS	Government Finance Statistics
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MIT	managed investment trust
NANE	non-assessable non-exempt
TAA 1953	*Taxation Administration Act 1953*

Chapter 1
Stapled structures

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 trading business to a rate equal to the top corporate tax rate.

Context of amendments

1.2 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.

1.3 Staples have been used in Australia by the property sector since the 1980s. Prior to the introduction of the MIT regime in 2008, stapled entities bore a similar level of Australian tax as if they had been operated as 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.

1.4 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 rental income. In recent years, the MIT withholding tax rate has generally been 15 per cent.

1.5 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.

1.6 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.

1.7 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.

1.8 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.

1.9 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.

1.10 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.

1.11 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.

1.12 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.

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

Summary of new law

1.14 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 trading business to a rate equal to the top corporate tax rate.

1.15 To achieve this, income of a MIT that is attributable to trading business will be treated as non-concessional MIT income.

Comparison of key features of new law and current law

New law	*Current law*
Fund payments made by a MIT to a foreign investor are subject to MIT withholding tax at the top corporate tax rate to the extent that they are attributable to non-concessional MIT income.	No equivalent.

Detailed explanation of new law

1.16 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 trading business to a rate equal to the top corporate tax rate.

1.17 To achieve this, the MIT withholding tax provisions are modified so that, to the extent that a fund payment reflects amounts of income derived by a MIT that is non-concessional MIT income, the amounts are subject to withholding tax at the top corporate tax rate (currently 30 per cent), rather than 15 per cent.

1.18 With some exceptions, an amount of a fund payment will be non-concessional MIT income if it is attributable to:

- an amount from certain cross staple arrangements; or
- a distribution from an entity that carries on or controls a trading business.

1.19 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 highest corporate tax rate. ***[Schedule 1, items 1 to 2, paragraphs 12-385(3)(a), 12-390(3)(a) and 12-390(6)(a) in Schedule 1 to the TAA 1953]***

Non-concessional MIT income attributable to certain cross staple arrangements

1.20 A MIT will have an amount of non-concessional MIT income that is attributable to a cross staple arrangement 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 attributable to amounts that are not fund payments of a MIT that are derived, received or made by the second entity, or by any other entity — 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 6, subsection 12-440(1) in Schedule 1 to the TAA 1953]

1.21 In these circumstances, an amount will be non-concessional MIT 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 an amount that is derived, received or made by the MIT from the second entity — this amount would be an assessable amount to the asset entity.

[Schedule 1, item 6, subparagraphs 12-440(2)(a)(i), (b)(i) and (c)(i) in Schedule 1 to the TAA 1953]

1.22 In addition, an amount will be non-concessional MIT 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 that 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 6, subparagraphs 12-440(2)(a)(ii), (b)(ii) and (c)(ii) in Schedule 1 to the TAA 1953]

1.23 There are three circumstances in which an amount that is attributable to a cross staple arrangement will *not* be non-concessional MIT income of a MIT.

1.24 First, an amount that is attributable to a cross staple arrangement will *not* be non-concessional MIT income of a MIT to the extent that it is attributable to an amount of rent 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 6, subsection 12-440(3) in Schedule 1 to the TAA 1953]***

1.25 Therefore, if an amount derived, received or made by an operating entity is rent from an unrelated party that, directly or indirectly, flows through to a MIT as part of a cross staple payment, the amount will *not* be non-concessional MIT income of the MIT and therefore will continue to attract the 15 per cent fund payment withholding rate (unless subsection 12-440(7) applies to the amount).

1.26 In this regard, under existing stapled structure arrangements in the traditional property sector, the assessable income of a MIT is directly or indirectly attributable to an amount of rent from third parties that is derived, received or made by an operating entity and passed on to an asset entity as a cross staple payment. In these circumstances, if the whole of the cross staple payment is attributable to the rent, no amount of the cross staple payment will be non-concessional MIT income.

1.27 However, if the operating entity derives a combination of third party rental income and other non-eligible investment business income then, to the extent that a cross staple payment received by the asset entity from the operating entity is not attributable to that third party rent, the amount will be non-concessional MIT income.

1.28 Second, an amount that is attributable to a cross staple arrangement will *not* be non-concessional MIT income of a MIT if the de minimis exception in section 12-445 (which is explained below) applies. ***[Schedule 1, item 6, subsection 12-440(4) in Schedule 1 to the TAA 1953]***

1.29 Third, an amount that is attributable to a cross staple arrangement will *not* be non-concessional MIT income of a MIT if:

- the amount is rent; and
- the approved economic infrastructure exception in section 12-450 (which is explained below) applies.

[Schedule 1, item 6, subsection 12-440(5) in Schedule 1 to the TAA 1953]

Non-concessional MIT income attributable to trading business

1.30 A MIT will have an amount of non-concessional MIT income that is attributable to trading business if the MIT holds a total participation interest (as defined in section 960-180 of the ITAA 1997) in the second entity and the second entity is:

- a unit trust that is a trading trust — 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.

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

1.31 An amount constitutes non-concessional MIT income to the extent the MIT receives distributions directly or indirectly through interposed entities from the trading trust or partnership because these amounts are effectively trading income that are appropriately taxed at the top corporate tax rate.

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 a trading trust;
- does not carry on a trading business; or
- does not directly or indirectly control another person who carries on a trading business.

[Schedule 1, items 6 and 8, subsection 12-455(1) in Schedule 1 to the TAA 1953 and the definition of 'asset entity' in subsection 995-1(1) of the ITAA 1997]

1.33 This effectively means that the asset entity must be a passive investment entity — that is, the asset entity is a trust that is taxed as a MIT or an AMIT, or a trust or partnership that is taxed as a flow-through vehicle. The asset entity can only derive income from eligible investment business — *eligible investment business* is defined in section 102M of the ITAA 1936 to mean, broadly, business that consists of investments that are of a passive nature.

What is an operating entity?

1.34 An ***operating entity***, in relation to an income year, is a trust, that:

- is a trading trust;
- carries on a trading business; or
- directly or indirectly controls another person who carries on a trading business.

[Schedule 1, items 6 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]

1.35 An ***operating entity***, in relation to an income year, is also a partnership or company that, if it were treated as a trust, meets these conditions. ***[Schedule 1, item 6, subsections 12-455(2) and (3) in Schedule 1 to the TAA 1953]***

1.36 Unlike an asset entity, an operating entity can derive trading income.

What is a cross staple arrangement?

1.37 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 have 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 of the external entities in each arrangement is 80 per cent or more.

[Schedule 1, items 6 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]

1.38 For these purposes, the total participation interests that an investor has 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 6, subsection 12-455(5) in Schedule 1 to the TAA 1953]

1.39 In these circumstances, for the purpose of working out the total participation interests that an investor has in another entity, the amount of the test entity's total participation interest amount is equal to the lowest participation amount. ***[Schedule 1, item 6, subsection 12-455(6) in Schedule 1 to the TAA 1953]***

Example 1.1: Cross staple arrangement – total participation interest

A foreign investor holds a participation interest in two entities. These include an interest of:

- 40 per cent in an asset entity; and
- 60 per cent in an operating entity.

The 40 per cent interest in the asset entity falls short of the 60 per cent participation interest in the operating entity.

For the purposes of determining whether a cross staple arrangement exists, the 60 per cent participation interest is treated as being equal to the lowest participation interest (that is, 40 per cent).

This 40 per cent interest is summed with the participation interests of the other investors in the entities to determine whether a cross staple arrangement exists.

1.40 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 is also covered by the definition.

1.41 However, a cross staple financial arrangement that gives rise to interest income (for example, a cross staple loan) is excluded. This is because non-concessional MIT income excludes amounts that are not fund payments (such as interest income).

What is a stapled entity?

1.42 Each of the entities that have entered into the cross staple arrangement is a ***stapled entity***. ***[Schedule 1, items 6 and 8, subsection 12-455(7) in Schedule 1 to the TAA 1953 and the definition of 'stapled entity' in subsection 995-1(1) of the ITAA 1997]***

Cross staple payments — the de minimis exception

1.43 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 if both:

- the non-concessional MIT income of the MIT in the previous year did not exceed five per cent of the total assessable income (disregarding any net capital gains) of the MIT for that previous income year; and
- if the non-concessional MIT income was attributable to a payment made by another trust (including another MIT), the sum of those payments made by that other trust in the previous year did not exceed five per cent of the total assessable income (disregarding any net capital gains) of that trust for the previous income year.

[Schedule 1, item 6, paragraph 12-440(4)(a) and subsections 12-445(1), (2) and (3) in Schedule 1 to the TAA 1953]

1.44 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, both:

- the non-concessional MIT income of the second entity in the previous year did not exceed five per cent of the total assessable income (disregarding any net capital gains) of the second entity for that previous income year; and
- if that non-concessional MIT income was attributable to a payment made by another trust (including another MIT), the sum of those payments made by that other trust in the

previous year did not exceed five per cent of the total assessable income (disregarding any net capital gains) of that trust for the previous income year.

[Schedule 1, item 6, paragraph 12-440(4)(b) and subsections 12-445(1), (2), (3) and (4) in Schedule 1 to the TAA 1953]

1.45 The de minimis exception applies only in respect of non-concessional MIT income arising from cross staple arrangements. It does not apply to non-concessional MIT income from trading entities.

1.46 If the de minimis exception applies to a MIT, any amount that is attributable to a cross staple arrangement will *not* be non-concessional MIT income of the MIT. ***[Schedule 1, item 6, subsection 12-440(4) in Schedule 1 to the TAA 1953]***

1.47 The de minimis exception does not apply to a MIT that is first established in an income year (because it does not have any non-concessional MIT income or assessable income for the previous income year).

Cross staple payments — the approved economic infrastructure asset exception

1.48 The approved economic infrastructure asset exception applies in relation to a fund payment of a MIT where the fund payment is attributable to a cross staple payment in relation to an asset at a time if:

- the asset 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 that the asset is first put to use.

[Schedule 1, item 6, subsection 12-450(1) in Schedule 1 to the TAA 1953]

1.49 An Australian government agency (other than the Commonwealth) may make an application to the Treasurer in respect of a particular infrastructure asset specified in the application. ***[Schedule 1, item 6, subsection 12-450(2) in Schedule 1 to the TAA 1953]***

1.50 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.

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

- the asset is an economic infrastructure asset;
- the estimated capital expenditure on the asset is $500 million or more;

- the asset is yet to be constructed, or the asset is an existing asset that will be substantially improved;
- the asset will significantly enhance the long-term productive capacity of the economy; and
- approving the asset is in the national interest.

[Schedule 1, item 6, subsection 12-450(3) in Schedule 1 to the TAA 1953]

1.52 An asset is an ***economic infrastructure asset*** if it is:

- transport infrastructure for public purposes;
- energy infrastructure for public purposes;
- communications infrastructure for public purposes;
- water infrastructure for public purposes.

[Schedule 1, items 6 and 8, subsection 12-450(4) in Schedule 1 to the TAA 1953 and the definition of 'economic infrastructure asset' in subsection 995-1(1) of the ITAA 1997]

1.53 An economic infrastructure asset is for public purposes if it is, for example:

- available for use by the public;
- used for the provision of services to the public; or
- used to transport goods that are available for use by or sale to the public.

1.54 Consequently, infrastructure assets that would be for public purposes and eligible to qualify for the exemption include:

- roads that are used to transport the public or transport goods that are available for use by or sale to the public;
- ports that are available to be used by the public or to unload or load cargo that are available for use by or sale to the public; and
- electricity generation, transmission or distribution facilities, where the electricity generated, transmitted or distributed is for use by or sale to the public.

Example 1.2: Whether a transport infrastructure asset is for public purposes

A road is available for use by the public and for the transportation of goods for sale to the public. Access to the road is subject to a toll. Since the road is available for use by the public, it is an economic infrastructure asset for public purposes.

A road is built on private property to enable coal to be transported from a mine to a processing facility. As the road is not available for use by the public, the road is not economic infrastructure for public purposes.

1.55 In determining whether an asset will significantly enhance the long-term productive capacity of the economy, the Treasurer may consider whether:

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

1.56 The list of matters provides an assessment of things for the Treasurer to consider. Each factor does not need to be present to a particular degree. The Treasurer may also consult with other Commonwealth government departments and agencies to assess whether the criteria are met.

1.57 The Treasurer's approval of an asset must be in writing, must specify the asset 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 6, subsection 12-450(6) in Schedule 1 to the TAA 1953]***

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

1.59 If the Treasurer decides not to approve an asset, the Treasurer must notify the applicant of the decision in writing as soon as practicable after making the decision. ***[Schedule 1, item 6, subsection 12-450(8) in Schedule 1 to the TAA 1953]***

1.60 The approved economic infrastructure asset exception applies only in respect of non-concessional MIT income that is attributable to rent arising from cross staple arrangements. It does not apply to non-concessional MIT income from trading entities.

1.61 If the approved economic infrastructure asset exception applies to an asset, any amount that is attributable to a cross staple arrangement and that is rent will not be non-concessional MIT income of a MIT. ***[Schedule 1, item 6, subsection 12-440(5) in Schedule 1 to the TAA 1953]***

1.62 Although an asset may be an economic infrastructure asset, the asset would need to include an interest in land that is capable of giving rise to rent in order to benefit from the exception.

1.63 In addition, an entity that is an operating entity in relation to the cross staple arrangement will be entitled to a deduction of an amount of rent for an income year if:

- another entity derives, receives or makes an amount of rent from the operating entity in the income year;
- the rent is derived or received on or after 27 March 2018;
- the other entity is an asset entity in relation to the cross staple arrangement;
- the operating entity would be entitled to a general deduction under subsection 8-1 of the ITAA 1997 for the amount — that is, the amount would otherwise be deductible;
- the cross staple arrangement was entered into in relation to an asset;
- the amount of rent from the operating entity relates to the asset;
- the asset is covered by the Treasurer's approval as an economic infrastructure asset throughout the year that the rent is derived or received; 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 6, subsection 12-453(1) in Schedule 1 to the TAA 1953]

1.64 A choice that is made under paragraph 12-453(1)(h) must be made in writing before the start of the income year in which the asset is first put to use and is irrevocable. ***[Schedule 1, item 6, subsections 12-453(2) and (3) in Schedule 1 to the TAA 1953]***

Application and transitional provisions

1.65 The amendments to modify the MIT withholding tax provision to tax fund payments that are attributable to non-concessional MIT income at the top corporate tax rate apply to a fund payment made by a MIT on or after 1 July 2019. ***[Schedule 1, item 9]***

Transitional rule for non-concessional MIT income from cross staple arrangements

1.66 A transitional rule applies in relation to non-concessional MIT income from a particular cross staple arrangement that relates to a particular asset.

1.67 The transitional rule will apply if:

- before the 27 March 2018, an Australian government agency:
  - decided to approve the acquisition or creation of an asset;

  - 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 asset before 27 March 2018; or
  - it is reasonable to conclude that a cross staple arrangement will be entered into in relation to the asset;
- it is reasonable to conclude that 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, subitem 10(1)]

1.68 The transitional rule will also apply if:

- an entity entered into a contract before the 27 March 2018 in respect of the acquisition or creation of an asset;
- it is reasonable to conclude that a cross staple arrangement will be entered into in relation to the asset;
- 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, subitem 10(2)]

1.69 A choice made under subitem 11(1) or (2) must be in writing, be made no later than 30 June 2020 and is irrevocable. ***[Schedule 1, subitems 10(6) and (7)]***

1.70 If the transitional rule applies to a MIT, an amount derived, received or made by the MIT will not be non-concessional MIT income of the MIT if:

- the amount is derived, received or made from another entity (the second entity);

- the amount relates to the asset that is subject to the transitional rule;
- 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 paid from an operating entity in relation 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 paid from an operating entity in relation to cross staple arrangement to an asset entity in relation to the cross staple arrangement; and
- the time when the amount was derived, received or made by the MIT meets the timing requirements in subitem 10(5).

[Schedule 1, subitem 10(3)]

1.71 In addition, if the transitional rule applies, an entity that is an operating entity in relation to the cross staple arrangement is entitled to a deduction of an amount for an income year if:

- another entity derives, receives or makes an amount of rent from the operating entity in the income year;
- the amount relates to the asset;
- the time when the other entity derived or received the amount is on or after 27 March 2018 and meets the timing requirements in subitem 10(5);
- the rent is derived or received on or after 27 March 2018;
- the other entity is an asset entity in relation to the cross staple arrangement; and
- the operating entity would be entitled to a general deduction under subsection 8-1 of the ITAA 1997 for the amount — that is, the amount would otherwise be deductible.

[Schedule 1, subitem 10(4)]

1.72 Where the asset to which the cross staple arrangement relates is not an economic infrastructure asset, 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 the asset that is subject to the cross staple arrangement is first put to use for the purpose of producing assessable income.

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

1.73 Where the asset to which the cross staple arrangement relates is not an economic infrastructure asset, 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 the asset that is subject to the cross staple arrangement is first put to use for the purpose of producing assessable income.

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

1.74 Therefore, if the asset that qualifies under the transitional rule is an existing asset that is already in use and is currently producing income, the transitional rule applies to an amount that is derived, received or made before:

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

1.75 If the asset that qualifies under the transitional rule is currently being constructed, or construction of the asset has not yet commenced, the transitional rule will apply to an amount that is derived, received or made after the time that the asset is first put to use and starts producing income and:

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

Example 1.3: Enhancement to an existing, non-income producing asset

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

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

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

As a result, the transitional period for the asset 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 income.

Example 1.4: Enhancements to an existing income producing asset

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.
- Operating Entity leases that land from Asset Trust and operates a business of providing electricity for public purposes, in accordance with a project deed with the State Government.

The project deed requires that Operating Entity will provide services to a set standard 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 asset that existed before 27 March 2018;
- was held in a cross staple arrangement; and
- has previously been used to produce 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 network to the new suburb in order to satisfy obligations under the project deed. 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 asset base (which includes the value of any enhancements).

The network connections to the new suburb are enhancements to the existing electricity network asset. Cross staple rent paid in respect of the extension will be able to access the transitional treatment until 1 July 2034.

Example 1.5: Enhancement of an asset

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 asset 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 complete. The executive wing is expected to become operational in late 2020.

The new floors are an enhancement to an existing asset that has previously been used to produce income. Therefore, the rent charged on the premium wing will not be treated as non-concessional MIT income until 1 July 2026.

Example 1.6: Application of transitional arrangements to assets contracted before 27 March 2018

In May 2017, the Trustee of Hotel Asset Trust and Board of Hotel Operating Co approved plans to add a commercial carpark 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.

Before 27 March 2018, all relevant building approvals had been successfully obtained and 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 asset to the hotel and a new asset 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 income on 1 January 2020.

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

Example 1.7: Non-concessional MIT income for new asset

In May 2017, the Trustee of Hotel Asset Trust and 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.

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

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

Transitional rule for non-concessional MIT income from trading income

1.76 A transitional rule applies if:

- a MIT has an amount of non-concessional MIT income (the relevant amount);
- immediately before 27 March 2018, the MIT held a total participation interest in the second entity of an amount (the pre-announcement amount) of an amount greater than nil; and
- the amount was derived, received or made by the MIT before 1 July 2026.

[Schedule 1, subitem 11(1)]

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

1.78 If a MIT acquires a new total participation interest in the second entity on or after 27 March 2018, the transitional provision applies so that a part of the relevant amount is taken not to be non-concessional MIT income and 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, subitems 11(2), (3) and (4)]

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

1.80 The post-announcement TPI amount is the amount of the MITs total participation interests 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, subitem 11(4)]***

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 a deduction 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.

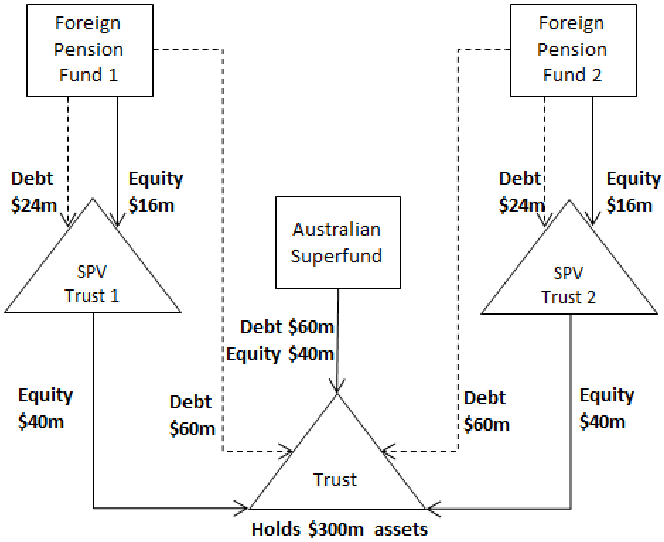
2.4 Foreign investors are increasingly entering into 'double gearing' structures that allow them to convert more of their active business income to interest income that is subject to interest withholding tax of 10 per cent, or less in certain circumstances.

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 effectively allows investors to provide a greater proportion of their capital as investor debt and gear higher than the intended thin capitalisation limits.

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 an ownership 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.

2.7 It is common in some sectors for consortiums to provide funding through a combination of equity and debt. These investors typically have ownership 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 and SPV Trust 2 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 issue, the Government has decided to improve the integrity of the income tax law by lowering the associate entity threshold under the thin capitalisation rules from 50 per cent to 10 per cent to 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

New law	***Current law***
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. 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.	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.

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:

- lower the thin capitalisation associate entity test for associate interests held in trusts (other than public trading trusts) or partnerships 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 entity will be taken to be a trust for the purposes of applying the thin capitalisation associate entity test.

[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).

Example 2.2: 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. The amendments ensure 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.

2.16 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). For the purposes of determining the arm's length debt amount, the factors specified in subsections 820-105(3) and 820-215(3) must be taken into account.

2.17 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. ***[Schedule 2, items 1 and 2, subparagraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv)]***

2.18 The debt to equity ratio of a direct or indirect interest in an entity should only be taken into account to the extent that is relevant to the considerations of both a prudent independent borrower and a prudent independent lender. That is, 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.

2.19 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.

2.20 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.

2.21 The inclusion of the new factor into subparagraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv) do 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 2.3: Consideration of the factor in subparagraph 820-105(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

2.22 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 that is exempt from income tax in the country in which it resides (paragraph 128B(3)(jb)). 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 superannuation funds that have foreign resident members 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 superannuation funds that have foreign resident members 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 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 pay withholding tax on payments of interest, dividends or non-share dividends from an entity unless the foreign superannuation fund has a portfolio-like interest in the entity making the payment.

Comparison of key features of new law and current law

New law	*Current law*
A superannuation fund for foreign residents will be liable to pay withholding tax on payments of interest, dividends or non-share dividends from an entity if the foreign superannuation fund has a portfolio-like interest in the entity making the payment.	A superannuation fund for foreign residents is not liable to pay withholding tax on payments of interest, dividends or non-share dividends from an entity.

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 ownership interest of 10 per cent or more and does not have influence over the entity's key decision making.

3.12 Consequently, a superannuation fund for foreign residents will no longer be exempt from withholding tax on interest and dividends paid by an entity if the total participation interest (as defined in section 960-180 of the ITAA 1997) of the fund in the entity from which the superannuation fund derived the income (that is, the interest income or the dividend or non-share dividend income) is 10 per cent or more:

- 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.

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

3.13 In addition, a superannuation fund for foreign residents will no longer be exempt from withholding tax on dividends or interest if it has a membership interest, debt interest or non-share equity interest in the entity that paid it the income costing of interest or dividends, where the superannuation fund has voting rights or rights to participate in making financial, operating and policy decisions relating to the entity that paid the dividends or interest.

3.14 To achieve this, for the purposes of subsection 128B(3CA), an entity (the first entity) is taken to hold a total participation interest in another entity (the second entity) of 10 per cent at a time if, at that time:

- the first entity holds a membership interest, debt interest or non-share equity interest in the second entity;
- that interest confers, or those interests confer, a right on the first entity:
  - to vote at a meeting of the Board of Directors (or other governing body) of the second entity;
  - to participate in making financial, operating and policy decisions in respect of the second entity; or
  - to deal with assets of the second entity.

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

3.15 However, for these purposes, a right conferred by a debt interest, is disregarded if the right arises because of a breach of terms of the debt interest by the second entity. ***[Schedule 3, item 2, subsection 128B(3AC)]***

3.16 A superannuation fund for foreign residents must test the size of its interest and influence over key decision making at the first level of its investment into Australia. The fund will be taken to have influence over key decision-making if it has any of the specified rights, however obtained. This means that rights arising from side letters and ancillary agreements must be taken into account when considering this criterion.

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.

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.

FSF also holds a debt interest in Aus Trust on which interest is paid. The debt interest is on normal commercial terms and does not allow FSF to influence (either directly or indirectly) Aus Trust in any way in its decision-making.

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

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

Therefore, any dividends or interest paid by Aus Trust to FSF 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. Members of the Advisory Board participate in making financial, operating and policy decisions of Aus Co.

In these circumstances, subsection 128B(3CB) applies so that FSF is taken to hold a total participation interest in Aus Co of 10 per cent.

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

3.17 The amendments to limit the withholding tax exemption for superannuation funds for foreign residents apply to payments of interest, dividends or non-share dividends made on or after 1 July 2019. ***[Schedule 3, subitem 3(1)]***

3.18 A seven year transitional rule applies to investment assets held by a superannuation funds for foreign residents on or before 27 March 2018. In these circumstances, the amendments apply to payments of interest, dividends or non-share dividends made from such investment assets on or after 1 July 2026. ***[Schedule 3, subitem 3(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 generally exempts a sovereign entity from tax, where the moneys invested are and will remain government moneys, if the sovereign entity is not deriving income from a commercial activity and is not able to influence the decision-making of the Australian entity that the sovereign entity invests into.

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

4.8 The Government has decided to create a legislative framework for the existing tax concession for foreign governments (including sovereign wealth funds) and limit the exemption to portfolio investments. As a result, interest and dividend income derived by foreign government investors from non-portfolio investments will be taxed.

Summary of new law

4.9 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.

4.10 A sovereign entity will not be liable to tax on amounts paid by another entity if the sovereign entity has a portfolio-like interest in the entity making the payment and the payment is not derived from a commercial activity.

Comparison of key features of new law and current law

New law	***Current law***
A sovereign entity will not be liable to tax on amounts paid by another entity if the sovereign entity has a portfolio-like interest in the entity making the payment and the payment is not derived from a commercial activity.	No equivalent.

Detailed explanation of new law

4.11 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.

A sovereign entity is liable to pay tax

4.12 A sovereign entity is liable to pay tax on its taxable income. ***[Schedule 4, item 3, subsection 880-55(1)]***

4.13 A sovereign entity is any entity that satisfies all of the following requirements:

- the entity is:
  - an exempt foreign government agency; or
  - an entity in which an exempt foreign government agency holds a total participation interest of 100 per cent;
- the entity is a foreign resident;
- all of the entity's investments are funded by public monies, and all returns of those investments are public monies — consequently, the entity's investments cannot be funded by or returns given to an individual or a company (including in relation to third part debt financing);
- the entity is not a superannuation fund for foreign residents; and
- the entity is not:
  - a public non-financial corporation in accordance with GFS Australia (within the meaning of the *Clean Energy Finance Corporation Act 2012*); or
  - a public financial corporation in accordance with GFS Australia (within the meaning of the *Clean Energy Finance Corporation Act 2012*), other than a public financial corporation that only carries on central banking activities.

[Schedule 4, items 3 and 5, subsections 880-55(2) and (3), and the definition of 'sovereign entity' in subsection 995-1(1)]

4.14 An *exempt 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, if the authority is of a similar nature to an authority that is an *exempt Australian government agency* (as defined in subsection 995-1(1)); or
- an authority of the government of part of a foreign country, if the authority is of a similar nature to an authority that is an exempt Australian government agency.

4.15 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.

4.16 A *public non-financial corporation* and a *public financial corporation* are defined in the Australian System of GFS: Concepts, Sources and Methods, which is based on the IMF Government Finance Statistics Manual.

4.17 A public non-financial corporation is a corporation whose principal activity is the production of non-financial goods and/or non-financial services at economically significant prices. Public non-financial corporations include corporations such as airlines, 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.

4.18 A public financial corporation is a corporation that is principally engaged in providing financial services (including insurance and pension fund services) to other institutional units. Public financial corporations include deposit-taking corporations, financial intermediaries, financial auxiliaries, and captive financial institutions and money lenders.

4.19 A central bank will qualify as a sovereign entity even if they are considered to be a public financial corporation. A central bank is a public financial corporation that issues bank notes and coins and holds the international reserves of the country (in Australia, this is the Reserve Bank of Australia).

Income of the sovereign entity that is NANE income

4.20 An amount of ordinary income or statutory income of a sovereign entity is NANE income if:

- the amount is derived, received or made from a trust or a company (the paying entity);
- if the paying entity is a trust — it is a MIT in relation to the income year in which that amount is derived or received;
- 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 sum of the total participation interests of the sovereign entity, and any other sovereign entity of the same foreign country, in the paying entity is less than 10 per cent:
  - 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;
- the sovereign entity did not acquire any membership interests, debt interests or non-share equity interests in the paying entity in the course of carrying on a trading business (within the meaning in Division 6C of Part III of the ITAA 1936); and
- the amount of ordinary income or statutory income is not attributable to a fund payment made by a MIT, to the extent that the fund payment is attributable to non-concessional MIT income.

[Schedule 4, item 3, subsection 880-105(1)]

4.21 For these purposes, an entity (the first entity) is taken to hold a total participation interest in another entity (the second entity) of 10 per cent at a time if, at that time:

- the first entity holds a membership interest, a debt interest or a non-share equity interest in the second entity;
- that interest confers, or those interests confer, a right on the first entity:
  - to vote at a meeting of the Board of Directors (or other governing body) of the second entity;
  - to participate in making financial, operating and policy decisions in respect of the second entity; or
  - to deal with assets of the second entity.

[Schedule 4, item 3, subsection 880-105(2)]

4.22 However, for these purposes, a right conferred by a debt interest, is disregarded if right arises because of a breach of terms of the debt interest by the second entity. ***[Schedule 4, item 3, subsection 880-105(3)]***

4.23 A sovereign entity must test the size of its interest and influence over key decision making at the first level of its investment into Australia. The sovereign entity will be taken to have influence over key decision-making if it has any of the specified rights, however obtained. This means that rights arising from side letters and ancillary agreements must be taken into account when considering this criterion.

Example 4.1: Total participation interest less than 10 per cent

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 not an Australian resident for tax purposes.

As part of a broad worldwide portfolio of investments across listed equities and government bonds, 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.

Based on the circumstances outlined above, the total participation interest of SWF in Listed Company is less than 10 per cent.

Example 4.2: Total participation interest of greater than 10 per cent

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. Neither SWF 1 nor SWF 2 is an Australian resident for 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, their respective interests in ABC Pty Ltd are amalgamated for the purposes of determining their respective total participation interest. Consequently, the total participation interests of both SWF 1 and SWF 2 in ABC Pty Ltd are 15 per cent.

Example 4.3:

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 not an Australian resident for tax purposes.

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

Under the constituent documents of ABC Unit Trust, any investor with an equity interest of 9.95 per cent or more is entitled to appoint an individual to an Advisory Board of ABC Unit Trust. Members of the Advisory Board participate in making financial, operating and policy decisions of Aus Co.

In these circumstances, subsection 880-105(2) applies so that SWF is taken to hold a total participation interest in ABC Unit Trust of 10 per cent.

Liability to withholding tax

4.24 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 if the foreign resident is exempt from income tax on the dividends or interest (subsection 128B(3) of the ITAA 1936).

4.25 Therefore, subsection 128B(3) of the ITAA 1936 is amended to ensure that dividends and interest 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]***

4.26 A sovereign entity is subject to dividend and interest 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 become NANE income under section 128D of the ITAA 1936.

4.27 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 2, subsection 840-805(9)]***

4.28 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.

Application and transitional provisions

4.29 The amendments to specify the boundaries for the sovereign immunity tax exemption apply on or after 1 July 2019. ***[Schedule 4, subitem 4(1)]***

Transitional rule to protect existing investments

4.30 Transitional rules apply to protect an investment asset held by a sovereign entity if:

- the sovereign entity acquired the asset on or before 27 March 2018;
- on or before that date, the Commissioner gave the sovereign entity a private ruling to the effect that the investment asset qualifies for sovereign immunity; and
- the private ruling still applied on 27 March 2018.

[Schedule 4, subitems 4(2) and (3)]

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

- 1 July 2026; and
- if the private ruling still applies on 1 July 2026 — the day before the private ruling ceases to apply.

[Schedule 4, subitems 4(2) and (3)]

Transitional rule to reset the tax costs of assets

4.32 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 holds an asset (other than money) on 1 July 2026; and
- the Commissioner has given a private ruling to the effect that an investment asset qualifies for sovereign immunity that is current on 27 March 2018.

[Schedule 4, subitems 5(1) and (3)]

4.33 If the transitional rule applies to an asset, the sovereign entity is taken to have sold and repurchased the asset, for consideration equal to its market value, on the day that is the later of:

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

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