Mr Brendan McKenna
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

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By email: stapledstructures@treasury.gov.au

Improving the integrity of stapled structures (second stage)

Dear Brendan

PricewaterhouseCoopers (**PwC**) welcomes the opportunity to make a submission to Treasury in relation to the Exposure Draft (**ED**) legislation and accompanying Explanatory Memorandum (**EM**) (Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax and Other Measures) Bill 2018) released for comment on 26 July 2018.

The intention of our submission is not to cover detailed technical points but rather to highlight several key issues. We note that we have already discussed a wide range of technical issues relating to the drafting of the provisions with you and your team at Treasury over the past couple of months. We would be happy to discuss any of our submission points with you further.

PwC makes the following general submissions on the ED.

Submissions for Non-Concessional MIT Income

Submission 1: The interplay between renewable energy economic infrastructure facilities and agricultural land

It is accepted that renewable energy facilities such as wind and solar farms meet the definition of an "economic infrastructure facility" in proposed section 12-450(4) and should, if they meet the criteria in section 10, Part 3, be eligible for the 15 year transitional period if they are held in a stapled structure. However, such facilities tend to be built on land that has been acquired, or leased, from a farmer and such land could meet the definition of agricultural land in proposed section 12-465.
In respect of wind farms, we understand that the developers/owners do one of two things, namely:

1. Lease the whole land required for the wind farm and allow the farmer access; or
2. Lease only the area required for each turbine plus the access road and associated infrastructure.

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The position can differ by project.

On solar farms, we understand that the developer/owner will either lease or own the whole land with no access for the farmer. This is because a solar farm is much more contained and having livestock roaming the land could pose a risk to the facility.

There is currently no hierarchy as to which set of non-concessional MIT income provisions apply. Each transitional provision gives a limited exception for the transition period relevant to a class of non-concessional MIT income. If the agricultural land transitional provisions apply, then the transitional period will only be 7 years as opposed to 15 years. This will have a major impact on project economics.

We understand that it is not, in such circumstances, the intention for the agricultural income provisions to take priority over the economic infrastructure facility transitional provisions. We suggest that the next version of the draft legislation makes it clear that economic infrastructure facilities located on agricultural land are not subject to the agricultural land provisions.

For completeness, we note that the risk of interplay could be reduced if a less expansive definition of agricultural land (for example, similar to the definition used for land tax purposes) were used.

Submission 2: Proposed section 25-115 and corresponding section in transitional provisions

Despite your comments, we remain concerned that the ATO could still seek to apply Part IVA in respect of cross-staple rent as it is not explicit under the proposed wording. The actual wording is that the operating entity "could otherwise deduct the amount under section 8-1…". We are aware of the ATO currently seeking to deny deductions under section 8-1 for cross-staple rent.

Consequently, we suggest that the legislation makes it clear that Part IVA is turned off during the period the choice is in effect. This could be done, for example, by way of a note to proposed section 25-115(2).

Submission 3: Proposed section 12-440 and "MIT cross staple arrangement income"

It is possible that some taxpayers may seek to restructure their arrangements with customers, e.g. by separating out rent from service charges rather than having one composite charge, such that part of their income meets the requirements of section 12-440(3). We recommend that a comment is included in the EM saying that such restructures would be acceptable from a tax perspective as they would meet the objectives of the provisions. Precedent for this is the comment in the EM that accompanied the introduction of the hybrid mismatch rules.

Submission 4: Proposed section 880-105

It is not particularly clear why, in proposed section 880-105(1)(e), the income needs to be derived from a trust that is a MIT. If the sovereign entity is only meant to derive income from a trust that carries on passive activities, we would recommend that the trust referred to in this subsection be one that carries on an Eligible Investment Business within the meaning of Division 6C ITAA 1936.

Submission 5: Proposed section 12-450 and Part 3, section 10

In the above provisions, there is reference to the relevant time period commencing on the first "day on which an asset that is part of the facility is first put to use." Paragraph 1.70 of the EM then suggests that this would be when the relevant asset becomes operational (even if it does not produce assessable income).

We would suggest that this could be before the relevant asset has received engineering/vendor sign off (e.g. a wind turbine can generate electricity before the constructor has handed it over to the facility owner) or the asset can be ready well before the project is open to the public (e.g. the overhead toll machinery or toll booths on a toll road). We would suggest that the provisions be amended such that the time period commences when the entire facility is completed and ready for use.

We also suggest clarifying in section 10(2) of Part 3 that the reference to "acquisition" and "owns" covers the situation where the facility is held under a long term lease from a Government entity.

Submission 6: Meaning of facility

Whilst there are examples of what could constitute a facility in the EM, we consider that further guidance would be useful. We will separately raise this with the ATO in the context that they could perhaps publish a Taxation Ruling on this as well. This could be similar to what they did in TR 94/11 for a "unit of property".

Submissions for the foreign pension exemption and Sovereign Immunity

Submission 1: Foreign Pension Fund and Sovereign Entity influence test

The influence test is discussed in Example 4.6 of the EM and, in the example, an investor with an equity interest of 5% or more which is entitled to appoint a member to the Advisory Board of the investment vehicle would be considered to have influence. This would have the consequence that any income from that vehicle would not be NANE.

Would this still be the case:

(i) Where the investor, by way of side letter, agrees to give up their entitlement to a seat on the Advisory Board;
(ii) As for (i) but the investor can be an Observer at Advisory Board meetings; and
(iii) Advisory Boards are often limited to a set number of individuals. What if, in your example, not all investors could be on the Advisory Board?

Submission 2: Foreign Pension Fund - Portfolio Test

Schedule 3, item 2 of the ED broadly states that an exemption from interest and dividend withholding tax for a superannuation fund for foreign residents ("foreign superannuation fund") is only available if the total participation interest of the foreign superannuation fund in the ***paying entity*** is less than 10%. Furthermore, paragraph 3.15 of the EM clarifies that the paying entity is the entity in which the foreign superannuation fund holds the first level of its investment into Australia (i.e. if the foreign

superannuation fund invests through an Australian trust, an assessment must be made of the foreign superannuation fund's level of interest in that trust).

Although it is appropriate to test the foreign superannuation fund's level of interest where it derives the interest and dividend income directly we are unclear on the policy and purpose on why the proposed provisions specifically do not cater for indirect investments by foreign superannuation funds in debt and equity instruments (for example, it is common practice for foreign superannuation funds to invest into an Australian pooling vehicle, such as an Australian trust, and it is this Australian trust that then holds the relevant debt or equity instrument).

In such a scenario, Section 128A (3) of the ITAA 1936 states:

> *"For the purposes of this Division, a beneficiary who is presently entitled to a dividend, to interest or to a royalty included in the income of the trust estate shall be deemed to have derived income consisting of that dividend, interest or royalty at the time when he or she became so entitled."*

Where a foreign superannuation fund holds units in an Australian trust, it is clear that section 128A (3) will deem that the foreign superannuation fund will derive interest and dividend income at the time when it is presently entitled to that income of the trust. Under current drafting of the ED, the level to test the participation interest is in the Australian trust, and not in the underlying entity that is held by the Australian trust that is actually paying the interest or dividend. This is the case even though the foreign superannuation fund may only hold a portfolio indirect interest in the underlying investment (i.e. less than 10%) or no equity interest at all (where the Australian Trust is a 3rd party lender to an Australian resident borrower).

We submit that there should be no difference in outcome where a foreign superannuation fund invests in debt and equity instruments directly or indirectly.

This outcome is different to that previously adopted.

We therefore suggest that further guidance is provided for this change and, absent any clear policy objectives, allow indirect tracing for the purpose of satisfying the portfolio interest test. We submit that the "*paying entity"* (as defined in the proposed section 128B (3C) should be the third party borrower making an interest payment to either an Australian interposed trust or directly to the foreign superannuation fund or the third party company making a dividend payment to either an Australian interposed trust or directly to the foreign superannuation fund which should be defined as the *paying entity*.

If this is not amended, Australian Fund Managers will be at a disadvantage when setting up Australian based debt funds to attract foreign superannuation fund investments as the foreign superannuation funds would be worse off investing via an Australian fund manager compared to a direct investment. We do not see the policy reasons behind the change proposed with the ED to support this outcome. While the proposed rules relating to the sovereign immunity would also apply at the trust, there is a clear differentiation between the two regimes as the sovereign immunity exemption goes beyond withholding tax and applies to other income and gains from the disposal of the investment as well. Therefore, there is in our view no necessity to align the two sets of rules with regard to direct and indirect interests in the ultimate investee entity in Australia.

Submission 3: Definition of Covered Sovereign Entities

The definition of covered sovereign entities in section 880-120 specifically excludes:

- a superannuation fund for foreign residents; and/or
- a foreign superannuation fund.

This position is different to that previously adopted by the ATO in practice in providing sovereign immunity rulings. There are a number of sovereign entities that may also fall within the definition of superannuation funds for foreign residents and which satisfy all other conditions of a sovereign entity in section 880-15. The policy and purpose regarding this exclusion is unclear to us. We therefore suggest further guidance is provided and, absent clear policy objectives, the exemption be extended to foreign government pension funds.

Equally, further explanation would be desirable with regard to the criteria that "*the entity is funded only by public money*" in section 880-120(1)(a). As noted in our prior Submission, we understand that in the past, the practice of the ATO was to give rulings in respect of specific sovereign investments on the basis that the investment was wholly funded by public money. Whether or not other investments existed (which did not rely on the principle of sovereign immunity), did not impact the availability of the principle of sovereign immunity to the specific investment wholly funded by public monies.

We raise again our concern that other investments held by the sovereign entity could impact on the availability of the principle of sovereign immunity (now expressed in the proposed section 880-105) to specific Australian investments that are solely funded by public monies. This would undermine the principle of sovereign immunity which we understand the Government intends to maintain albeit in legislated form.

Applying this provision consistently with policy could be difficult as every sovereign body not only raises *public monies* by way of taxes and other sovereign means but also borrows funds in the financial markets. Therefore, the meaning and width of the criteria of being "*funded only by public money*" in the proposed section 880-120(1)(a) requires clarification.

A possible approach to address this issue would be to replace the reference to the entity being funded by *public monies* to a reference that the relevant investment is being funded by *public monies*.

Submissions for the Agricultural Measures

Submission 1: Agricultural measures - transitional measures - capital gains tax transition

Many investors into Australian agriculture have made long term investment decisions based on the existence of the managed investment trust (**MIT**) regime's taxation of capital gains at a rate of 15%. Most of these investments have been made on a long term basis and accordingly, the 7 year transitional period from 1 July 2019 to 1 July 2026 is welcomed.

However, the proposal to tax all capital gains relating to agricultural land at a rate of 30% from 1 July 2026 onwards is distortionary and could significantly impact investment and divestment decisions in 2026 and preceding years.

Based on current drafting, a disposal of an agricultural investment on 1 July 2026 would incur double the tax cost of a disposal of the same investment on 30 June 2026. This significant tax difference will drive vendor decisions. This could result in market distortions - particularly given certain agriculture segments are tightly held. Tax driven selling could negatively impact small investors through declining comparable sales (impacting loan to value ratios and other debt covenants) and could impact institutional investors who may have to impair their investments.

We recommend that the capital gains tax measures for agricultural investments should operate so that affected assets have a deemed market value as at 1 July 2026 for the purpose of determining capital gains post 1 July 2026. That is, gains which accrued between the acquisition time of the relevant asset and 1 July 2026 should be taxed at 15% (even where the relevant capital gains tax event occurs after 1 July 2026), with any gains in excess of the 1 July 2026 deemed market value cost base being taxed at 30%.

This measure:

- fulfills policy objectives;
- is consistent with the approach taken for the sovereign immunity transitional provisions;
- avoids market distortions; and
- should be easy to implement with the potential to mandate independent valuations where there are integrity concerns.

Submission 2: Agricultural measures - transitional measures - less than 100% holdings

The legislation as drafted only provides for transitional relief for indirect agricultural income if the MIT holds 100% of the asset holding entity (refer paragraph (f) of section (1) of Item 12 of Part 3).

The 100% ownership requirement differs from the Explanatory Memorandum which only refers to a requirement that *"the MIT had a participation interest in the entity for the whole of that period"*. The proposed legislation which limits transitional relief to indirect investments only if they are 100% owned by a MIT:

1. is distortionary because it creates asymmetric treatment between direct and indirect investments;

2. is arbitrary because it changes the tax treatment for long-term investments without any reasonable transition period (and therefore is contrary to the 27 March policy announcement); and

3. is perverse and contrary to policy objectives because it penalises investors who have created joint ventures with Australian farmers (relative to investments which are 100% foreign owned).

Many investors have made several long-term investments in Australian agriculture based on the MIT regime. Further, many of these investments involve managed investment trusts investing in less than 100% owned joint venture entities (usually trusts). These joint venture trusts often involve institutional investors (who hold their investment in a managed investment trust) co-investing with other local investors (often Australian farming families) in the trust.

These joint ventures with Australian farmers provide patient capital to support Australian farming businesses expand and grow with continued Australian involvement. The approach of partnering with Australian farmers should not be penalised by the transitional arrangements.

The arbitrary removal of this regime - without any transitional arrangements - represents a significant sovereign risk.

Accordingly, we recommend that the transitional rules should apply to any amounts derived, received or made by the managed investment trust from an entity in which it held **a** participation interest (i.e. consistent with the explanatory memorandum) over the relevant period.

Submission 3: Agricultural measures - transitional measures - 'asset held' requirement

Paragraphs (d) and (e) of Item 12 of the Transitional measures operate so that transitional relief for MIT agricultural income is available only where the managed investment trust (paragraph (d)) or other entity (paragraph (e)) *"**held** the asset throughout the period that… started just before 27 March 2018"*.

This approach is inconsistent with the MIT cross staple arrangement income provisions (Item 10 of the Exposure Draft) which apply the transitional relief to circumstances where an entity *"entered into a contract before 27 March 2018 in respect of the acquisition [of the relevant asset]"*.

There is no principled basis for the distinction. Taxpayers who had entered into binding contracts for the acquisition of agricultural land based on the MIT fiscal regime should not be prejudiced simply because the contract had not yet completed.

The lack of transitional relief in these circumstances creates sovereign risk and is inconsistent with the policy document which did not differ in the transitional arrangements for Elements A, C, D and E (i.e. including the cross staple income and agricultural income measures) stating that *"**arrangements in existence** at the date of government announcement of this package will have access to a seven year transition period."*

We recommend that the reference to *"**held** the asset"* be replaced with *"held the asset **or** entered into a contract… in respect of the acquisition of the asset"*.

This is consistent with the policy announcement and is appropriate to reflect the change of tax treatment of long term investments, and to avoid inappropriately differentiating between different classes of assets.

Submissions for the MIT Residential Housing Measures

Submission 1: MIT Residential Housing Income measures - "Attributable to"

The reference to the phrase "to the extent that it is **attributable** to an asset" in the definition of "MIT residential housing income" is very broad and would currently capture financial arrangements including mortgage securitisation arrangements and other similar arrangements including those being adopted in the university housing sector. The university housing sector is a strong growth area which continues to attract increasing international student participation which in turn creates substantial flow-on benefits for the broader Australian economy and accordingly there are strong policy reasons to not remove the MIT concessional rate on foreign capital flowing into these projects.

These financial arrangements would ordinarily be subject to the TOFA provisions and would typically meet the definition of "eligible investment business" activities in section 102M. It is not clear whether the policy intention was to capture such financial arrangements. If this was not an intended outcome we would recommend that the definition of "MIT residential housing income" be amended to exclude such financing arrangements.

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We look forward to the opportunity of discussing our submission with you in further detail. In the interim, if you have any questions please contact us.

Yours sincerely,

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