THE TAX INSTITUTE

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

By email: stapledstructures@treasury.gov.au

Dear Mr McKenna

Stapled Structures and Other Measures

The Tax Institute welcomes the invitation to make a submission in relation to the Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018 (**Bill**) and the related exposure draft explanatory material (**EM**).

The Tax Institute is disappointed with the two-week consultation period for this Bill. Given the importance of these measures and the potential impact, a full consultation period of at least 4 weeks should have been provided.

Stapled Structures – general comments

Stapled structures are used in a variety of industries and for a variety of purposes. They are also a useful tool to attract foreign investment into Australia. The proposals outlined in the Bill to remove the tax concessions for certain stapled structures, may deter foreign investors from investing in Australia due to the exposure to the high Australian corporate tax rate.

Given that Australia is a 'capital importer', it is important that these types of tools are available to ensure capital continues to be attracted to Australia. If they are not made available, then other incentives will be required to ensure that Australia remains internationally competitive (for example having a corporate tax rate that is comparable to international competitors).

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Stapled structures are generally associated with long term projects, where foreign investors such as sovereign wealth funds and foreign pension funds have chosen to invest for a given price on the basis that Australia has a stable political landscape. Foreign investors view any amendments to the tax law which are not accompanied by grandfathering provisions for the life of that investment as representing sovereign risk, which may adversely affect future decisions by a foreign investor to invest in Australia.

For these reasons, we do not support the stapled structure measures outlined in the Bill and do not think the Bill should proceed. Notwithstanding this, we have outlined more specific concerns in relation to the Bill and EM below.

Stapled Structures - Part IVA

In the 27 March 2018 Treasury paper titled 'Stapled Structures – Details of integrity package' it was indicated at paragraph 33 that following the implementation of the integrity package, the Part IVA provisions would not apply with respect to the choice of a stapled structure to obtain a deduction in respect of cross staple rent during the transitional period.

This will cause uncertainty in respect of whether Part IVA would apply after the expiry of the transitional period (even where the specific integrity rules yet to be announced are complied with) and whether Part IVA could apply to resident and non-resident investors in respect of any other potential tax benefits which the ATO might otherwise determine arise as a result of the stapled structure.

The Bill needs to make it clear that Part IVA will not be applied to disturb any of the associated tax outcomes (eg in addition to the deduction, the flowthrough of the connected income and the application of the MIT withholding regime) where the proposed stapled structure provisions apply. The Bill and the EM should be amended accordingly.

The EM should be amended to include a clear statement that Part IVA will not apply. In relation to the Bill, this could be achieved, for example, by amending the references in proposed s12-453(1)(d) and proposed item 9 paragraph 4(e) in Schedule 1 of the Bill to refer to "the criteria under section 8-1 of the *Income Tax Assessment Act 1997*, other than paragraph 8-1(2)(d), for the operating entity to claim a general deduction for the amount are satisfied".

Stapled Structures - De minimis Exception

In our opinion, the de minimis exception in the Bill should be redrafted. The de minimis exception should be drafted as a dollar amount (ie the stapled structure provisions will not apply if the non-concessional MIT income is less than a specified amount). In our opinion, the specified amount needs to be set at an appropriate amount so that entities with relatively small amounts of non-concessional income will not need to undertake the compliance burden of determining whether the stapled structure provisions apply.

We recognise that some taxpayers may try to establish lateral structures to fit within the de minimis exception. However, we think the de minimis exception can be set at a specified amount that would mean that the costs associated with setting up additional structures would not be justified. It therefore should address such concerns.

Stapled Structures - Definition of infrastructure

In our opinion, the definition of infrastructure in the Bill should be structured so that the Treasurer has the discretion to include things in the definition in the future.

In our opinion, this will help to ensure that technology that has not yet been considered can be dealt with under the proposed legislation.

For example, as digital technology develops, new forms of infrastructure could emerge. We have already seen a number of States privatising land titles registries, which have some of the features of infrastructure. Confining the rules to categories of infrastructure that are prevalent under current concepts is arbitrarily restrictive and may result in difficulties in future.

Stapled Structures - Rent definition

The Tax Institute considers that it is important to define the term “rent” as used in the Bill. At the current time, there is significant uncertainty as to whether the concept of “rent” is confined to legal form rent in relation to a lease, or whether it extends to other payments that are functionally the same as legal form rent, such as licence fees to use a particular space.

The ATO has traditionally considered that the term rent is confined to legal form rent. This creates a distortion in the market as there are different tax outcomes to economically similar arrangements (eg structuring agreements for the use of space as lease agreements and charging rent rather than licence agreements). This can lead to inefficient market outcomes since in many cases it may be more commercially appropriate to draft an agreement as a licence.

For example, assume an entity developing student accommodation has the choice between constructing dorm accommodation or single room accommodation. Some forms of dorm accommodation cannot be drafted as a legal form lease, due to the difficulty of providing for exclusive possession. This uncertainty may therefore result in the investment in the construction of single room accommodation, which can readily be drafted as a legal form lease, as the entity may be concerned to preserve access to the concessional MIT rate. However, in many cases, the efficient market outcome would be for more dorm accommodation to be built. Therefore, the arbitrary distinction between legal form rent and legal form licence fees can lead to inefficient economic outcomes.

In other countries, such as the US, it is accepted that rent includes payments for the use of space or real estate, rather than legal form lease income (ie legal form rent) This amounts to taking a "substance over form" approach, and leads to a more tax neutral outcome. We submit that the same approach should be taken in the Bill.

Stapled Structures - Transitional arrangements

In our opinion, the election required to be made under the transitional provisions should not be irrevocable. Until all further details in relation to the proposed stapled structure provisions are finalised, we cannot support the irrevocable nature of the transitional provisions.

Further, in our opinion, the timing for making elections under section 12-453 of the Bill should be expanded so that elections can be made by "the later of" the timing currently specified in the Bill (ie when the asset is first put to use) and an appropriate time after the Bill is enacted.

Thin Capitalisation

The Tax Institute considers that it is clear on the face of the text of the proposed new sub-paragraph (iv) to paragraphs 820-105(3)(g) and 820-215(3)(g) that an additional factor to be taken into account in determining the arm's length debt amount is the debt to equity ratio of each and every entity in which the entity (in respect of which the arm's length debt amount is being determined) has a direct or indirect interest throughout the year. Paragraph 2.17 of the EM expresses a consistent view. That is, the debt to equity ratios of any entities in which the entity has a direct or indirect interest <u>must</u> be taken into account (our emphasis).

By contrast, paragraphs 2.11, 2.18 to 2.20 and Example 2.3 of the EM are not consistent with proposed new sub-paragraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv) as they clearly indicate that the additional debt to equity ratios do not need to be taken into account in each and every case but "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" (paragraph 2.18). The concept of relevance is not found in proposed new sub-paragraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv). The same issue arises in relation to the third paragraph of Example 2.3.

Paragraph 2.20 of the EM sets out a number of indicators of relevance. However, as mentioned above, the concept of relevance is not to be found in new sub-paragraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv).

Further, the first sentence of paragraph 2.19 introduces another concept, that of materiality. The concept of materiality is also not found in proposed new sub-paragraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv).

We also note that the views expressed in paragraphs 2.11, 2.18 to 2.20 and Example 2.3 of the EM are not consistent with Taxation Ruling TR 2003/1 issued by the ATO. In this regard, we note that paragraph 46 states that "All of the relevant factors <u>must</u> be taken into account in determining this notional amount" (our emphasis).

As such, it is not clear whether the underlying policy intention of the proposed amendments is to make it compulsory in all cases that the debt to equity ratio of each and every entity in which the entity (in respect of which the arm's length debt amount is being determined) has a direct or indirect interest throughout the year must be taken into account or whether the underlying policy intention is that an additional debt to equity ratio analysis is only to be taken into account in more limited circumstances. For example, where such direct or indirect interests are considered to be relevant to the considerations of a prudent independent borrower and prudent independent lender and also material.

The compliance costs associated with performing the additional debt to equity ratio analyses in all cases may be a significant burden. Therefore, in our view, the preferred approach would be to modify the proposed new sub-paragraph (iv) to be added to paragraphs 820-105(3)(g) and 820-215(3)(g) in order to make it clear that any debt to equity ratio analyses to be taken into account for purposes of sub-paragraphs 820-105(3)(g)(iv) and 820-215(3)(g)(iv) are limited to those that would be relevant to the considerations of a prudent independent borrower and prudent independent lender and also material.

Superannuation Funds for Foreign Residents WHT exemption

Given the short consultation period provided in relation to the Bill. We have not been able to provide comments in relation to Schedule 3 of the Bill. However, we will submit an addendum to this submission to cover any issues we consider need to be raised in relation to the proposed withholding tax exemption provisions.

Sovereign immunity

We are concerned that Treasury has taken these measures further than intended. We query whether these proposals are in breach of international law. In our opinion, there are broader implications that need to be fully consulted before this reform is implemented.

We recommend including an analysis of what other countries do in relation to this area in the EM to provide more context for the amendments.

The drafting of section 880-55 which provides that a "*sovereign entity is liable to pay tax on its taxable income"* is extremely broad and will apply in (what we assume) are unintended ways. The broad drafting of the section would appear to mean that a foreign consulate in Australia would, for example, be subject to Australian taxation on the visa application charges for visitors to its country. Further examples now becoming subject to Australian tax would include direct interests in real estate held by a sovereign entity as a passive investment as well as capital gains tax on the sale of land used for diplomatic or consular purposes.

The Bill appears to deem all sovereign entities to have submitted themselves to Australia's jurisdiction to tax, irrespective of whether the relevant activity is a governmental function or a commercial activity. This position creates a risk of creating future litigation as to the validity of the laws in question.

The issues identified in the government announcement are limited to concerns regarding commercial investments.

Therefore, in our opinion, section 880-55 should be confined to income from investment. For example, a sovereign entity is liable to pay tax on its taxable income to the extent it arises because the sovereign entity holds any of the following kinds of interest in an entity:

- a membership interest;
- a debt interest; or
- a non-share equity interest.

The normal principles of sovereign immunity would then continue to apply for other forms of income, such as visa application fees, capital gains from disposal of consular real estate, or passive rental from real estate, where the income is derived from governmental functions. On the current drafting of section 880-105(1)(a) – (c), none of these forms of taxable income would be eligible for sovereign immunity on the face of the law.

If our submission in relation to section 880-55 above is not accepted, we consider that more detailed legislation needs to be drafted that gives due consideration to all forms of income likely to be derived by sovereign entities, so that the rules would constitute a comprehensive code for the application of sovereign immunity.

Notwithstanding our comments above, if the draft legislation is enacted as outlined in the Bill, we make the following comments in relation to the proposed legislation.

The requirement in section 880-105(1)(b) that if the paying entity is a trust it must be a managed investment trust (**MIT**) should be changed. There are numerous strict requirements in order to be a MIT, many of which would not appear to be relevant in the case of a sovereign investment. Instead if this limitation was intended to limit the types of income which could be distributed to “passive” types of income this would be better achieved by using the concepts of “eligible investment business” in Division 6C.

The requirement in proposed section 880-105(1)(c) that the sovereign entity derives the income only from a membership, debt or non-share equity interest is too narrow as it does not take into consideration that passive investment income can be derived from arm’s length third parties (such as tenants in a commercial office building).

Given the gravity of the change proposed in relation to sovereign immunity, we consider that the transitional provisions need to be widened.

More specifically, the transitional provisions need to be expanded to all situations in which assets were held by a sovereign entity at 27 March 2018 which were subject to sovereign immunity at that date. There are many circumstances in which a sovereign entity may not have a “private ruling” from the Commissioner in relation to a particular asset. These situations may include:

- Where sovereign immunity has been confirmed by a different arm of the Australian government (for example a direct exchange of letters between the Treasurers of Australia and the other sovereign nation);
- Where sovereign immunity was confirmed by the Australian Taxation Office by letter to the sovereign entity prior to the modern system of private rulings;
- Where the sovereign entity obtained a ruling, but has changed name under a restructure of the sovereign government;
- Where a sovereign entity from one part of a foreign country has obtained a ruling, but another sovereign entity from the same country relies on the ruling in relation to similar investments;
- Where the sovereign entity obtained a ruling in relation to one investment and has continued to apply the principles of that ruling to subsequent purchases of assets in similar situations; and
- Where the sovereign entity has relied on the clear statement of the ATO position in ATOID 2002/45 in relation to its investments.

In some cases, the sovereign entity will have held the asset, and relied on sovereign immunity, for many decades and in these circumstances, it is unreasonable to apply the new law to those long-standing assets from 1 July 2019 with no adequate transitional period in which to restructure their affairs.

Given the range of circumstances in which sovereign entities would have justifiably relied on the principle of sovereign immunity, we recommend that the requirement that the sovereign entity held a “private ruling” in Schedule 4, Part 2 4(2)(b) and (c) and 5(1)(b) be deleted.

Further, if section 880-105(1)(d) is to aggregate sovereign entities (as it does under the current drafting), then the transitional provisions should apply on an aggregated basis (ie regardless of which sovereign entity holds the ruling/approval).

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If you would like to discuss, please contact either me or Tax Counsel, Angie Ananda, on [redacted].

Yours sincerely

Tracey Rens
President