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20 April 2017

Division Head
Corporate and International Tax Division
The Treasury
Langton Crescent
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By email: Stapledstructures@treasury.gov.au

Dear Sir/Madam

Stapled Structures Consultation Paper, March 2017
EY Submission

We are pleased to provide this submission as part of the Australian Treasury's review of potential policy options in relation to stapled structures, the taxation of real property investments, and the re-characterisation of trading income.

We welcome Treasury's commitment to ensuring that Australia is an internationally competitive location for foreign investment. The Australian Government has had a long standing policy to support and develop Australia as an attractive location for foreign investment, including the advancement of the Managed Investment Trust (MIT) regime to enhance the international competiveness of the Australian managed funds sector.

We agree administrative action alone is unlikely to create sufficient certainty for existing and future investors, particularly in light of:

- The Australian Taxation Office's (ATO's) recent focus on potential integrity and compliance issues through the release of Taxpayer Alert TA 2017/1 and the January 2017 Draft Privatisation and Infrastructure – Australian Federal Tax Framework document.
- Treasury announcements in 2016 in relation to strengthening the consultation occurring between the Foreign Investment Review Board (FIRB) and the ATO and the use of that consultation in evaluating transactions seeking FIRB approval.

We stress that caution must be exercised in evaluating the need for, designing, and implementing new policy settings to ensure Australia retains its reputation as a competitive and low sovereign risk location for foreign direct and indirect investment. Ultimately, restricting the supply of global (and domestic) capital will have an adverse impact on the price consumers pay for infrastructure provision. The size of infrastructure investment required in the coming decades is significant, with various sources estimating Australia's infrastructure deficit to be up to $800 billion in the next 10 years, though the estimates vary.

Any tax policy change in respect of stapled structures must ensure that the environment for foreign direct and indirect investment into Australian infrastructure is broadly aligned with international norms in comparable countries and recognise the concessions available to domestic investors including through the utilisation of franking credits and reduced tax rates available for domestic superannuation fund investors.

To summarise, we submit that:

1. The time provided for the consultation has not been sufficient to undertake a detailed consideration and analysis of the matters identified by Treasury for input and indeed too short to allow Treasury to recommend appropriate measures to the government in time for the May 9 Budget.

2. We recommend a longer consultation period with input from all relevant stakeholders and caution against any immediate changes in the absence of such a consultation. We propose an urgent review led by the Board of Taxation to report by year end 2017.

3. Stapled structures underpin significant investment in Australia and are supported by various commercial drivers. Critical is the flow-through treatment to facilitate capital / cash repatriation to investors and to facilitate efficient financing packages.

4. Australia does not currently have alternative structures that provide the same economic outcomes for investors as do other jurisdictions. This also means that a direct comparison of the use of stapled structures in other jurisdictions is not appropriate, particularly as other jurisdictions also have various collective investment vehicles and / or other concessions that can effect similar flow-through treatment. We submit that a holistic review of the Australian and foreign regimes for facilitating investment into property and infrastructure should be undertaken.

5. Australia is a net capital importer and has enacted several policies to promote Australia as a financial services hub. The consultation must therefore be undertaken with due consideration so as not to adversely impact the appetite for investment into Australia's property and infrastructure sectors.

6. The impact of any changes to the existing regime could be significant and any restructuring required to conform with any new rules costly. In particular:
   a. There could be significant stamp duty costs arising from restructures; and
   b. Many projects with locked-in contractual arrangements spanning years, or even decades, might see significant break costs for altered structuring and/or significant financial damage to the investors in those projects.

   Accordingly, any changes made should be supported by detailed economic impact analysis.

7. We caution against any immediate changes to policy in the absence of further consultation.

8. Further, we submit that if specific integrity measures are found necessary then minor prospective amendments to the existing legislation could be made to address the Government's concerns.

We set out some further detail on our submissions in Appendices A.

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Thank you for the opportunity to provide this submission. We would welcome the opportunity to be involved in further consultation as the policy options are refined including clarification of any issues or questions arising from the initial consultation process.

Should you have any queries in relation to this submission, please do not hesitate to contact our Oceania Energy and Infrastructure Tax Leader Paul Laxon on (07) 3243 3735, or our Oceania Real Estate Tax Leader Stephen Chubb on (02) 9248 4799.

Yours sincerely

Ernst & Young

Appendix A

EY Submission: Stapled Structures Consultation Paper, March 2017

Introduction

We note that Australia has well-established infrastructure and property industries that are highly attractive to both domestic and foreign investors. In particular, we note that:

- 94 per cent of participants in Infrastructure Partnerships Australia's Australian Infrastructure Investment Report 2016 indicated that they are 'highly likely" to invest in Australian opportunities in the next two to three years. This was an increase on the prior year's results.
- "*Investors identify Australia's strong track record in infrastructure and our stable economic, fiscal and regulatory environment as key features driving the attractiveness of the Australian market; with the depth of market knowledge and ease of doing business adding further appeal.*"[1]
- Australia has a mature Real Estate Investment Trust (A-REIT) regime which facilitates the growth of direct real estate investors from overseas and has created a very competitive domestic market, with Australia (alongside Japan) being one of the fastest growing markets in the last five years. [2] The existing A-REIT regime is mature, having developed over several decades, is well understood, and has developed to allow A-REITs to supplement their passive income with income from other complementary businesses.

Australia has traditionally been a net capital importer and has long maintained policy settings reflecting the importance of an open economy and attracting foreign capital (even with a comparatively high headline corporate tax rate). The benefits of this foreign investment include, inter alia:

- Increased competition in our markets, enhancing the value of Australian assets (particularly in respect of the privatisation of infrastructure assets in recent years);
- Additional supply of capital, resulting in a reduced cost of capital;
- Ultimately, this has resulted in enhanced assets and lower prices for services products for consumers.

Australia has been successful in attracting foreign capital through the introduction of the MIT regime, which further supports the flow-through tax treatment of passive income. For example, a recent study published by the Financial Services Council and Perpetual, *2016 Australian Investment Managers Cross-Border Flows Report*, found that the "*money flowing into Australian vehicles from overseas sources has increased significantly over the six year study period[3], growing at a compound rate of 17.8% per annum*." Furthermore, the study found that the main asset class for Australian Investment Managers was Australian real estate (31.1%) as at 31 December 2015[4]. We note that the maintenance of the MIT regime is consistent with the Government's policy intention to build Australia as a financial services hub. Furthermore, withholding MITs require Australian investment managers and other Australian service providers in order to comply with the rules. This results in additional revenue generated from annual investment management fees which is subject to the 30% corporate tax rate. Investment management fees are generally calculated as a percentage of funds under management, with additional fees for acquisitions and disposals.

However, recent announcements from the ATO have caused concern and uncertainty regarding the administration of the current system of taxation in the infrastructure and property industries, in particular

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[1] Infrastructure Partnerships Australia & Perpetual, *Australian Infrastructure Investment Report 2016*
[2] EY *Global Perspectives: 2016 REIT Report*
[3] The study period of the report was from 2010 to 2016 to examine the impact of the MIT regime.
[4] *2016 Australian Investment Managers Cross-Border Flows Report*

in relation to the use of stapled structures. Accordingly, we welcome the consultation into stapled structures in the hope that this will ultimately restore certainty to the industry. However, we note that the current consultation should be undertaken with due consideration so as not to adversely impact the appetite for investment into Australia's property and infrastructure sectors.

Commercial reasons for stapled structures

Stapled structures are integral to the property and infrastructure industries by providing a flow-through structure that facilitates the derivation of complementary passive and active income, increased capital investment from investors and pre-tax funding from debt providers. Stapled structures are typically used for investments where there is a significant land component that gives rise to passive income. Whilst from a tax perspective the stapled structure provides an ability to supplement the passive income with complementary trading income (from the operating side of the staple), there are also significant commercial reasons for the structure, including those outlined below.

- Flow-through status of the "land holding" trust
  - Investors have the flexibility to structure their affairs based on their individual circumstances. This is particularly important where consortia form to buy certain assets (e.g. infrastructure) as tax structuring decisions do not need to be made at the asset level; rather the investors in consortia can make their own tax structuring decisions impacting their own internal rates of return.
  - The flow-through tax status means that lenders can calculate lending ratios on a pre-tax basis as tax payable is outside the lenders security net. Such a structure also results in lenders structurally ranking ahead of unsecured liabilities for income tax (which is not available in a corporate structure).

- Capital / cash repatriation
  - In the property and infrastructure industries, the ability to repatriate cash is critical, particularly in light of the cash, accounting and tax profile of property and infrastructure assets. Typically such assets will become cash positive, prior to generating accounting, and finally tax, profits.
  - In the absence of a flow-through vehicle, capital will be "trapped" within the vehicle with limited ability to repatriate it to investors given the restrictions on capital repatriation in the *Corporations Act 2001* (refer comments below regarding deficiencies in the operation of Section 254T of the *Corporations Act 2001*).
  - The absence of a flow-through vehicle can also result in a double economic taxation where unfranked dividends are paid out early on in the project life-cycle (due to the absence of taxable profits, and therefore franking credits), but then franking credits become "trapped" within the vehicle towards the latter stages of the project life cycle (due to the absence of sufficient accounting profits to pay dividends).

- Separation of active and passive income
  - In the real estate industry, there are some investors who only want exposure to the passive assets, some who only want exposure to the active assets whilst others are happy to invest in both sides (e.g. student accommodation).
  - The separate holding of entities which derive active and passive income respectively preserves the commercial flexibility for the introduction of new capital partners and future sale(s) without a need for a costly restructure.

- Australia does not have alternative investment vehicles offering similar economic outcomes
  - Limited partnerships are taxed under a corporate tax model in Australia (vis–à–vis flow through limited liability partnerships (LLPs) in other jurisdictions).

- Whilst other partnerships in Australia are taxed on a flow-through basis, they also give rise to joint and several liability for the partners, which is not commercially desirable, and any change in the identity of partners results in a new partnership and consequential taxation events.
- The use of a single trust can be problematic as changes to the identity of investors can impact the tax treatment of the trust.
- The Federal Government has announced the introduction of a new collective investment vehicles (CIV) regime in recognition of the need for Australia to remain competitive in the funds management industry. Currently, such structures are common in foreign jurisdictions.

In light of the rationale for stapled structures as outlined above, any changes to the existing tax treatment, and specifically on the ability to effect distributions of "free cash", could have significant impacts. Given the short timeframe of the consultation, it is not possible to provide a comprehensive analysis of the potential impacts and we submit that Treasury should undertake a detailed economic impact analysis of any change before that is effected.

In the absence of any knowledge as to what the alternative treatment would be, it is difficult to articulate what the precise impacts could be. However, should the alternative be a corporate tax regime, we suggest that some of the impacts may include:

- The breach of debt covenants resulting in defaults on loans from financiers;
- Depression in the value of existing assets;
- Liquidity risk for investors in existing assets;
- Reduced attractiveness of Australia as a destination for foreign capital;
- Increased risk and cost of capital for greenfields projects;
- Increased cost of infrastructure provision for Australian consumers; and
- Prohibitive transaction costs for restructuring.

International comparisons: international treatment of infrastructure

The Consultation Paper notes that stapled structures are only used in limited jurisdictions, including Australia, Singapore and Hong Kong. Furthermore other jurisdictions have introduced mechanisms to remove the tax advantages from stapled structures. In the time given for submissions, it is not possible to undertake a comprehensive analysis of the tax regime for property and infrastructure in foreign jurisdictions. We note that the comparison with other jurisdictions should be undertaken in a holistic manner and it is not sufficient to merely focus upon the use of "stapled structures" in other jurisdictions as each jurisdiction has its own challenges and benefits. In this regard, we note consideration should also be given to:

- The existence of alternative flow-through vehicles / flow-through treatment;
- The existence of any thin capitalisation concessions or concessional depreciation rates for infrastructure investment;
- Corporate tax rates;
- The ability to repatriate capital efficiently and effectively throughout the life of the project;
- Relevant distribution taxes and credits imposed on / available to investors; and
- The existence of a level of double taxation vis a vis Australia's dividend imputation regime.

Case study: Renewable Energy

The complexity in accurately comparing Australia's regime for taxing infrastructure against those in foreign jurisdictions can be demonstrated by looking at a specific subset of infrastructure projects, the renewable energy industry.

Treasury must appreciate that a large number of renewable energy projects, which provide critical power generation infrastructure and rely predominantly on the use of land and fixtures, have been established as rental staples. To date, the growth of the renewables industry has been encouraged through State and Federal Government incentives, including grants and government-backed power purchase agreements. This support is being gradually withdrawn as the industry matures, leaving developers reliant on private capital, predominantly foreign, to fund the new projects required to meet various State and Federal Government renewable energy targets.

Appendix B provides a brief overview of the international landscape for investment in renewable energy projects. More than 20 countries, including many developed countries, offer specific tax incentives to encourage investment in renewable energy projects, such as:

- A reduction in the headline rate of corporate tax payable, through reduced tax rates, full tax relief and tax holidays;
- Investment tax credits; and
- Significant acceleration of capital allowances, which may include immediate deductions for certain renewable energy equipment.

Conversely, Australia has a comparatively high corporate tax rate and no specific tax incentives to encourage the development of this emerging sector within the infrastructure industry.

The extent of the concessions available overseas for renewable energy projects reinforces our view that an examination of the use of stapled structures must properly examine the tax regimes, including concessions, applicable to the property and infrastructure industries in different jurisdictions (and not merely be limited to a comparison of whether “stapled structures” are used in other jurisdictions) in order to be considered truly holistic.

Impacts of policy options on investment

As noted above, any change in policy relating to the use of stapled structures could have significant impacts to the property and infrastructure industries. Furthermore, any change to the current regime (e.g. introduction of a new REIT style regime or special vehicles for infrastructure) could have a significant impact on Australian fund administrators and custodians. With the introduction of the attribution MIT (AMIT) regime, financial institutions have already committed significant outlay (i.e. millions of dollars) to build new, or amend existing, systems and processes to accommodate the new requirements. That process was not a simple task and was not able to be implemented in a year. Given the industry’s adaptation to recent changes, the risk of further unexpected changes in these regimes will damage Australia’s reputation as a financial services hub.

Accordingly, we submit that an extended and holistic consultation must be undertaken to ensure all options are considered and analysed in detail to highlight the appropriateness in the context of Australia’s tax regime and any associated costs for restructure.

We acknowledge that the value of assets held in stapled structures has grown substantially over the past 10 years and has more recently been used in industries other than “traditional” property and infrastructure industries. However, it is important to better understand some of the reasons for that growth which includes:

- A significant wave of privatisations affecting the electricity sector (including networks and generation in NSW), the ports sectors (NSW, Qld, Victoria), roads (Qld, NSW, Victoria). The enterprise value of these businesses entering the Commonwealth tax regime for the first time is in the order of $100bn and all involve businesses that include substantial interests in real property and fixtures. This trajectory is unlikely to continue given the remaining large asset bases in these sectors (electricity networks and generation, and ports in Qld and WA) are located in States whose Governments are currently opposed to privatisation.

- Significant changes to our economy and technological advancements. For example specific Federal and State Government policy settings (including the Renewable Energy Target (RET)) that encourage the development of renewable energy facilities as our nation seeks to embrace a greater contribution of renewables to our energy mix.
- The strong demand and competition for exposure to Australian investments, in particular in light of the quantum of foreign capital seeking long-term, secure returns such as those generated by infrastructure and property. This has also resulted in increased prices being paid for Australian assets.

Some of the above factors have led to advantageous conditions in which to transact in the infrastructure and property industries in recent years, however such conditions may not continue indefinitely. Furthermore, the stability and certainty historically provided by Australia's tax regime for these types of investments, as well as more recent policies enacted by the Government to attract foreign investment, have also resulted, in some part, the significant investment in these sectors in recent years. In this regard, we note that specific regimes have been enacted to encourage investment that attracts a lower tax rate, including the MIT regime (15% tax rate on fund payments which are subject to existing "non arms-length income" integrity rules), the domestic superannuation regime (15% during accumulation phase and 0% during the pension phase), and various other concessions for non-resident pension funds including with respect to withholding tax rates imposed under domestic law (0%).

The mischief which the Consultation Paper and the ATO seek to identify in terms of fragmentation of businesses (with continued common ownership) with no apparent observable independent market ignores the evolution of business models which are explicable other than with reference to tax driven motivation. Those reasons include:

- The ability to accommodate financiers through access to pre-tax cashflows allowing for higher gearing levels (cheaper capital vis–à–vis equity)
- Access to cash by investors at a time when dividend distributions through a corporate structure may not be possible or are otherwise problematic. Infrastructure projects commonly involve tax/accounting profiles that start with accounting and tax losses, move into a phase of accounting profits but continued tax losses resulting from differences in tax and accounting amortisation rates, and finally into a phase of tax and accounting profits, whilst potentially being cash positive throughout. Corporate structures are not sympathetic to ease of cash distributions even after the amendments to Section 254T of the *Corporations Act 2001* in 2010. Those amendments have not removed the profits test from company law in terms of the ability to pay a dividend (this is acknowledged by the ATO in Taxation Ruling TR 2012/5).

Preserving the flow-through status of investment trusts afforded by Division 6 (with the safeguard afforded by Division 6C other than with respect to categories of investment falling within the definition of an "eligible investment business") to facilitate these objectives (with income taxed at the investor level) is fundamentally important to these outcomes and the attractiveness of Australia as an investment jurisdiction for both domestic and foreign mobile capital (particularly in the pension fund sector) as well as avoiding costly disruption to existing investment of long term capital in long term projects. If concerns exist in relation to the "layering" of concessions, including upstream gearing, then that could be addressed through targeted reform with prospective application. Such reform needs to be sympathetic to transitional implications including;

- Existing long term investment decisions that involve long term deployment of patient capital made in the context of long term investments
- The impact any changes will have on asset valuations including the flow on impact to domestic pension fund valuations of Australian citizens
- Avoiding adverse impacts on financing structure in place including ensuring loan covenants are not inadvertently breached for loan tenures that can involve lengthy terms in excess of 5 years (noting

that this needs to be sympathetic not only to traditional debt financing but potentially other capital markets issuances including bond issuances with much longer tenure and issued off the back of assumed access to pre-tax cash-flows).

In addition to the above factors, we note that any changes to the current regime may also have an impact on the new corporate CIV and limited partnership CIV that the Government announced in the 2016/2017 Budget. We suggest that the current consultation process is holistically and thoroughly considered prior to introduction of new CIV entities to prevent future uncertainty in launching new CIVs.

Policy Options

In the time available for consultation, it has not been possible to undertake a detailed analysis of the potential policy options available for the Government.

We would suggest that the use of continuity of ownership or same/similar business testing regimes to transition existing investments needs to be carefully analysed and tested and supported with appropriate economic modelling as any such regimes will invariably have impacts on asset valuations in a sell-down context if not earlier.

Targeted prospective amendments to the definition of an "eligible investment business" are one solution to the extent there are business sectors that are perceived to be problematic from a policy perspective. However, preservation of a flow-through regime remains fundamentally important in the context of the relative attractiveness of other jurisdictions that have more sympathetic flow-through investment structures, including limited liability partnership (LLP) models and efficient CIV regimes which Australia currently does not. Furthermore the introduction of some form of alternative minimum tax (AMT) regime night also provide part of the solution to layering issues, albeit the complexity of implementing any such regime would need to be thought through in detail.

In addition, we note that Australia already has significant integrity rules at its disposal that could be used and/or modified to better address the Government's concerns. Such integrity rules include:

- Thin capitalisation rules;
- Debt / equity rules;
- Non-arm's length income rules;
- Definition of "eligible investment business";
- Transfer pricing rules; and
- Part IVA.

Implementation and transitional issues

As noted, a detailed economic impact analysis should be undertaken to support any potential changes given the risk of significant impact to the property and infrastructure industries.

Subject to the nature of any potential changes, we suggest that some grandfathering of all or some existing arrangements be implemented to mitigate the impact to these assets. However, the terms of any proposed grandfathering should be carefully considered to ensure that it is administered in a manner that is in line with the policy intent (for example, the introduction of Subdivision 124Q, which allowed the top-hatting of stapled structures, has been administered in an extremely restrictive manner requiring no change to the existing businesses. This has limited the ability to grow those businesses lest they breach the conditions of 124-Q).

In this context, we suggest the terms of any grandfathering of existing arrangements include consideration of:

- The potential impact on valuations of existing assets vis–à–vis new assets
- Sovereign risk (including the pricing of such risk in future transactions)
- Allowance for organic growth, technological advancement and asset refreshing.
- The impact on the future sell-down of assets

Costs of undertaking restructures to conform

As noted above, any changes to the existing regime could have significant impacts and the costs to investors to restructure existing structures to conform with any new regime could be significant. The time allowed for consultation has not allowed us to undertaken a comprehensive analysis of the potential costs (including the potential industry wide costs). However, some of the costs may include:

- Advisor's costs in relation to the provision of advice as regards any restructure, including accounting and legal fees, which could be significant depending on the specific asset.
- Stamp duty is likely to be imposed in respect of any restructure on the basis the impacted structures are all land rich. Whilst stamp duty relief may be available in some situations, the circumstances are limited to specific fact patterns (eg transfers within wholly-owned groups), which may not be satisfied in the current context.
- Restructures may also trigger taxing events for investors in some circumstances (for example if rollover relief cannot be applied).
- Given the large number of A-REITs that are listed, any restructure would result in significant costs for both the restructure and listing separate and/or new entities. .
- Even if domestic rollovers are available in respect of any restructures, there may be foreign tax payable if the restructure results in "phantom" income (eg, under the US PFIC rules).
- There is also a risk that any restructures could be costly for foreign investors, for example any new structure may breach limitations in foreign jurisdictions.

Specific REIT Regime

Australia has a REIT regime that has fostered the development of a vibrant active and open real estate investment sector. The majority of listed REITS in Australia operate through stapled structures. In addition there are many more unlisted REITS. As acknowledged by the ATO in TA 2017/1 the A-REIT sector is not the focus of concern and so it would seem counterproductive to seek further legislative amendment that impacts a sector that might involve unintended consequences. This sector has been the subject of significant policy scrutiny including through the enactment of what has become the MIT regime and the AMIT reforms more recently.

We submit that listed A-REITs (and widely held A-REITs) do not exceed the boundaries of acceptable dealings by staples. Furthermore, the market uncertainty which would arise from continued involvement of listed and widely held A-REITs, especially if the Budget announced a protracted policy development phase, would disrupt the pricing and willingness of investors to invest. This could have serious consequences for the industry.

Furthermore, previous reviews undertaken by the Board of Taxation have recommended that a specific REIT regime is not appropriate in Australia; and they have also recommended improvements to the existing legislation (for example, that the safe harbour rule in Division 6C should be increased to 10%). Furthermore we submit that the 2016 non-arms' length income (NALI) rules for stapled entities provide adequate protection for all MITs.

* * * * *

Appendix B

Renewable energy infrastructure tax incentives

	Corporate Tax Reduction	Investment Tax Credit	Accelerated Capital Allowances
Belgium			●
Brazil	●		
Canada			●
China	●	●	
El Salvador	●		
France		●	
Guatemala	●		
Honduras	●		
India	●		●
Ireland	●		●
Italy	●	●	
Japan			●
Mexico			●
The Netherlands		●	
Peru			●
Philippines	●		●
Romania	●		●
South Africa	●	●	●
Sweden			●
Ukraine	●		
United Kingdom			●
United States	●	●	
Uruguay		●	