Division Head
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

20 April 2017

By email: Stapledstructures@treasury.gov.au

Stapled Structures
Submission on behalf of foreign capital investors

Dear Sir/Madam

Thank you for the opportunity to comment on the Treasury consultation paper dated 24 March 2017 (**Consultation Paper**), issued as part of 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 also thank Treasury for the time it has invested in consultation since the release of the Consultation Paper.

This submission has been prepared by the undersigned firms on behalf of non-resident institutional capital investors. Each firm has consulted with its clients in this sector at length to ensure the submission reflects their views, concerns and experiences in infrastructure and real property investment in the Australian market. It also draws on those clients' experiences in transacting in other markets globally.

As Treasury would be aware, non-resident institutional capital is critical to funding Australia's immense infrastructure and real property needs. The policy setting to date has clearly supported a deep and liquid market for existing infrastructure and real property, as evidenced by many of the privatisation transactions, PPPs, real estate transactions (including in non-traditional areas such as student accommodation, aged care and agriculture) and greenfield projects undertaken over the last five to ten years. Non-resident institutional capital has invariably formed a part of not only the successful consortiums on these transactions but also the under-bidding consortiums. It is equally clear there is insufficient domestic institutional capital to meet Australia's investment needs and a reduction in the depth of non-resident institutional capital will adversely impact asset values, liquidity and the cost of capital for all market participants.

The importance of foreign direct investment into Australian infrastructure and real estate assets has been reflected in Australia's tax policy for over 10 years. This policy is reflected in the transparent taxation of trusts and the managed investment trust (**MIT**) regime that allow foreign investors to use a MIT to hold land-based assets. This policy has enabled foreign investors to competitively price investments based on confidence in the legislature, and we understand that this has been very successful in attracting and retaining foreign capital. As other developed countries lower their corporate tax rates and offer incentives to attract such capital to fund infrastructure assets, continuity of, and certainty in respect of, this policy is critical.

In light of the importance of infrastructure and real property investment to the Australian economy as well as the complexity of the tax technical issues involved, we consider the length of time provided for consultation and response inadequate. We strongly request that further consultation be undertaken, together with some of the recommended analysis set out in this submission, prior to undertaking any action.

A member firm of Ernst & Young Global Limited
Liability limited by a scheme approved under Professional Standards Legislation

Issues addressed in this submission

Notwithstanding the time constraints (and without prejudice to our strong recommendation that further consultation be undertaken prior to undertaking any action), we wish to briefly set out in this submission:

- the importance of the commercial (non-tax) advantages of utilising stapled structures, building on the discussion outlined on page 6 of the Consultation Paper;
- the importance of a more comprehensive comparison between the Australian tax framework for infrastructure and real property investment and similar regimes in other jurisdictions;
- the need for caution in approaching any changes (particularly given there are safeguards that protect the integrity of the Australian tax system whilst further consultation is undertaken); and
- the importance of certainty and stability to sustainable, ongoing investment in Australian infrastructure and real property.

In full transparency, we do not seek to address all of the questions outlined in the Consultation Paper. Among other reasons, we consider that would be inconsistent with our key recommendation to undertake a more complete consultation process before taking any material action.We also wish to point out that this submission does not focus specifically on investments in the widely held Australian real estate investment trust (**A-REIT**) sector, as we understand that the Property Council of Australia will be providing a separate submission on behalf of this sector.

For the reasons set out in this Submission, we consider it would be premature to make any announcements in the Budget in relation to this consultation process. However, if there is to be an announcement, we recommend that the announcement should expressly state that Treasury:

- intends to ensure there is stability, certainty and confidence for investors into Australian infrastructure and real property; and
- is committed to undertaking an extensive consultation to identify the most appropriate response to any specific circumstances that may have the potential to compromise the integrity of the tax system.

Summary

As noted above, we are extremely concerned that the time allowed for submissions does not allow for a properly considered and analysed response to the highly complex tax technical and policy issues raised in the Consultation Paper. We submit that a much more comprehensive and expansive consultation and analytical process (including economic modelling) is required before any material decisions are made to change the current Australian tax landscape for infrastructure and real property investment. Any material change to the current Australian tax landscape impacting capital invested in long term infrastructure and real property has the capacity to:

- reduce competition, which is vital for public confidence and value for money for all stakeholders;
- adversely impact asset values for resident and non-resident investors alike, which can have numerous flow-on consequences through the economy (including on the value of retirement savings);

- introduce significant uncertainty into third party financing decisions; and
- ultimately increase the cost of capital (for both domestic and non-resident investors).

We would be very happy to consult further in a more reasonable timeframe to help to develop an appropriate response to the issues raised in the Consultation Paper in the coming months.

We wish to make the following points in this submission in the time made available:

- Stapled structures provide a number of significant commercial benefits that facilitate greater investment into the infrastructure and real property market. This leads to more available capital for new 'greenfield' infrastructure and real property and competitive, liquid markets for 'brownfield' infrastructure, including through the privatisation of assets and the recycling of capital raised into new projects, as reflected in the depth of non-resident institutional capital deployed in Australia over the last five to 10 years.
- More specifically, one of those commercial benefits is the ability to achieve efficient debt-sizing at the project level. This benefit occurs because the flow-through nature of the asset holding trust minimises project-level tax and therefore increases the amount of cash available to service the debt throughout the life of the project. Investor-level taxes will typically not be factored into third party financing decisions as that tax is payable 'outside the financier's security net' and is therefore excluded from debt service cover ratios. Naturally, the larger the 3rd party debt available to support the institutional investor's capital, the larger the overall capital available to be directed towards new 'greenfield' investment or competitive pricing on existing 'brownfield' infrastructure (including privatisations).
- Another key commercial benefit of stapled structures is the ability to make consistent cash distributions throughout the lifecycle of the investment, consistent with the industry expectation of a "bond-like" return from infrastructure and real property assets. Allowing different classes of investors to access these distributions is critical in avoiding competitive disadvantages and distortions of the kind referred to on page 8 of the Consultation Paper, given that investment returns are typically measured based on a combination of cash yield and mark-to-market computation of the underlying investment value. In particular, if cash is trapped within the project, it will materially impact the return on the investment. Cash distributions are especially important for super fund and pension fund investors who look to match the distributions with their liability-based investment policy.
- Global market expectations are that cross-border and related party transactions, including transactions between related vehicles such as stapled structures, are priced on arm's length terms, having regard to long-established market valuation and transfer pricing principles. The ATO's recent practice of introducing arbitrary rules on cross-staple purchase price allocations, gearing levels and shareholder loan pricing that do not accord with conventional market valuation or transfer pricing methodologies (or indeed current legislative regimes) is creating unwelcome uncertainty and is adversely impacting foreign investors' assessment of Australia's sovereign risk. Treasury should, as part of further consultation, consider ensuring that Australia's approaches on these matters are consistent with international norms of market valuation and transfer pricing.
- The commercial benefits identified above are consistent with these global market expectations and are not achievable under other structures in Australia in the absence of a flow-through collective investment vehicle.

- Any comparison with approaches taken by other jurisdictions should involve a holistic assessment of the broader tax policy and macro-economics of that country with respect to long-term investments into infrastructure and real property assets and not be limited to an assessment of the availability of stapling per se. It is considered that the analysis in the Consultation Paper does not adequately reflect a comprehensive analysis of:

  - the availability of collective investment vehicles that are taxed on a flow-through basis;

  - the extent to which capital can be returned efficiently and effectively throughout the life of the project (without the incurrence of double tax);

  - the rate of corporate tax;

  - the ability to pass tax depreciation benefits to investors;

  - the existence of any specific concessions in in the thin capitalisation or depreciation rules;

  - the role and relevance of Australia's imputation system when determining tax paid;

  - the availability of foreign tax credits for distributions made by trusts but, in many cases, not companies; and

  - the existence of any integrity measures already in place (of which there are many in the Australian landscape, including control tests in Division 6C, non-arm's length income rules for Managed Investment Trusts and issues such as Division 58 and Division 250 impacting depreciation entitlements).

- Further, any comparison must necessarily take account on the broader economic ramifications of reform. This would necessarily take into account the fact that Australia has a pressing need for a deep pool of long term capital, but investment returns in Australia are currently quite low by global standards and that investment into Australia comes with some unique costs (such as many investor's internal requirements to hedge against the Australian dollar). These market conditions mean that the depth and liquidity of non-resident institutional capital is very sensitive to any change.

- While we think it premature to propose specific solutions without more consultation and detailed analysis, if any changes are to be made after further consultation they should:

  - work within the current framework rather than increasing uncertainty by introducing a new system;

  - target inappropriate uses of stapled structures rather than targeting the general use of stapled structures;

  - allow for – and indeed stimulate – organic growth and innovation across the property and infrastructure industries; and

  - have regard to the recommendations in the OECD report to the G20 Finance Ministers on tax certainty around retrospectivity, clarity and the avoidance of uncertainty.

A member firm of Ernst & Young Global Limited
Liability limited by a scheme approved under Professional Standards Legislation

Such an approach is critical because the above commercial benefits, as well as tax outcomes, have already been priced into existing transactions. Any change that impacts the current expected cash yield or results in any cash traps within the investment structure would have a dramatic adverse effect on the value and attractiveness of investors' current investments. It naturally follows that this will impact future investment behavior in the infrastructure and real property market in Australia, and could lead to a loss of competition and a funding gap that impacts both domestic investors and the Australian public more generally. We therefore strongly recommend that Treasury exercise extreme caution.

Commercial benefits of stapled structures

As noted on page 6 of the Consultation Paper, there are a number of commercial benefits of stapled structures that are commonly identified. The Consultation Paper queries the importance of these benefits. Further to the questions posed in the Consultation Paper, we submit that these commercial reasons are extremely important and are consistently sought by global investors. In this respect, the two most significant commercial benefits are:

► the ability to consistently repatriate capital throughout the lifecycle of the investment; and

► taxation on a flow-through basis.

Capital repatriation

As noted previously, infrastructure investment is expected to provide a consistent, reliable "bond-like" return over the life of the asset. It is therefore important that the transaction structure does not adversely affect that outcome.

The stapled structure is the only efficient and stable structure available in Australia that facilitates consistent cash repatriation without double tax. The Consultation Paper queries what the impact of removing the ability to make cash distributions at the early stages of a project would be. We submit that this change would have a very significant impact on the attractiveness of infrastructure investment due to the impact on returns and asset valuations referred to above. The inefficiencies that arise under the alternative structures are outlined in greater detail below.

Under current Australian corporations and tax law, holding an infrastructure investment in a single company is typically commercially inefficient. More specifically, following the amendments to section 254T of the *Corporations Act 2001* (Cth) in 2010, companies are only able to pay dividends where, among other things, assets exceed liabilities immediately before the dividend is declared. This can be a significant impediment to early stage cash distributions from infrastructure vehicles, given the capital intensive nature of the projects and the significant interest and depreciation shelter. While it may be possible in very limited cases to make a distribution to investors by way of share capital reduction, any such payment requires compliance with Corporations Law requirements that increase the cost of compliance as compared to paying a dividend. In addition, there are complex tax provisions to be considered. This ability to return capital is especially important in the context of fixed life concession assets, where there is minimal prospect of resale (meaning that any cost base in the ownership interest at expiry will merely generate a capital loss on winding up).

Even for projects that are not prevented from distributing cash in the early stages (e.g because there are accounting profits due to asymmetry between accounting profits and taxable income), the corporate structure creates significant inefficiencies. While it may be possible to make a distribution by way of dividend in these circumstances, this would typically represent an unfranked dividend due to the

existence of tax losses in the early stages of a project. This effectively leads to economic double taxation over the life of the project when, towards the end of the project, taxable income exceeds the accounting profits as the relevant timing differences reverse, resulting in trapped franking credits.

Whilst an investment in a single trust can achieve similar capital distribution efficiency to a stapled structure, it is inherently unstable under current tax law as even a single change in investor can fundamentally change the status of that vehicle from a flow-through trust to a company for tax purposes under Division 6C. Similarly, an investment in a partnership can be dramatically impacted by a change in owners. There are also very significant joint and several liability issues associated with investments in partnerships.

Flow-through taxation

Global investors are accustomed to investing through collective investment vehicles that are taxed on a flow-through basis. This is because, among other reasons, a flow-through structure:

► provides for efficient debt-sizing, as the tax will typically be paid at the investor level rather than at the project level. This means lenders can take security over the project's assets and calculate cash flows available for debt service on a pre-tax basis; and

► increases the potential for the formation of consortiums (and increase competitiveness in privatisation and other processes) by allowing each member of a consortium to structure their affairs in a manner appropriate to their own circumstances – this means tax structuring decisions do not need to be made at the project level and factored into consortium internal rate of return (**IRR**) calculations and bid pricing. In other words, a flow-through structure can assist in levelling the playing field between IRR requirements of different investors.

Australia does not otherwise offer a broadly available collective investment vehicle that has equivalent flow-through characteristics, as:

► limited partnerships are generally taxed as companies in Australia;

► while partnerships are taxed on a flow-through basis, they also give rise to joint and several liability between partners that is often not commercially acceptable. In addition, they are less stable and flexible to deal with changes in partners; and

► as explained above, the use of a single trust does not provide flexibility for changes of ownership and attracting the broadest capital base, as the status of the trust for tax purposes can change with the investor mix.

International comparison

The Consultation Paper draws out a number of basic comparisons to other jurisdictions that have introduced legislative measures to restrict the use of stapled structures on pages 9 and 10. Given the time allowed for providing submissions, it is not feasible to undertake a fulsome analysis between Australia and other jurisdictions to factor in the impact/benefit of any existing policy on the true cost of capital for the various jurisdictions or to address all of the information outlined in Appendix 1 of the Consultation Paper. We have nevertheless set out preliminary suggestions as to how any comparison should be undertaken.

A member firm of Ernst & Young Global Limited
Liability limited by a scheme approved under Professional Standards Legislation

As a starting point, we caution against any comparison of stapling per se. Rather, we consider that any comparison should be a more holistic comparison having regard to the tax framework for infrastructure investment more broadly, including:

- the availability of collective investment vehicles that are taxed on a flow-through basis;
- the corporate tax rate;
- the relevant distribution taxes and credits available to investors including any capital gains tax measures or exceptions available;
- the extent to which capital can be returned efficiently and effectively throughout the life of the project (without the incurrence of double tax),
- the ability to pass tax depreciation benefits to investors;
- the existence of any concessional thin capitalisation or depreciation rules;
- the role and relevance of Australia’s imputation system when determining tax paid;
- the availability of foreign tax credits for distributions made by trusts but, in many cases, not companies;
- the existence of any integrity rules, of which there are many in the Australian landscape (including control tests in Division 6C, non-arm’s length income rules for Managed Investment Trusts and issues such as Division 58 and Division 250 impacting depreciation entitlements); and
- whether there is a classical system of taxation or some other system that avoids economic double taxation.

For example, while Australia does allow the use of stapled structures, it has a comparatively high corporate tax rate and does not have a corporate regime that facilitates efficient capital repatriation (indeed its corporate regime can often give rise to double tax). In addition, Australia does not offer any thin capitalisation exceptions for infrastructure or significant depreciation concessions – instead, there are extensive rules limiting depreciation benefits in privatisations and other transactions involving government parties.

Whilst we don’t purport to provide a detailed analysis in the time available we do comment below on 3 of the key jurisdictions discussed in the Consultation Paper.

<u>UK</u>

The UK comparison in the Consultation Paper focuses only on the REIT regime, and does not taken into account the attractiveness of the conventional corporate structure once the following aspects are taken into account:

- a competitive 17% tax rate (that is obviously similar to Australia’s MIT rate);
- no withholding tax on dividends, and a number of exemptions from withholding tax on interest;

- a very efficient means of repatriating cash from heavily depreciated assets in their earlier years and distribution of refinancing proceeds (from both a tax and corporate law perspective); and

- more favourable thin capitalisation rules for certain infrastructure projects.

Canada

The Canadian comparison in the Consultation Paper focused on the SIFT legislation and in our view failed to take into account:

- the differences between the use of SIFT structures in Canada to re-characterise the entirety of the income of a business (including active income), and the use of staples in Australia (with a key difference being that the staples include a related party transaction that can be priced based on transfer pricing principles); and

- other aspects of the Canadian tax regime, including:

  - a more competitive effective corporate tax rate, even after taking into account provincial tax;

  - a range of flow-through structures using partnerships that are flexible and stable to accommodate the needs of strategic investors as well as domestic and foreign institutional investors; and

  - a tax policy that allows capital to be returned to investors as a priority before having to make profit distributions.

US

Similar to the other jurisdictions discussed above, the US analysis in the Consultation Paper has a narrow focus and is somewhat misleading. In this respect, we note the following:

- whilst Treasury point to limitations in the US REIT regime on ‘stapling’ with common ownership, the ability to achieve flow-through taxation for infrastructure assets is much broader and more certain than in Australia, including for cell towers and billboards, pipelines, transmission lines, roads and bridges, data centres, agriculture and other land rich assets; and

- furthermore, and equally importantly, the US has a comprehensive regime of limited partnerships and flow through LLCs which allows benefits of income and depreciation (ie tax equity investors) to be adjusted such that investors can each optimise on their own structure when investing in infrastructure projects.

US resident investors can therefore access the benefit of any tax attributes/exemptions when investing in such projects and foreign investors have considerably flexibility to determine their own upstream structures above that flow through vehicle.

Approach to formulating a response

As noted previously in this submission, we recommend that further consultation and caution be undertaken prior to taking any action.

It is submitted that this approach would be consistent with the joint OECD/IMF Report for the G20 Finance Ministers on Tax Certainty that was released in March 2017 (**Tax Certainty Report**). Among other key recommendations, the Tax Certainty Report noted “confining changes to appropriate circumstances sends important signals to taxpayers and investors about the stability, credibility and certainty of the tax rules and the level of legislative risk in relation to a particular jurisdiction”.

This is further supported by the fact that:

- the majority of the infrastructure stapled structures currently in existence involve very land intensive businesses that, in our experience, are comprised of 80% or more land (including improvements to land) that do not generate material income re-characterisation risk and should be allowed to continue; and

- the Commissioner has a range of measures already at his disposal including the provisions of Division 6C (specifically the “eligible investment business” and “control” tests), the specific anti-avoidance measures in section 974-80, the arm’s length rule for managed investment trusts and the general deductibility provisions (in addition to the anti-avoidance provisions in Part IVA).

It is acknowledged that there may be cases of abuse of the stapled structure regime in recent times. We are sympathetic to Treasury’s concern that Part IVA should not be the primary basis for ensuring appropriate use of stapled structures on a long term basis and the concern identified in the Consultation Paper regarding “where the line should be drawn as to what should be considered acceptable or not acceptable within the current legislative framework”. While more comprehensive and considered analysis is undertaken, Part IVA (and the other integrity measures referred to above) can continue to be an adequate safeguard to the Australian revenue base despite their limitations.

We recommend that Treasury assess whether specific integrity measures could adequately address any key concerns. Particular integrity measures that warrant further consideration could relate to the inappropriate re-characterisation of trading income identified in the context of synthetic equity staples and royalty staples. Amendments could also be explored to prevent arbitrage between the CGT provisions in Division 855 and the definition of “eligible investment business”. Through the introduction of targeted integrity measures, Part IVA could then remain as an appropriate tool to deal with any other abusive practices that emerge over time.

We also recommend that Treasury utilises this consultation process to consider improvements to the Australian landscape for infrastructure and real property investment (as opposed to focussing purely on “curbing inappropriate behavior”). In this respect, we recommend that Treasury should assess means for providing greater clarity and certainty for future infrastructure and real property investment. We recommend that further analysis be undertaken regarding including within the definition of “eligible investment business” a definition of critical infrastructure that:

- is drafted broadly to incorporate all ‘appropriate’ classes of critical infrastructure and real property, therefore minimising any distortions creating by particular land tenure arrangements or State-based legislation impacting whether an asset is a fixture or a chattel. Among other commercially based tests, regard could also be had to concepts such as whether there are observable third party market transactions that are analogous to the cross-staple arrangements, thereby demonstrating an aggregation rather than fragmentation; and

- is flexible so that it can adapt to innovation and market trends, with new classes able to be added by regulation and/or by application to Infrastructure Australia.

Finally, if any changes are to be made it is absolutely critical that pre-existing structures be grandfathered. Transitional rules will result in significant transactional, Australian tax, foreign tax and duty costs and will subject parties who have paid a purchase price that reflected expected returns net of tax to effective double tax. We do not recommend the use of transitional rules with a defined "change date" as these are highly likely to result in taxpayers being left with illiquid assets that are not able to be re-sold or re-financed in an efficient manner. Similarly, it is submitted that undertaking an analysis of debt terms to determine a potential transitional period is a flawed exercise. This is because the consequences on refinance would be instantly priced in, meaning the asset value would drop regardless of the remaining debt term and liquidity in the market would still be adversely impacted, which would affect residents and non-residents alike.

We acknowledge Treasury's concerns that grandfathering may lead to the use of grandfathered structures to warehouse inappropriate arrangements. However, we consider these concerns can be managed with appropriate integrity measures, provided that those integrity measures do not prohibit improvement, maintenance and organic growth in those assets to service the ongoing needs of the Australian public.

In conclusion, whilst it is absolutely true that non-resident institutional capital is seeking greater certainty than is currently the case in the Australian landscape following recent and dramatic changes in ATO's interpretation of long standing principles, we nevertheless strongly advocate caution and further consultation in making any changes as we are extremely concerned that the ramifications of anything less than a fully-considered approach will be far greater than the detrimental impacts of the current uncertainty.

Yours sincerely

Allens > < Linklaters
Signed

Allens

Deloitte.
Signed

Deloitte Tax Services Pty Ltd

EY
Signed

Ernst & Young

KING & WOOD MALLESONS
金杜律师事务所
Signed

King & Wood Mallesons

KPMG
Signed

KPMG

pwc
Signed

PwC