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

Treasury consultation regarding tax reform for stapled structures

1 Introduction

King & Wood Mallesons welcomes the opportunity to respond to Treasury's consultation paper on stapled structures, the taxation of real property investments and the re-characterisation of trading income ("**Paper**").

King & Wood Mallesons acts for a range of participants in the types of arrangements and activities that are the subject of the Paper. While our experiences with these clients have informed our views, the views expressed in this submission are our own and are not provided on behalf of any particular client.

We have outlined below some specific observations in relation to some, but not all, of the questions asked in the Paper where we believe we can provide constructive comments and feedback. We would welcome the opportunity to engage with Government and other stakeholders to discuss our observations in more detail.

2 Executive Summary

2.1 Key observations

- The Paper raises a number of important issues concerning the tax treatment of stapled structures, which are an entrenched form of structuring Australian and foreign investment in privatised assets, infrastructure, Australian real property and other associated businesses.
- Stapled structures have a long history in Australia and have helped facilitate significant investment across a range of industries and sectors. Investors are drawn to stapled structures for a number of commercial reasons, many of which are unrelated to tax.
- Whilst we understand that there have been some uses of stapled structures in recent years that have not been within the broader policy framework and which have raised the concerns identified in the Paper, those structures should not be taken to suggest that there is widespread use of stapled structures in a manner that is not consistent with the original policy intent or which

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has not otherwise been previously been accepted by the Government and the Australian Taxation Office ("**ATO**").

- If the Government concludes that reforms are necessary, it is important that these are clearly and specifically targeted, provide certainty of outcome and do not adversely impact Australia's attractiveness as a place to invest. In particular, our view is that any reforms should be aimed at addressing the Government's specific concerns regarding the use of stapled structures in arrangements which seek to artificially re-characterise trading income, without affecting the tax treatment of stapled structures more broadly.
- Associated with this, we consider that some reforms to the tax laws that apply to stapled structures (including the concepts used to define "eligible investment business" for the purposes of Division 6C) are not only warranted, but needed, to address the current uncertainties in this area, particularly in light of recent actions by the ATO and changes to the foreign investment rules. A number of these recent actions have combined to increase the perceived sovereign risk of investing in Australia.

2.2 Nature and timing of reforms

- Given the complexity of the issues raised in the Paper and the significant investments that have been made through stapled structures, we would strongly caution against rushing to any particular announcement. However, if an early announcement is otherwise considered necessary, it should make clear that the purpose of any reforms is to deal with targeted concerns, to increase the certainty of Australian tax and investment laws and that an appropriate period of consultation will be undertaken with stakeholders.
- Changing the taxation treatment of stapled structures could be a disincentive for foreign investment in sectors such as agriculture, tourism, renewables, accommodation as well as infrastructure. These sectors have commonly used stapled structures, and the perceived benefits of increased tax collections need to be carefully balanced against the risk of loss of investment to other countries with more attractive or effective investment regimes.
- It necessarily follows that any changes to the tax treatment of stapled structures, or changes that impact the tax treatment of real property and infrastructure arrangements more broadly, require careful consideration of the short and long term consequences, as well as a modelling of outcomes, to ensure that any reforms achieve their objectives and do not simply result in additional complexity, uncertainty and cost.
- It is also important that any reforms are addressed in a formal and transparent manner, through legislative change, and not by administrative means such as the publication of guidelines or by subjecting other regulatory decisions (such as foreign investment approvals) to tax conditions.

2.3 Application of reforms to existing arrangements

- If reforms are to be made, they should not apply to existing arrangements. Any application of new rules to existing structures is likely to result in significant costs for projects and investors, which will impact on the value and liquidity of investments.
- Any application to existing structures would also add to concerns that have been voiced recently as to the sovereign risk associated with investing in Australia and the significant uncertainties that have arisen because of changes in law and administrative approaches. Investors, domestic

and foreign, will be closely watching the Government's approach and assessing the regulatory certainty in this area.

3 Commercial reasons for using stapled structures

There are many important commercial reasons why stapled structures are used.

While the weighting of the reasons will vary between different business and projects, they all have the same underlying rationale, which is to facilitate greater investment by maximising value and returns to investors.

In our experience, some of the key commercial reasons for establishing and investing through a stapled structure are:

• to achieve **efficient debt sizing** and **lower financing costs**	The flow through nature of a passive asset holding trust typically facilitates higher levels of gearing than for assets held through a company. This is because tax on income derived from the investment is taxed at the investor level, which means that third party financiers do not need to have regard to income tax at the project level when assessing the ability to service project level debt. Separating legal ownership of the passive and trading aspects of a business or project can also assist with quarantining operational liabilities, which may assist the stapled group to secure a lower cost of external financing.
• the **ability to make cash returns at** the **early stages** of a project or investment	Separating ownership of the underlying income producing assets and the operating business can allow investors to access returns from their investment earlier than would be the case if the business was acquired through a single corporate entity. This enhances the value of the investment to the investor (irrespective of tax). Notwithstanding the amendments made to section 254T of the *Corporations Act* 2001 (Cth), the ability for companies to pay dividends in the absence of accounting profits remains limited with concerns regarding the effectiveness of these reforms. Further, the *Corporations Act* 2001 (Cth) places significant barriers on the ability for corporates to distribute capital without complex and time consuming shareholder approvals being sought and

	obtained. These issues and restrictions do not arise with trusts. While the ability to access investment returns earlier is valuable to all investors, it is particularly valuable to those investors who are seeking a "bond-like" return from their infrastructure investments. Further, investors who are investing to satisfy funding liabilities (such as superannuation funds and life insurance companies) may prefer to invest in these structures due to the ability to access cash at an earlier stage than would otherwise be the case.
• the **ability to quarantine operational liabilities** by separating legal ownership of the passive and trading aspects of a business or project	Separating legal ownership of the passive and trading aspects of a business or project also assists with quarantining operational liabilities. This can have commercial benefits, which extend beyond the lower cost of financing already mentioned. It is also the case that in some privatisation transactions which involve the grant of a finite concession, bidders are required to hold operational assets in a separate vehicle in order to facilitate a hand back of those assets at the end of the concession period.
• to **facilitate co-investment by different types of investors**, domestic and foreign, who may have different structuring requirements	Stapled structures facilitate co-investment by a range of investors, both domestic and foreign, with different tax profiles and structuring requirements. Stapled structures are, for example, commonly used to facilitate co-investment between taxable and tax-exempt entities (including State Government bodies). It can also be necessary, even within a single investor group, to separate ownership of the passive and trading assets to suit the regulatory and non-Australian tax requirements of the investor group. In some cases this may require different entities in the same investor group investing in the constituent entities in the stapled structure.

• **flexibility to separate ownership of the passive and trading assets**	Particularly in the case of unlisted stapled structures, the stapling will often take the form of a "soft staple" under which the owners may choose to dispose of their interests in one stapled entity while holding onto the other. This is particularly valuable in industries (such as agriculture and energy) where the owners of the key income producing asset may initially or over time be different to the owners of the operating business conducted through the key income producing asset.
• **global market expectations and acceptance**	Given the long history of stapled structures in Australia, they are well understood by investors and are now an ordinary and entrenched practice in structuring Australian and foreign investment in privatised assets, infrastructure, Australian real property and other associated businesses (such as hotels, renewable energy, agriculture, student housing, retirement villages etc.). Any movement away from these well-understood structures will generate significant uncertainty for investors, leading to a likely erosion of value which would inevitably undermine Australia's attractiveness as a place to invest and increase concerns regarding sovereign risk.

4 The importance of tax in determining Australia's competitiveness as a location for foreign investment

4.1 Overview

In assessing the importance of tax in determining Australia's competitiveness as a location for foreign investment, both the rate of tax and flexibility around the choice of investment structure are important. Our observations below focus on the latter issue.

4.2 The importance of flow through vehicles

The ability to use flow through vehicles is an important driver for the types of investment that are typically held through stapled structures.

This is because flow through vehicles allow consortiums with different tax profiles to pool the capital required to invest in a number of these projects, assets and businesses. The use of stapled or segregated structures does not necessary mean that lower tax is paid, but that tax is paid at the investor and not asset level.

The use of stapled structures may also facilitate investment by entities (such as State Government entities or other tax exempts) where they would not otherwise invest, or their investment could result in adverse consequences for other investors.

Further, as already noted, in our experience, flow through vehicles facilitate consortiums being able to raise the external debt capital required to fund these investments, as the cash flows which banks and other lenders have access to are gross of tax.

4.3 The importance of certainty and stability

At a more macroeconomic level, it is important for Australia, as a net capital importer, to have a stable tax system for investments of the kind that are typically held through stapled structures.

Australia competes with jurisdictions all around the world for foreign capital investment, and the current tax uncertainty, including in relation to administration of the existing laws, that exists is undermining this. In some instances, we have seen this uncertainty either discourage foreign investors from deploying capital into Australia entirely (particularly if there is the potential for adverse retrospective tax reforms) or applying a discount in the price they are willing to pay to compensate for the risks assumed, with tax administration and foreign investment reforms themselves being cited as significant concerns. This would seem to us to run counter to the work done by various Governments in recent years to encourage foreign capital into Australia.

5 Formulation of policy response

5.1 Overview

It is crucial that any legislative response to the issues raised in the Paper have proper regard to the potential policy ramifications of any changes.

Any changes in this area are likely to have a significant impact not only on the investment activities and behaviours of market participants, but also existing asset values.

It is therefore important that any reforms are carefully considered by reference to broader policy and Australia's role in the wider market and, if implemented, provide certainty for investors going forward.

5.2 A possible outline for reform

Although it is difficult to provide any precise recommendations or suggestions given the timing, we would recommend that any response operate within the following parameters:

- **The existing tax framework and legislation should be used, as much as possible.** While we appreciate that there is a concern that, in some cases, this is being pushed beyond its original intention, it is generally, at a structural level, well understood and consistent with entrenched practice and there are already safeguards provided in the taxation laws against such arrangements including arm's length dealing rules and the general anti-avoidance provision.
- **If specific structures or arrangements are identified as problematic, they should be targeted directly by any reforms.** Wholesale changes to the tax system or framework (including a broader prohibition on stapled structures) should not be necessary to deal with particular identified exceptional cases.

- **Particular integrity concerns may be addressed by the introduction of a specific integrity rule that treats entities in a disqualifying structure as not carrying on "eligible investment business".** This type of rule could operate easily within the framework of the existing tax rules.
- **Reliance on traditional legal concepts such as "rent" and "royalties" in the definition of "eligible investment business" is outdated and needs reform.** At present the borderline between eligible and ineligible arrangement is often a matter of administration by the Commissioner of Taxation. Consideration should be given to updating and clarifying what activities are eligible, to eliminate some of the uncertainty that currently exists in relation to how the provisions apply to particular investments and asset classes, including renewables, student accommodation and other land based activities. For example, the definition of rent could be amended such that it also includes all income from Australian real property, even where:
    - the relevant tangible asset may not at law constitute a fixture; or
    - the relevant interest granted in order to generate income may not strictly constitute a lease and simply be a contractual licence.

  Income from these types of assets and activities is still passive investment income, even though it may not neatly fall within the relevant legal category of "rent".

5.3 Other integrity measures

Page 14 of the Paper outlines a number of possible measures to remove the tax advantages of stapled arrangements. While these measures may be effective at targeting or discouraging the relevant behaviour, their application is likely to be complex and may generate outcomes that are not appropriate. For example:

- Making the payments and receipts from such arrangements non-deductible on one side and non-assessable non-exempt income on the other side may create a "franking credit trap" if the stapled entity making the payments is a corporate, as it will be paying tax that generates franking credits but may not be able to distribute those through dividends if, for example, it has insufficient profits.
- Treating stapled entities as consolidated for tax purposes is likely to be complex and difficult to implement as a result of the application of consolidation principles to stapled groups (as illustrated by the complexity of the existing consolidation provisions for corporate consolidated groups).
- Imposing corporate tax treatment on the relevant income may be too adverse an outcome, as it could result in the stapled structure potentially having a worse tax outcome than if a single entity was used to undertake the relevant activities (for example, where the relevant trust is not a "public unit trust"). Such a response would go well beyond resolving the mischief that is being targeted.

6 International comparisons

When considering international approaches to the tax treatment of infrastructure and similar types of investments, the analysis is not as simple as whether nor not they use stapled structures or have provisions which specifically deal with stapled structures or similar arrangements.

To undertake a comprehensive comparison of different jurisdictions is an inherently difficult and complex task which cannot, and should not, be rushed. Simplistic comparisons are unhelpful and, worse, have the potential to mislead.

Our view is that any comparison needs to be done within an appropriate timeframe on a holistic basis by reference to the broader tax laws of the relevant jurisdiction including effective tax rates, specific tax concessions, access to flow through vehicles, ease of returning capital and the specific circumstances of that jurisdiction including access to capital and investment opportunities.

Australia’s position in the global market and need to attract foreign investors to fund assets and infrastructure in Australia should also be taken into account.

7 Grandfathering of existing structures and arrangements is both essential and appropriate

7.1 The importance of grandfathering

It is premature to comment on the specifics of any grandfathering relief until the final form and likely impact of any changes is known.

However, as a general comment, we consider that grandfathering relief is both appropriate and essential to safeguard the value of existing long term capital intensive investments that were entered into based on legitimate assumptions made regarding future ongoing tax treatment.

Subjecting an existing investment to adverse tax changes (i.e. no grandfathering) may trigger a breach of debt financing covenants and, potentially, a range of other undertakings given to other stakeholders. This may result in the borrowing entity or entities being required to immediately repay their external financing or at least pay it down to a level that is commensurate with what the external financiers regard as appropriate, taking into account the added tax drag on the investment as a result of the tax change.

An absence of grandfathering would also have an immediate impact on asset values, the significance of which should not be underestimated. Investors determine their bid prices and negotiate financing arrangements based on certain tax assumptions. To change the tax treatment of existing investments without appropriate grandfathering measures would put significant pressure on asset values and raise further concerns as to Australia not being a safe and stable place to invest and deploy capital.

Aside from the immediate valuation impact of factoring in the additional tax costs arising from the changes, subjecting existing investments to adverse tax changes could generate the need, desire or preference to sell affected investments, which is likely to place further downward pressure on asset prices which would be adverse to all in the market.

It also needs to be recognised that many assets will require ongoing capital expenditure and whilst it might be thought that a grandfathering system coupled with some transitional relief might mitigate immediate impacts on original investment returns, infrastructure in particular requires long term and ongoing capital spends to ensure it remains up to date and of the standard demanded by users. Any change to returns will delay or reduce future capital programs and this should be considered in any analysis of revenue implications.

7.2 Why transitional relief is not an appropriate solution

Transitional relief, as opposed to grandfathering, would not provide a satisfactory outcome.

The object of providing transitional relief would be to provide investors with a specified period of to restructure their arrangements in response to the relevant tax changes. It is difficult to see how such restructuring could be undertaken without incurring significant stamp duty and, possibly, other tax costs, including non-Australian taxes. These costs would inevitably place further downward pressure on asset values, particularly if there is also a need to refinance during the transitional period.

Given the land intensive nature of the types of business commonly held in stapled structures, the stamp duty costs of restructuring are likely to be very significant, unless the restructure can be effected in a way that qualifies for relief or other exemption from duty.

History would suggest that it is likely to be very difficult to persuade the various State and Territory Governments to introduce any specific form of stamp duty relief, particularly where there is no benefit to the States and Territories in encouraging this type of law reform, especially given the likely adverse impact on the prices achievable in future privatisation transactions.

To the extent any restructure triggers any non-Australian taxes, there would obviously be no scope for relief.

Any concerns about the potential abuse of grandfathering arrangements could (and should) be addressed through appropriate integrity measures.

8 Further consultation

We would welcome the opportunity to discuss these issues further with Treasury.

In the first instance, please contact Scott Heezen on (02) 9296 2078, Katrina Parkyn on (07) 3244 8346 or Mark Upfold on (02) 9296 2304.

Yours faithfully

King & Wood Mallesons