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Stapled Structures Consultation Paper

The Property Council of Australia welcomes the opportunity to respond to Treasury's review of stapled structures.

The Property Council is the peak body representing the interests of owners and investors in Australia's $670 billion investment industry. Critically, this includes ASX listed stapled property groups, which represent 94% of all listed Real Estate Investment Trusts (REIT) and 7% of the total ASX index by market capitalisation (at February 2017).

The property industry supports Government's desire to undertake a holistic review of Division 6C and ensure stapled structures are not used to inappropriately re-characterise trading income as passive income. We are keen to work with Treasury, ATO and Government to modernise Division 6C and develop a targeted solution that addresses the specific integrity concerns.

However, while the discussion paper indicates it is not targeted at REITs, many of the potential policy proposals cannot be supported by the property industry as they could in fact have a very substantial impact and, in some cases, require a complete restructuring of the Australian REIT sector.

For example, the discussion paper canvasses taxing stapled groups as companies, which would undermine long-standing tax flow-through treatment and create profound negative impacts on the international competitiveness of Australian REITs.

The other major reform option presented in the paper is the establishment of a specific REIT regime, a proposal the Board of Taxation recommended against. Australia has a mature property investment market operating within a world class REIT regime that has developed over a period of nearly 50 years and attracts significant international capital. International REIT regimes cannot be retrofitted to suit the Australian market without fundamentally overhauling existing REITs.

Importantly, taxation of REITs was modernised through the introduction of the new managed investment trust regime which only came into effect on 1 July 2016 – this was developed by Government, Treasury, ATO and industry through a detailed and considered process and includes a specific integrity rule for cross-staple arrangements.

Any new integrity measure must preserve the current tax framework for Australian REITs. REITs underpin the investment needed to create our homes, sustainable cities, retail and entertainment precincts and build strong communities. REITs also underpin the retirement savings and economic prosperity of Australians, with 14.1 million Australians invested in REITs through their superfunds.

Critically, Australian REITs should be able to continue to operate development and funds management activity ("active") and long-term property ownership ("passive") under the one common ownership. This integrated business model leverages the expertise and capital of REITs and maximises value for their investors. Significant changes to the existing REIT model would trigger considerable restructuring and refinancing obligations, jeopardise investment in cities and housing supply and adversely impact Australia's global reputation.

The four-week window for submissions is inadequate for industry to properly understand the Government's policy settings and work through these very significant issues. We are extremely concerned that the Government may be rushing to a budget announcement which will result in fundamental impacts on the Australian REIT sector and the broader economy.

At this stage, any announcement should be limited to reassuring REITs and investors that Government will commit to a detailed and consultative process with Treasury, the ATO and industry to co-design a targeted measure to address the inappropriate re-characterisation of trading income as passive income, while preserving the current REIT tax framework. A broader consultation process also presents an opportunity to fine-tune and modernise Division 6C having regard to changing consumer and government expectations (for example, allowing REITs to derive rent-like income, institutional investment in multi-family housing, mixed use precincts etc).

Our attached submission sets out the crux of the property industry's position, proposed terms of reference for the consultation process, and industry's response to the questions posed in the paper that are relevant to the property sector.

In summary, we believe there is substantial risk in many of the reform options proposed in the paper and rushing the discussion will have a material impact on the industry and investors.

Given the critical nature of the concerns raised in our submission, we would welcome the opportunity to meet with Treasury following the submission closing date to discuss further. Please contact Director of Tax Policy, Belinda Ngo (0400 356 140 or bngo@propertycouncil.com.au) to arrange a suitable time.

We look forward to hearing from you.

Yours sincerely

Ken Morrison
Chief Executive

PROPERTY COUNCIL of Australia

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Stapled Structures Consultation Paper

Implications for property

April 2017

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Executive Summary

The Treasury Consultation Paper on Stapled Structures (the Paper) flags Government's concerns with the growing use of stapled structures by industries other than the property sector to inappropriately re-characterise trading income into more favourably taxed passive income.

As noted in the Paper, stapled structures have been in operation in Australia since 1988, and the mere existence of a stapled structure does not indicate there is mischief or tax integrity concerns.

The issue though is that in seeking to address perceived integrity issues, the Treasury paper opens the door to sweeping changes to stapled REITs. Of the 51 ASX listed REITs, 34 are stapled REITs and collectively represent 94% of the REIT index by market capitalisation ($124.9 billion at February 2017). There are also many unlisted stapled REITs.

The Australian REIT market has developed within the current operating framework, and is a mature and globally competitive industry. Importantly, stapling allows one common ownership structure that caters for different operating models and different scales of activity across the whole spectrum of property – from development and funds management (in the company) to long-term property ownership (in the trust). This allows stapled REITs to leverage their expertise and capital to run an integrated business platform that maximises value for their investors.

The tax policy settings for REITs have been reviewed and refined on many occasions in recent times by:

- Government – e.g. Senate Inquiry into Corporate Tax Avoidance in 2015 and review of the managed investment trust (MIT) withholding tax rate in 2012;
- the Board of Taxation – e.g. MIT report in 2009; and
- Treasury and ATO – e.g. development of the Attribution MIT (AMIT) regime which was enacted in 2016 following a detailed and well-considered development period which included a Senate Committee review.

Australian property groups should be able to continue operating active and passive businesses as part of an integrated business model. While we welcome the opportunity to fine-tune and modernise Division 6C, industry does not support, or see the need for, a new and separate REIT regime. The current rules are robust and have a range of well-developed integrity measures including the new AMIT non-arm's length income test and sections 974-70 and 974-80 in the debt/equity rules. Introducing a new REIT regime will add further complexity and challenges to the tax regime, and trigger considerable restructuring and refinancing obligations for existing stapled REITs.

We urge Treasury to take the time it needs to work with industry and the ATO to develop targeted anti-avoidance measures which address the integrity concerns of Treasury but preserve longstanding arrangements for the REIT sector.

If required, any budget announcement should be limited to:

1. **Commencing a consultation process to co-design a targeted integrity measure to address the inappropriate re-characterisation of trading income as passive income.**

   In designing the terms of reference for the consultation, regard should be had to the following:

   - Embrace a co-design approach between Treasury, ATO and industry. This process was effective during the development of the AMIT regime.
   - Holistic review of the scope and operation of Division 6C that is aimed at modernising the rules.
   - Review the effectiveness of existing integrity measures that can be used to address the integrity concerns.
   - If required, options that could be canvassed to address the integrity concerns include (but are not limited to):
     - Introduce a specific anti-avoidance rule that targets inappropriate structures; or
     - In addition to REITs, deeming other asset classes (such as critical infrastructure) as being eligible for the existing tax treatment of stapled securities.
   - A reasonable timeframe for the process would be 12 months, provided adequate resources are dedicated to the consultation.

2. **Confirming that any consultation process will not interfere with the current tax policy settings for REITs**, namely the following will continue:

   - Use of stapled structures for REITs with active and passive operations.
   - Tax flow-through treatment of passive income.
   - Cross-staple arrangements within REITs are not an integrity risk and are subject to the AMIT non-arm's length income rule.
   - REITs can elect into the recently enacted AMIT regime.
   - MIT withholding tax regime applies to international investors in REITs.

Further details of a proposed terms of reference are set out at page 14 of the submission.

The property industry – an overview

Let property grow the economy

Property is the nation's largest industry and creates prosperity, jobs and strong communities.

Property is a major part of both the household balance sheet and the Australian economy.

Property:

- directly contributes 11.5 percent of economic activity – or $182 billion to Australian GDP.
- is the nation's second largest employer, creating 1.1 million jobs – which is more than mining and manufacturing combined.
- helps provide a wage to one in four Australians.
- pays $72.2 billion in wages directly, and another $119 billion in wages indirectly.
- delivers 16 percent of the nation's tax revenue, with $72 billion in taxes paid to federal, state and local governments.
- allows people to save for their retirement and reduce government's pension costs, with 14.1 million having a stake in property through their super funds.

It is crucial that policymakers work to support the industry given it is vital to Australia's economic fortunes.

About the Property Council

The Property Council champions the interests of more than 2200 member companies that represent the full spectrum of the industry, including those who invest, own, manage and develop property across all asset classes.

Australia has a robust and mature REIT market

REITs are the means to attract the investment which provides our homes, sustainable cities and buildings, retail and entertainment precincts and builds strong communities.

Evolution of the Australian stapled REIT market

The first Australian REIT was listed on the ASX in 1971, and the first stapled REIT came into operation in 1988.

Since then, the Australian REIT market has matured and attracts significant international capital. Australia has the second largest REIT sector in the world, attracting a 7% share of the global REIT market (EPRA, 2016).

The sector has evolved remarkably in the last 30 years with stapled structures emerging as the mechanism for allowing REITs to expand their operations to exploit world-class expertise in more facets of the property industry.

The expansion of REITs from holding real estate (traditionally office, industrial and retail) into development activities and real estate management is a natural consequence of Australia's sophisticated firms leveraging their knowledge and skills.

The tax system has required a demarcation to be made between active income (to be taxed at 30% on a net basis) and passive income (to be taxed on a flow-through basis and concessionally at 15% gross basis for certain non-resident investors). Stapled structures in the property sector exist to allow both sides of an expanded and diversified business to co-exist and be taxed appropriately.

Benefits of stapled REITs

Stapling allows one common ownership structure that caters for different operating models and different scales of activity across the whole spectrum of property – from development and funds management (in the corporate side) to long-term property ownership (in the trust side). It allows groups to leverage their experience and capital across the different property sectors and cycle.

Property groups use a stapled structure because it allows REITs to undertake active business operations without jeopardising the tax flow through treatment of the passive rental income.

Importantly, stapling allows REITs to:

- **be internally managed** (i.e. the unitholders also own the trustee).
- **run an integrated business platform** that includes not just passive ownership of real estate but complementary operational businesses such as funds management and development activities – this creates efficiencies for the REITs and an additional income stream where services are provided to third parties.
- **diversify into mixed use of assets** – e.g. combining retail, office, hotel and housing (multi-family, student accommodation, seniors living) in the one precinct. This is a core planning objective for many state and local governments as they look to create liveable cities.

Stapled REITs are not an integrity risk

The re-characterisation concerns set out in the Paper are not a feature of the real estate sector.

While it is common for stapled REITs to have commercial arrangements between the company and the trust – including acquisitions, developments, financing arrangements, leasing of property, licensing of property, leasing fees, fees paid to responsible entities, property management fees, development service fees, etc – the property industry does not inappropriately re-characterise active income.

In some instances, these commercial arrangements are put in place to deal with situations where income from the underlying investment is for the use of space within the real estate but the income may not be legal form rent (e.g. it may be rent-like income such as license fees). The AMIT non-arm's length income test operates to ensure these arrangements are priced on an arm's length basis to protect the integrity of the tax base.

In summary, the REIT sector is too important for rushed or ill-considered proposals; it is already taxed under an appropriate and effective tax model, is not an industry where re-characterisation practices are rife, and it is an industry where the interests of government are well protected already by a suite of integrity measures in Division 6C and arm's length rules.

A new REIT regime is not the solution

Introduction of a new REIT regime does not, of itself, address the re-characterisation concerns set out in the Paper. Rather, it will introduce further complexity and challenges in the tax framework and trigger significant restructuring obligations for existing REITs.

Board of Tax recommended against a REIT regime

The Paper examines the possible usefulness of international REIT regimes as a model for Australia's law. This is not a new debate.

This option was examined and discounted by the Board of Taxation in its 2009 report, *Review of the Tax Arrangements Applying to Managed Investment Trusts - A Report to the Assistant Treasurer*.

The Board recommended –

> *… there be a specific taxation regime for qualifying MITs to be known as Regime MITs. In order to be considered a Regime MIT an MIT must:*
>
> *- satisfy a 'widely held' requirement;*
>
> *- be 'engaged in primarily passive investment'; and*
>
> *- satisfy a 'clearly defined rights' requirement. (Recommendation 1)*

In May 2010, the then Assistant Treasurer, Senator Nick Sherry, announced in a press release,

> *The Government agrees to this recommendation and will consult the managed fund industry on the implementation and design details.*

This became the AMIT regime which began in 2016.

The Board also examined, but recommended against, enacting a dedicated REIT regime:

> *The Board recommends that there should be no separate Real Estate Investment Trust (REIT) regime. (Recommendation 6)*

Senator Sherry announced –

> *The Government agrees to this recommendation.*

We note that many participants in the REIT sector have already, or are in the process of adopting the AMIT regime. This typically comes with significant investment of time and resources.

Given that the AMIT regime appropriately deals with REITs and the effort that has gone into designing and implementing that regime, discarding it would not be a desirable option for the industry.

Overseas regimes cannot be "imported" to Australia

There are several reasons why overseas models are not appropriate for the Australian REIT market:

- **Australia is not starting with 'a blank sheet of paper'**. Any new regime that is introduced would inevitably have significant implications for the existing market and could require a fundamental overhaul of existing REITs. A narrowly defined REIT regime would force existing REITs to demerge parts of their business, restructure and transfer assets, and trigger repayment or refinancing obligations. Further, consideration would also need to be given to the way any new arrangement is viewed under Australia's double tax treaty network – e.g. trusts in ASX listed stapled groups are presently "LAPTs" as referred to in the Australia/US treaty.

- **Overseas REIT regimes commonly have asset or income restrictions**. As noted above, Australia has a mature real estate market where many REITs have an integrated business model, with both passive and active business operations. It is likely that many existing REITs would not satisfy the narrow asset and income tests in these rules.

- **Australia is in a very different market environment –** the US and other overseas jurisdictions had no real estate investment industry and introduced REIT regimes to encourage investment. Australia already has a mature real estate investment industry, and a world class REIT regime that governs its operation.

Adverse implications of a new regime

The introduction of a fundamentally new REIT regime for a mature investment market will give rise to the following adverse impacts:

- **Restructuring and refinancing obligations for existing REITs**. This will give rise to CGT and stamp duty liabilities, unless comprehensive roll-over provisions are introduced for all relevant State and Commonwealth taxes. The difficulty of introducing roll-over relief cannot be underestimated. For example, when the top-hatting rules (Subdivision 124-Q) were introduced in 2007, it took several years for state governments to introduce stamp duty roll-overs or exemptions, and in some states (e.g. QLD) those exemptions are still not available for unlisted groups.

- **Risks damaging Australia's international reputation**. This is particularly relevant given the industry is still working through the recent AMIT changes, the introduction of the CGT withholding rules, changes to FIRB legislation and processes and the introduction of new state-based charges on foreign investors. Australia is a net importer of capital and the Australian property industry relies heavily on patient, long-term global capital to finance major investments including mixed use developments and social infrastructure projects. A competitive and stable environment is essential to attract global capital from pension and sovereign wealth funds.

- **Ability to operate an integrated business model.** REITs have been able to effectively create an integrated business model within the existing REIT framework which maximises value for their investors. In particular, the use of stapled structures provides critical scalability and diversification strengths which over the decades have allowed the property industry and small diversified property groups in Australia to grow and prosper into mature REITs. This business model would be put at risk if a specific REIT regime was introduced based on overseas regimes.

Current REIT framework is robust

It is worth remembering just how much has been done by Treasury, the ATO and industry over the last decade to bring the suite of Australia's tax laws for REITs to their current state and why it would be very premature to embark upon major revisions of those rules.

Senate Inquiry

In 2015, the Senate Economics Reference Committee undertook a review into corporate tax avoidance and minimisation. In their interim report, the Senate recognised and supported property trusts as necessary flow-through vehicles and none of their recommendations targeted property trusts or stapled groups. In discussing how the corporate tax system works, the Senate said:

> *Property trusts, such as Real Estate Investment Trusts (REITs), do not pay corporate income tax on passive rental income but distribute this to investors who pay tax at their own individual tax rate. In Australia, stapled securities are used to split the passive and active income earning activities of property investments. Active income from trading activities, such as funds management and property development, are subject to corporate income tax.*

New AMIT regime

The AMIT regime is a new and robust tax regime for MITs which has only been in place since 1 July 2016. It represents a modern and competitive regime for the REIT sector. It was developed through a collaborative consultation process leading to a regime that is detailed and considered.

The regime includes a specific non-arm's length income test to address Government's integrity concerns about cross-staple transactions. The non-arm's length income test is still in transitional phase and should be given time to be fully implemented before its effectiveness is reviewed or changes are made.

Moreover, REITs have invested significant time and resources over the past several years preparing for the implementation of the AMIT regime. It would be an enormous deadweight loss to supplant those rules or modify them significantly.

The current tax settings for REITs in Australia are consistent with broader policy settings relating to the importance of:

- neutrality between direct investments and investments through a collective investment vehicle and
- having tax flow through collective investment vehicles to attract international capital to Australia.

Division 6C

Division 6C determines the line between what is active and passive income and has been in place for over 30 years. Industry has been consulting with the ATO to develop practical guidance on the application of Division 6C to property.

Industry would support a holistic review of the active/passive activity test in Division 6C that overcomes the current cumbersome, restrictive and penal nature of the rules.

However, the purpose of such a review should be clearly defined and should be aimed at modernising the rules to have regard for the changing consumer and government expectations from the real estate investment industry (for example, allowing REITs to derive rent-like income, institutional investment in multi-family housing, mixed use precincts etc).

The Division 6C review should also consider amendments to enable REITs (if they elect to do so, or for new REITs going forward) to:

- operate through a single flow-through head entity (currently a trust, but this could be a company or limited partnership under the proposed collective investment vehicle regime) and
- have taxable subsidiaries without any limit on the size of the subsidiaries relative to the trust.

Any review of Division 6C would not represent the designing of a new REIT regime; rather its purpose should be to modernise and fine-tune the existing tax framework for REITs and other passive investments.

MIT withholding tax rate

The MIT withholding tax rate represents a critical part of the REIT picture.

Australia is a net importer of capital and the Australian property industry relies heavily on patient, long-term global capital to finance major investments including mixed use developments and social infrastructure projects. A competitive and stable tax environment, including the rate, is essential to attract global capital from local and foreign pension and sovereign wealth funds. These investors are typically tax exempt in their country of residence, therefore, any tax paid in Australia represents a real cost to them.

The 15% flat rate MIT withholding tax is an important element of the system. When the rate was introduced in 2008 by the then Treasurer, it was stated that it was primarily designed to attract investment for Australian property trusts. In the 2012-13 Budget, the Government revised the rate for the MIT withholding tax to 15% on the basis that this higher rate represented an appropriate and competitive rate that allowed Australian MITs to continue to attract foreign capital.

Thin capitalisation and debt/equity rules

In recent years, we have also had significant reviews of the thin capitalisation and debt/equity rules. This included a reduction in the safe harbour rate from 75% to 60%, and changes to the debt/equity rules (sections 974-70 and 974-80) which clearly contemplates and allows cross-staple loans.

Consultation period needs to be extended

While the property industry would have liked to propose a solution to the issues raised in the Paper, there has been insufficient time to ventilate the issues and understand the Government's policy settings – as such, a rushed solution will likely have unintended consequences for REITs and the broader economy.

Co-design approach needed

Industry recommends to the Government that it commit to a detailed and consultative process with Treasury, the ATO and industry to co-design a targeted integrity solution that both addresses the concerns raised in the Paper and does so in a way that preserves the current tax framework for REITs.

The policy options being canvassed in the Treasury paper could have a material impact on the property industry and a four-week consultation period is simply insufficient time to properly develop and analyse solutions to these issues. The haste increases the risks of unintended consequences and an adverse shock to the real estate sector which will send negative signals to investors. The development of a policy solution will need to be an iterative process to ensure the policy settings and the broader market impacts are understood and unintended consequences are avoided.

The property industry accepts the integrity concerns raised by Treasury regarding the misuse of stapled structures to re-characterise trading income and the Property Council would support the development of a targeted solution to address these integrity concerns.

Proposed terms of reference

Industry recommends that the following be included in the terms of any proposed consultation:

- **Process should embrace a co-design approach between Treasury, ATO and industry.** The policy concerns and issues raised in the Paper are highly complex and affect not only REITs and infrastructure but also the broader investment framework and Australia's global reputation. An iterative process between Treasury, ATO and industry is essential to ensuring the policy settings and broader market impacts are understood and any unintended consequences avoided. This process was effective during the development of the AMIT regime.

- **Process should include a holistic review of the scope and operation of Division 6C that is aimed at modernising the rules.** Industry welcomes Treasury's observations that Division 6C is currently cumbersome, restrictive and penal. Industry would support a holistic review of the active/passive activity test in Division 6C that is aimed at modernising the rules to overcome some of the current complexity and uncertainty in the operation of that regime, potentially broaden the asset classes that can benefit from tax-flow through treatment and reduce the need to rely on stapled structures.

  This review would not result in the designing of a new REIT regime, rather the modernisation and fine-tuning of the existing tax framework for REITs and other passive investments. We acknowledge that amending Division 6C will not address the re-characterisation concerns evident in the Paper, but it is a worthwhile project in the circumstances.

- **Process should assess the effectiveness of existing integrity measures** – the AMIT non-arm's length income test is still in transitional phase and should not be amended until it has had the chance to be implemented and assessed. Amendments to the debt/equity rules (sections 974-70 and 974-80) are also expected to be introduced in the near future and should be given time to be implemented and assessed.

- **Process should be designed to develop a targeted solution, if required, to address concerns about the inappropriate re-characterisation of trading income** – options that could be canvassed as part of the process include (but are not limited to):

  (i) *Introducing a specific anti-avoidance rule that targets inappropriate structures* – any integrity measure would need to be targeted to ensure it does not result in unintended consequences, unnecessary compliance and significant uncertainty for taxpayers.

  The design of the relevant integrity measure will need to have regard to the overall policy objectives and potential impacts for different parts of the sector.

  Given the limited consultation period, we are not yet in a position to advocate a preferred integrity measure but are keen to work with Treasury and ATO to design a targeted solution through a more detailed and considered process.

  (ii) *In addition to REITs, deeming other asset classes (such as critical infrastructure) as being eligible for the existing tax treatment of stapled securities* – this could involve amending the 'eligible investment business' definition to redefine what is permitted to have tax flow-through treatment for the purposes of Division 6C, AMIT and the MIT withholding tax regime. A list of acceptable investments could be developed as part of the consultation process.

- **Process should have a specific timeframe** – industry recommends that a reasonable timeframe for the process would be 12 months, provided adequate resources are allocated to the consultation.

- **Process will not interfere with the current tax policy settings for REITs**, namely the following will continue:

  (i) Use of stapled structures for REITs with active and passive operations;

  (ii) Tax flow-through treatment of passive income;

  (iii) Cross-staple arrangements within REITs are not an integrity risk and are subject to the MIT non-arm's length income rule;

  (iv) REITs can elect into the recently enacted AMIT regime; and

  (v) MIT withholding tax regime applies to international investors in REITs.

Appendix: Response to Consultation Paper Questions

As noted in our submission, the Consultation Paper raises complex issues that cannot be adequately ventilated in a four-week consultation period. We have set out below initial responses to the questions set out in the Consultation Paper and highlight the areas where further time is required to develop the policy response. We have not commented on any infrastructure-specific questions.

Stapled structures

1. How important are the non-tax reasons for using stapled structures? Please explain your view

Stapled structures allow property groups to internalise management activities and create expertise across the entire real estate sector – for example, one entity which undertakes construction for external customers, another which undertakes development activities, another which specialises in the management of real estate assets, and so on.

This has provided a significant commercial benefit for REITs and their investors as REITs have been able to develop internal expertise to deal with broad real estate offerings, rather than having to rely on external providers. The internal management model reduces operating costs paid outside the group and can reduce perceived conflicts of interest between assets owners and external managers.

Stapled structures allow property groups to enhance the integrated business model. It also allows investors the opportunity to gain exposure to passive long-term income flows (such as rent) and more risky income flow (e.g. development).

Further, stapled structures allow a level playing field between investors and investments which do – and those which do not – simply involve a long-term passive income flows. REITs which undertake activities that go beyond the mere holding of assets (such as management activities) are not disadvantaged in raising capital compared to firms which merely hold assets.

2. (**Infrastructure**) What impact would the loss of an ability to make cash distributions at the early stages of a project have on the attractiveness of long-term infrastructure investment for investors? Are there alternative ways to address this problem, such as used in other countries?

No comment

International comparisons

3. Are there other countries where the use of stapled structures is common? If so, please provide details, including an outline of the tax rules applicable to stapled structures.

The Paper notes the existence of staple structures in Singapore and Hong Kong which are both competitors for long-term capital investment.

The Paper says stapled regimes are 'uncommon' but that may be due to rules in other regimes, for example, the US permits the use of taxable REIT subsidiaries (TRS). We note however that the replacement of the stapled structure with a US-style TRS regime in Australia will strip the critical scalability and diversification strengths of the stapled structure, which over the decades have allowed the property industry and small diversified property groups in Australia to grow and prosper into mature REITs. Further, it could trigger substantial restructuring costs given the mature REIT market and therefore is not the preferred solution for the integrity concerns raised.

4. (**Infrastructure**) Are there other countries which provide specific tax concessions or a separate regime for infrastructure investments? If so, please provide details of the concessions or regimes.

No comment

Policy considerations

5. How important is tax in determining the international competitiveness of Australia as a foreign investment location for assets and activities typically placed in stapled structures?

The typical investor in a real estate project or real estate fund in Australia is usually a long-term patient investor seeking a stable passive income flow. Decisions about these kinds of investments are very sensitive to rates of taxation. In other words, this kind of capital is particularly mobile.

This is especially true for investors such as sovereign wealth funds, foreign pension funds and charities which are usually tax exempt in their country of residence. Any tax paid in Australia represents a real cost to them since it will not credited against a tax liability in their own country.

In the 2012-13 Budget, the Government revised the rate for the MIT withholding tax to 15% on the basis that this was seen to be a globally competitive rate for investment in real estate and other passive income. The appropriateness of this rate was confirmed by the House Standing Committee on Economics on 25 June 2012.

Policy options

6. What would be an appropriate mechanism to remove the tax advantages of stapled arrangements?

It is not the act of stapling itself that creates tax advantages.

The existing set of rules in Division 6C, the AMIT regime and the MIT withholding tax represent a sophisticated and considered suite of measures for taxing the property sector, developed after much effort over an extended time.

A departure from those rules would have to be very carefully considered. Instead, we strongly recommend that Treasury's efforts should be developed by way of a precise integrity measure focussing on identified abuses.

It is critical that Treasury work with industry and the ATO to co-design a targeted integrity solution to the problems identified by the Government in the Paper without impacting the REIT sector, including its ability to use stapled structures.

7. Are there any international models for removing such advantages that could work in the Australian context?

Given the current timeframe to put together this submission, we have not been able to properly explore international models.

We reiterate it is crucial for Treasury to work with industry and ATO to design a solution.

8. What types of structures or arrangements, if any, should be excluded?

Whatever set of measures emerges from Treasury's consultations, it is important that REITS can maintain loans and leases between the arms of the stapled group. This kind of structure was fully examined by Treasury and the ATO during almost a decade of consultations on the MIT withholding tax, Division 6C and AMIT consultations. The non-arm's length income test in Subdivision 275-L is an appropriate way to govern the structure and address any potential integrity concerns.

9. If the tax advantages of stapled arrangements are removed, does Australia need a specific REIT regime to provide clarity for flow-through tax treatment for real estate investments? If so:

(a) What might be an appropriate measure and threshold for a designated maximum threshold for associated trading activities (e.g. percentage of profits, income or assets)?

(b) Are there any global 'best practice' models for REIT regimes that should be considered?

As noted above, at this point in the evolution of Australia's tax and regulatory regime it is not sensible to contemplate adding a dedicated REIT regime for use in Australia. This option was examined by the Board of Taxation in its 2009 report, *Review of the Tax Arrangements Applying to Managed Investment Trusts - A Report to the Assistant Treasurer* (recommendation 1). On reflection, it was accepted by stakeholders from the private and public sector that this recommendation was not worth pursuing and it was eventually supplanted by the work on the AMIT regime.

The current suite of measures in the MIT withholding tax, Division 6C and the AMIT regime represent a comprehensive and considered set of rules. While there can undoubtedly be improvements and refinements to those individual components, replacing them (or even supplementing them) with yet another model is definitely undesirable.

We note, in particular, adopting a regime based on an international REIT regime is not the solution. The REIT regimes in the US and other countries were introduced to create a REIT sector. Importing these rules to the Australian REIT sector, which is long established and very mature, does not make sense and will risk adversely impacting the Australian REIT market. For example, the US regime has restrictions on the size of the taxable REIT subsidiary – this would not work in the Australian market and would inhibit the ability of REITs to run an integrated business model.

10. If Australia did not introduce a specific REIT regime, what are some alternatives for providing greater clarity to taxpayers to distinguish between acceptable and non-acceptable fragmented structures with common economic owners?

As we noted above, the existing set of rules in Division 6C, the AMIT regime and the MIT withholding tax represent a sophisticated and considered suite of measures for taxing the property sector, developed after much effort over an extended time. The property industry is keen to work with Treasury and the ATO to potentially fine-tune the rules (to modernise them) and co-design a targeted integrity solution to the problems identified by the Government in the Paper. However, a new regime is not the answer to this issue.

11. (**Infrastructure**) If the tax advantages of stapled arrangements are removed, does Australia need specific concessions for critical infrastructure investment?

No comment

12. (**Infrastructure**) If Australia does need such concessions for critical infrastructure investment, what should be the form of these concessions?

No comment

Impacts of policy options

Our comments below are of a high-level nature as the specific impacts will depend on the policy option that is adopted.

13. If tax laws are amended to remove the tax advantages of stapled arrangements, what impact do you consider this would have on the Australian economy, including the cost of capital, level of investment and price of assets? Please include any supporting evidence.

Any policy options that force REITs to move away from the integrated business model they currently employ would make them less attractive to both debt and equity investors.

Higher tax rates for stapled REITs will mean Australian investment opportunities become less attractive to foreign investors, especially those who are exempt in their own jurisdiction but even for those who might be entitled to a credit for Australian tax. It seems reasonable to conclude that the decrease in the appeal of Australian assets would then mean a decline in the price of, and level of investment in, Australian real estate assets.

14. To what extent would alternative measures, such as a higher percentage of trading business permitted to be carried out by Division 6 trusts ameliorate these impacts?

Division 6C is certainly a very important explanation for the use of stapled structures. And it is clear that Division 6C is an obstacle to the industry evolving to meet international competition and emerging market practices (such as the increasing demand by occupants for services, technology, and so on to be supplied as part of the real estate bundle). We are therefore open to exploring opportunities to fine-tune Division 6C to modernise the rules.

But it is important to note that the underlying policy setting (active income is taxed at 30% and passive income taxed at potentially lower rate of 15%) is a sensible position for Australia to adopt. Hence, even if Division 6C were to be relaxed, there would always be a boundary to give effect to this policy bifurcation which would need to be policed. The boundary might sensibly be moved, but it cannot simply be dispensed with.

15. Are there any specific sectoral impacts that should be considered?

The rules should allow for the passive income from all real estate investment to be undertaken in flow through entities. That outcome is currently achieved for rental returns and should not be interfered with. Other passive rent-like income such as licences are currently dealt with through cross-staple arrangements and the non-arm’s length income test. If integrity measures are needed for other sectors of the economy, the Property Council would be pleased to assist with their design.

16. Would the impact be different for new and existing investment and entities? If so, how?

Both new and existing REITs will be impacted by any policy options that severely restricts their activities or changes the way they are taxed.

Existing REITs will have the added burden of potentially dealing with restructuring and refinancing obligations if they are forced to transition into a new regime.

Implementation and transitional issues

17. What is the typical term of external third party finance for stapled groups?

Finance can typically be in place for a term of up to 15 years.

18. Should pre-existing structures and instruments issued prior to any new taxation laws be grandfathered?

As noted above, industry's recommendation is to fundamentally retain the existing REIT tax framework. Our comments below assume this approach is not taken.

Requiring existing REITs to adapt immediately to a new and stricter regime presents both administrative challenges and substantive unfairness to existing investors. The implementation of any new regime should be carefully managed to allow a sufficiently long transition to mitigate against both problems.

Grandfathering is an attractive transitional approach and if acceptable, industry would be happy to work with Treasury to design an appropriate framework.

However, we acknowledge Treasury's concerns in the Paper that grandfathering rules have the potential to create an uneven playing field between established firms and new market participants. They may also need to be buttressed by integrity rules to prevent substantive changes being represented as modest adjustments.

19. What is an appropriate transition period and transitional arrangements for existing staples?

The transition to the MIT regime was achieved over 7 years. The implementation of any new regime should be similarly gradual.

20. What would be the types of compliance and other transaction costs (such as stamp duty) of undertaking such a restructure? Should specific tax relief be provided to facilitate a restructure?

It is not possible to give a meaningful estimate of the costs of compliance and restructuring without a fuller understanding of the likely model. However, it seems inevitable that the costs will include, at a minimum:

- capital gains tax and stamp duty costs on the transfer of assets – these are substantial deadweight costs (unless comprehensive restructuring relief is offered by the federal, state and territory governments).

- debt refinancing and break-costs in the event the transition results in debt agreements and other commercial contracts needing to be renegotiated.

- significant time and resources dedicated to understanding and implementing the new regime, including substantial fees paid to advisors – the deadweight costs associated with any significant restructuring are always substantial.

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