www.pwc.com.au

Stapled Structures: *Response to Treasury Consultation Paper*

April 2017

pwc

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

20 April 2017

By email: Stapledstructures@treasury.gov.au

Dear Sir/Madam

Submission on the 'Stapled Structures' Consultation Paper

We welcome the opportunity to make a submission to the Department of Treasury in relation to the consultation paper for stapled structures (the **Consultation Paper**) released for comment on 24 March 2017.

The Government has actively supported foreign investment into Australian real property assets through tax policy for over 10 years. This policy manifests itself in the taxation of trusts on a 'flow through' basis and the Managed Investment Trust (**MIT**) regime introduced in 2007. These policies have facilitated a substantial amount of foreign direct investment into a range of asset classes, including listed and unlisted real estate, privatised Government assets and infrastructure, renewable energy and agriculture. Any significant policy change from the current settings will inevitably have immediate consequences by reducing investor confidence and market capitalisation of Australian institutions.

The Australian Taxation Office (**ATO**), through Taxpayer Alert 2017/1, recently highlighted the proliferation of stapled structures in the market and their inappropriate use to "fragment" a business or "recharacterise" its trading income into a character that is subject to concessional taxation. We understand this Alert was a catalyst to Treasury's release of the Consultation Paper in relation to potential policy options to address these concerns.

The timing of the Consultation Paper and the consultation period (with submissions due on 20 April 2017) suggests that the Government intends to make an announcement in the forthcoming 2017/18 Federal Budget. The potential for a significant shift in tax policy, which impacts a range of institutional investors and foreign direct investment into Australia, requires appropriate consideration of the impact that the shortlisted policy options could have. The compressed consultation period has created uncertainty and concern for a range of stakeholders.

This concern is partly attributed to the scope of the Consultation Paper, which Treasury has confirmed is *not* limited to the integrity concerns raised in Taxpayer Alert 2017/1, rather it is a holistic examination of the taxation of investment income derived using stapled structures. Essentially, through the Consultation Paper Treasury is seeking to understand:

1. What is the right policy to deal with existing **integrity** concerns?
2. What **asset classes** should benefit from tax incentives offered to foreign institutions?
3. What is the right **framework** to deliver these incentives (ie. "stapled structures" or an alternative)?

It is clear that these questions cover a range of complex issues beyond the scope of those which the ATO raised concerns about in Taxpayer Alert 2017/1 (which sought to carve out Real Estate Investment Trusts (**REITs**) and privatised assets). As a consequence, the scope of the consultation affects a large number of stakeholders, including State and Territory Governments, foreign institutional investors, Australian superannuation funds and Australian Securities Exchange (**ASX**) listed staples (including but not limited to REITs).

We submit that a four week consultation period is inadequate to address the scope of Treasury's review. The sensitivity of the policy issues under consideration and the potential impact on the flow of foreign institutional investment to Australia are too significant to addresses these complex issues in this short period.

In the 2017/18 Federal Budget we encourage the Government to announce stronger integrity measures targeted at arrangements which are plainly outside the policy intent of the law – specifically royalty and synthetic staples used to "recharacterise" trading income and agree to undertake an appropriately scaled consultation process with industry and the ATO to determine the future of stapled structures.

We further encourage the Government to reiterate its commitment to policy objectives that have underpinned confidence and growth in Australia's property and infrastructure industries. In particular, the Government should affirm its commitment to:

- Continue to tax passive income derived from real property (including REITs and instances where a common observable market exists), privatised assets and Included Infrastructure on a flow through basis.

- Continue to provide a level playing field for foreign institutions making passive investments in Australian eligible Australian assets – with passive income from these structures (e.g. "rent") subject to a 15% withholding tax rate, and active trading income (e.g. management fees, development profits) subject to a 30% corporate income tax or withholding rate.

- In the event of fundamental change, implement comprehensive transitional rules to ensure that existing structures are not adversely impacted and planned projects are not delayed or curtailed, as this could increase the perceived sovereign risk associated with Australian investments.

We would like to take this opportunity to thank Treasury for the consultation process undertaken since the release of the Consultation Paper. We look forward to working further with you on this important policy matter over the coming months.

Yours sincerely

Paul Abbey
Partner

Abhi Aggarwal
Partner

Kirsten Arblaster
Partner

Luke Bugden
Partner

Joshua Cardwell
Partner

Michael Davidson
Partner

Mark Edmonds
Partner

Steve Ford
Partner

Christian Holle
Partner

Vaughan Lindfield
Partner

Chris McLean
Partner

Graham Sorenson
Partner

Contents

1	Recommendations	1
1	Restoring integrity – “Recharacterisation” concerns	4
2	Better targeting concessions – Reviewing the current framework	7
3	Better targeting concessions – Concerns with Treasury options	18
4	Better targeting concessions – Alternative policy options	21
5	Transitional measures –Movement with certainty	28
6	Preserving the REIT regime - Eligible investment business	31
7	Alternative frameworks – International comparisons	37
8	Response to Treasury questions	41
Appendix A: Section 93L of the Development Allowance Authority Act 1992		43
Appendix B: UK Corporate Interest Restriction in the Finance Bill 2017		45
Appendix C: Simplified and redacted examples of tax review event clauses		46

1 Recommendations

We make the following recommendations to the Treasurer and Government in relation to the Consultation Paper and process:

1 **Restoring the integrity of the tax system to address royalty and synthetic staples**

We recommend the Government take effective action to restore the integrity of Australia's taxation rules and protect the corporate tax base by addressing the ATO's concerns with respect to the "recharacterisation" of trading income through the use of contrived royalty and synthetic stapled structures.

Any amendment to the taxation laws to address these integrity issues should be effected through the withholding regime in the *Income Tax Assessment Act 1936* (**ITAA 1936**) and the *Taxation Administration Act 1953* (**TAA 1953**), rather than entity level taxation. That is, the amendments should require the trustee of a trust in receipt of royalty or synthetic income derived under arrangements entered into post the announcement in the 2017/18 Federal Budget to withhold and remit amounts to the ATO at Australia's corporate tax rate.

This approach should ensure effective collection of taxes and administrative action until any changes to the current tax policy have been finalised. It should also limit the potential for an adverse impact on the broader taxation system and stakeholder community (eg privatised assets) in the short term.

2 **Better targeting the tax concessions to foreign capital**

We recommend the Government undertakes a fulsome consultation and engagement process with stakeholders before any significant changes are implemented to the existing framework. The principles for any review should be clearly laid out and may include, amongst other things, to:

- **Constrain** the eligibility of the tax concessions to the intended asset classes
- **Protect** existing investors in stapled structures from adverse change
- **Enhance** the effectiveness of Australia's taxation regime and concessions.

We submit that there are four (4) transaction classes that should be permitted in a stapled structure to encourage foreign investment. These are:

- Australian REITs (including the incorporation of a broader definition of rent to include amounts paid for the use of "physical space")
- Privatisations
- Infrastructure
- Real property where a third party rental market exists.

We have commented on each of these classes in our submission below.

In conjunction with this consultation process, the Government should commission a review into the use of transparent vehicles and concessions used by other developed countries to attract foreign investment into 'Included Infrastructure'. While we have noted some of these regimes in our submission, there has been insufficient time to adequately explore the merits of each option in the context of Australia's macroeconomic environment. However, we consider this to be a critical step in any "holistic review" of stapled structures. The focus being not the type of entity used but the nature of its activities and income. This aligns with the pending CIV Regimes which are intended to be 'entity agnostic'.

3 Comprehensive carve-out, transitional and grandfathering rules

If changes are made to the eligibility of existing investments that fall outside the synthetic and royalty stapled structures, we recommend that comprehensive transitional measures are provided to protect existing investors, particularly foreign institutions that could be adversely impacted by any law change. This could result in one or more of the following adverse outcomes:

- A breach of debt covenants in existing financing arrangements
- The inability to extract cash from the project entities due to dividend traps
- The loss of flow through taxation treatment and impost of higher Australian withholding tax rates
- The inability to claim foreign tax credits in their home jurisdiction.

We consider this to be necessary to reduce the financial impact on existing investments and minimise the impact on Australia's sovereign risk. The scope and nature of any transitional provisions will necessarily depend on how comprehensive the law changes are, but consideration should be given to:

- Affirming that REITs, privatised assets (such as ports, airports, utilities, etc), Included Infrastructure (such as toll roads, renewables, etc) and assets where a third party rental market exists (such as agri-business, student accommodation and hotels) will not be affected by any changes or new rules.
- Grandfathering assets that are currently eligible to be in stapled structures but would be excluded as a result of any change in policy. Unless a specific carve-out is provided (per above), any grandfathering should at least include REITs, privatised assets, Included Infrastructure and assets where a third party rental market exists. The rationale for grandfathering these assets is that they typically have high restructure costs, complex banking arrangements, support the Federal Government's Asset Recycling Program and many have received explicit and implicit regulatory approval from the ATO. Grandfathering is also necessary to recognise that some investors have based the purchase price paid to State and Territory Governments for these assets on the basis of agreed taxation subject to MITs (or for subsequent purchasers) through stapled structures, and have entered into a 99-year Tax Deeds which are intended provide certainty to investors over the 99-year term of the project as to the tax characterisation of the stapled structure.
- An extended transitional period for structures that become subject to a higher rate of trustee withholding tax on distributions to foreign investors, or loss of flow through taxation treatment. Such a transitional period would need to be a minimum of five (5) years to allow existing structures to minimise the financial impact and restructure debt arrangements where required. This would apply to arrangements that do not fall into a carve-out or are grandfathered per above.

We further encourage the Government to provide a commitment to policy and outline their approach to carve-outs, grandfathering and transitional rules in a timely manner to reduce the uncertainty for transactions that are being delayed or curtailed as a result of the existing uncertainty.

4 Real estate investment trusts continue to be flow through vehicles

REITs (both listed and unlisted) are typically regarded as the aggregation of businesses, not the fragmentation of groups or re-characterisation of income. The "aggregation" of businesses creates economic efficiency and allows best use of assets. It also allows stapled groups scale for funds management capacity to attract new investment.

The current tax outcomes under this model are appropriate as passive income is taxed on a flow through basis at the investor's rate of tax or withholding tax, and the active income is taxed at the entity level at Australia's corporate income tax rate. Additionally, integrity concerns with cross staple

dealings in a REIT context are adequately addressed through the non-arm's length income rule in Subdivision 275-L of the *Income Tax Assessment Act 1997 (**ITAA 1997**)*.

We submit that historical REIT structures should not be adversely impacted by any changes and if they were to be, then they should be grandfathered and continue to be held in aggregation "staples". Prospectively, Treasury should focus on the potential enhancements to the existing Division 6C to (a) expand the term 'rent' to more appropriately include payments for the 'use of physical space', and (b) increase safe harbour thresholds. This may allow more REITs to be operated through a single trust structure. An enhancement of this nature could negate the need for stapled structures for aggregation by REITs going forward.

5 2017/18 Federal Budget announcement to deal with uncertainty

There is uncertainty in the market as to the future tax policy and regime for foreign institutional investment into Australian real property and infrastructure assets. Uncertainty does have a negative impact on foreign direct investment and is a drag on economic growth.

In addition to the targeted integrity measures to deal with royalty and synthetic staples outlined above, we encourage the Government to make an appropriate announcement in the Budget that acknowledges staples are not the problem: "re-characterisation" of income is the key mischief, and affirms the Government's commitment to:

- Continue to tax the rental income derived by REITs, privatisations, Included Infrastructure investments and real property where a third party rental market exists as passive income on a flow through basis.

- Continue to provide a level playing field for foreign institutions making passive investments in eligible Australian assets – with passive income from these structures (e.g. "rent") subject to a 15% withholding tax rate, and active trading income (e.g. management fees, development profits) subject to a 30% corporate income tax or withholding rate.

- In the event of fundamental change, implement comprehensive transitional rules to ensure that existing structures are not adversely impacted, as this could increase the perceived sovereign risk associated with Australian investments.

For completeness, we recommend the existing tax laws relating to rental and financing staples are not amended by announcing the adoption of one of the policy options set out in the Consultation Paper in the 2017/18 Federal Budget. Our concerns with these options are detailed in this submission.

1 Restoring integrity – *“Recharacterisation” concerns*

Identifying the immediate integrity concerns

6 The ATO has raised concerns about the growing number of taxpayers using stapled structures to access the MIT concessions beyond the original policy intention. The ATO has stated that this has resulted in an unquantified impact and future risk to Australia’s revenue base.

7 The ATO is advocating for timely action to curb access to these concessions.[1] Treasury is similarly seeking to review the existing tax policy settings in light of the ATO’s concerns, the increase in State and Territory Government asset privatisations and other transactions adopting stapled structures over the past 24 months.[2]

8 We agree that certain arrangements may go beyond the scope of the original policy intention, and administrative action alone is insufficient to protect the tax base. These include certain arrangements that seek to re-characterise trading income to passive income as identified in Taxpayer Alert 2017/1. Accordingly, legislative intervention is required to curtail these limited arrangements.

9 While “recharacterisation” can exist in other arrangements, the principal areas of concern are:

- **Royalty staples** - generally these arrangements involve the ownership of a tangible or intangible asset (eg. intellectual property, physical equipment, etc) being held by an Asset Trust and licenced to an Operating Trust or Company. Where the income received by the Asset Trust is a fee for the right to use the assets, the income may be characterised as a “royalty” and therefore qualify for a concessional rate of withholding tax.[3]

- **Synthetic staples** - generally these arrangements involve the Asset Trust entering into a contract with the Operating Trust or Company that entitles it to receive a share of the future income from the operating business in return for a lump sum payment (that is taxable in the hands of the Operating Company over the term of the arrangement). As the arrangement between the parties is a “financial arrangement”, the activities carried on by the Asset Trust may be an “eligible investment business” and therefore qualify for the concessional 15% MIT withholding tax rate.

10 However, we consider other traditional forms of stapled structures, such as the derivation of rent from real property, to be within the original policy intention. Moreover, the risk to Australia’s revenue base in respect of these arrangements is adequately protected through existing safeguards, such as the non-arm's length income rule in Subdivision 275-L of the *ITAA 1997* and the general anti-avoidance rule in Part IVA of the *ITAA 1936*.

---

[1] Refer Jeremy Hirschhorn presentation from 22 March

[2] Refer to page 4 of the Stapled Structures, Consultation Paper March 2017

[3] Article 12 of the of the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income

11 In addition to the safeguards described above, there are proposed new rules which the Government has released as exposure draft legislation that specifically address any integrity concerns regarding cross-stapled arrangements (including cross-staple loans). As such, finance staples should be excluded from any policy review of stapled structures.

12 We encourage the Government to limit any immediate changes to the tax system to those required to restore the integrity of the existing legislative framework and the changes should not reflect an overhaul or major change in policy direction until adequate consultation has been undertaken.

Recommended interim legislative changes targeted at royalty or synthetic stapled arrangements

13 PwC submits that prompt change to address the integrity issues could be achieved through a variation of "Option 2" considered on page 14 of the Consultation Paper. This would involve the trustee of the trust withholding at a rate equivalent to the Australian company tax rate for payments which relate to the receipt of income from royalties or synthetic arrangements entered into after an announcement in the 2017/18 Federal Budget where that underlying income has been received from an entity under common ownership.[4]

14 While the specific legislative drafting of this arrangement would need to be developed, the general machinery used to effect this integrity measure could reflect those used for Natural Resource Payments. This would require a provision equivalent to section 12-325 (Natural resource payment) of *TAA 1953* to require the trustee to withhold at the 30% corporate income tax rate, unless a clearance certificate has been received from the Commissioner of Taxation. It is noted that different types of income are already subject to the imposition of specific rates of withholding.

15 This approach would effectively ensure that:

- there is no risk to the corporate tax base (due to the higher rate of withholding tax);
- the Commissioner could review these relevant royalty or synthetic arrangements to confirm if Part IVA of the *ITAA 1936* does not apply; and
- there is no wide ranging impact on stakeholders which fit within the original policy intention (eg. REITs), or have been reviewed in detailed by the ATO (eg. privatised infrastructure).

16 At a high level, the provisions of the Tax Act that would need to be amended to give effect to this approach include:

- Division 12 of the *TAA 1953* to require the trustee of a trust in receipt of royalty or synthetic income to withhold and remit amounts to the ATO at Australia's corporate tax rate (ie. a provision equivalent to section 12-325 (Natural resource payment) which allows the trustee of the trust to obtain a clearance certificate from the Commissioner of Taxation and revert back to the standard royalty and MIT withholding tax rates where the Commissioner is satisfied)
- Section 128A(3) of the *ITAA 1936* to exclude royalties received, directly or indirectly, from an entity under common ownership - whether through stapled units or a majority common investors.

---

[4] Refer Treasury's policy option 2 on page 14 of the Report (trustee withholds at a rate equivalent to the Australian company tax rate)

- Section 12-405 (Meaning of fund payment - general case) of the *TAA 1953* to exclude amounts relating to synthetic and royalty arrangements which are received directly or indirectly, from an entity under common ownership - whether through stapled units or a majority common investors.

- Section 12A-40 (meaning of AMIT royalty payment) of the *TAA 1953* to exclude royalties received, directly or indirectly, from an entity under common ownership - whether through stapled units or a majority common investors.

17 The above amendments should broadly operate to ensure that a trustee of a trust in receipt of royalty or synthetic income from arrangements entered into post a commencement date, is liable to withhold from such amounts at the prevailing corporate tax rate. Pre-existing arrangements would remain subject to current law, including the existing anti-avoidance and integrity rules. Consultation will be necessary to exclude certain arrangements that fall below a de-minimus (such as incidental or ancillary chattel “rentals”) and consider the impact of statutory severance of affixed plant on the characterisation of rent or royalty.

2 Better targeting concessions – *Reviewing the current framework*

18 Australia has actively supported foreign direct investment into critical asset classes such as commercial and industrial real estate, privatised assets and Included Infrastructure through tax policy for over 10 years. These policies are now critical to Australia's ability to compete with other developed countries that are seeking to attract the same institutional capital through lower corporate tax rates and specific tax concessions.

19 We have provided a brief overview of the policy considerations that led to the current tax legislative framework, including modifications over the past decade. The two key features of the current Australian tax framework that encourage foreign investment into Australian assets are as follows:

- transparent taxation of public trusts that carry on an "eligible investment business"
- the Managed Investment Trust withholding tax regime

20 The critical features of these regimes are outlined below. We have also provided a high level explanation of the reasons why these structures are preferred by investors generally, in particular foreign investors, for their investments into passive assets. We would be pleased to provide further detail as part of the next round of Treasury consultation.

Current approach to "eligible investment business"

21 As a general principle, trusts are transparent vehicles for Australian income tax purposes. That is, the beneficiaries of the trust - rather than the trust or trustee itself - are assessable on their share of the income of the trust to which they are presently entitled.

22 However, Division 6C of the *ITAA 1936* seeks to limit this "flow through" taxation treatment for widely held or public unit trusts that carry on, or control, a trading business. Division 6C defines a trading business as a business that does not consist wholly of "eligible investment business". Accordingly, the phrase "eligible investment business" effectively limits or restricts the income that can be generated by a public flow through trust.

23 Eligible investment business is defined in section 102M of the *ITAA 1936* to include businesses which:

a. invest in land for the purpose, or primarily for the purpose, of deriving rent;

b. invest or trade in a range of listed financial instruments (eg, secured and unsecured loans, bonds, debentures, stock, shares in a company, units in a unit trust, derivative contracts), or

c. invest or trade in other financial instruments that arise under financial arrangements.

24 In 2008 the Government amended Division 6C "*to streamline and modernise the eligible investment business rules for managed funds*" and "*make it easier for managed funds, in particular property trusts, to comply with the law by reducing the scope for them to inadvertently breach Division 6C*"[5].

25 These amendments:

- clarified the scope and meaning of "investing in land" by ensuring that investing in movable property (ie, chattels) customarily supplied, incidental and relevant to the renting of the land and ancillary to the ownership and utilisation of the land are deemed to be investments in land (**deeming rule**);
- introduced a **safe harbour** for non-rental, non-trading income from investments in land;
- expanded the range of permitted financial instruments that a trust may invest or trade in to include any financial instrument (not already covered by paragraph (b)) that arises under financial arrangements, other than certain excepted arrangements; and
- provided a 2 per cent safe harbour allowance at the whole of trust level for non-trading income to reduce the scope for inadvertent minor breaches of the eligible investment business rules.

26 As a result of the approach taken by Parliament with the meaning of "eligible investment business" and the legislative amendments in 2008 to "make it easier" for taxpayers to comply with the rules, Australia's flow through trust taxation rules are designed to permit most forms of "passive" investment to be held in a trust, offering tax transparency for both resident and foreign investors.

Managed Investment Trust withholding regime

27 The MIT withholding regime was first introduced in 2007. The original regime was a non-final withholding tax that was intended to simplify the existing tax collection mechanisms for widely held managed funds and avoid the complexities and uncertainties that could otherwise occur under the rules which assessed trustees on behalf of foreign investors in Division 6 of Part III of the *ITAA 1936*.

28 However, these rules were then significantly re-written in 2008 with the express policy intention of encouraging foreign investment in Australia. The Explanatory Memorandum to the 2008 amendments[6] stated:

> *At present, **less than 3 per cent** of the fees derived by the Australian funds management industry are attributable to foreign investment. **Industry has contended this is due, in part, to the high withholding tax** that currently applies to certain distributions from the industry to foreign investors, namely, the 30 per cent non-final withholding rate that predominantly applies to distributions of Australian source rental income and capital gains from Australian property trusts.*
>
> *Industry argues the headline rate of withholding discourages foreign investment in the Australian funds management industry as it is higher, on average, than the withholding tax rates imposed by other countries, particularly those in the Asia-Pacific region.*

---

[5] Paragraphs 5.1 and 5.3 of the Explanatory Memorandum to Tax Laws Amendment (2008 Measures No. 5) Bill 2008

[6] Paragraphs 1.6 to 1.8 of the Explanatory Memorandum to Tax Laws Amendments (Election Commitments No. 1) Bill 2008, Income Tax (Managed Investment Trust Withholding Tax) Bill 2008 and Income Tax (Managed Investment Trust Transitional) Bill 2008

The Government, in furthering its objective to secure Australia's position as a financial services hub in the Asia-Pacific region, will replace the existing non-final withholding regime with a new final withholding tax regime with reduced withholding tax rates, to be implemented over a three-year period. Once fully implemented, foreign investors of jurisdictions with which Australia has effective exchange of information on tax matters will be subject to a 7.5 per cent final withholding tax, which will be one of the lowest internationally. This will enhance the competitiveness of the industry and ensure it is well-placed to attract and retain foreign investment. [Emphasis added]

29 As a result of further changes, the rate of withholding under the MIT regime for foreign investors in jurisdictions with which Australia has an exchange of information agreement was set at 15 per cent from 2012 onwards. A fundamental principle of the 2008 MIT policy was to create a **level playing field** between domestic superannuation and foreign pension and sovereign funds. This approach ensures that both Australia's Governments and private investors can maximise the sale price for assets, our superannuation funds can invest locally without tax rates being a competitive barrier and through introducing competitive foreign capital, our superannuation system is not over-committed or over-exposed to Australian assets.

30 These principles and above statements in the Explanatory Memorandum were echoed by the Assistant Treasurer, Chris Bowen, in his speech at the time of introducing the Bill into Parliament in 2008 - extracts as follows:

> *"We have an industry in Australia which…has the fourth largest pool of funds under management in the world—not per capita but in the world…* ***We have an industry which has built up great skills but which does not export those skills, because we have an industry which has been saddled with an uncompetitive tax regime…***
>
> *We have an uncompetitive tax regime where we have big superannuation funds and pension funds around the world looking at where to invest their money and they say: 'Well, Australia is pretty good at this. They have got a well¬ developed superannuation system. Australia is in a strategic time zone, placed between the United States and Asia. Australia has a well - respected prudential regulation system. Australia has stable government and a stable democracy. It is a good place to invest. Why don't we invest our money in Australia?* ***Because the withholding tax rate is 30 per cent.****'*
>
> *Yet around the world the average is 15 per cent, and some countries are as low as 10 or 7.5 per cent. Why don't we give this industry a break? Why don't we say to this industry: '****We will give you a level playing field'?*** *Why don't we say to this industry: 'You go out and win the business; why don't you export more than 21⁄2 per cent of your capacity?' … 'we'll give you a tax system which allows you to compete'? Those opposite will give them a tax rate of 30 per cent and shame on them! Shame on them for holding back an industry that wants to compete on its own. It is not asking for government assistance, it is not asking for special favours, but it is asking for a tax regime which allows them to be competitive. That is exactly the tax regime this government will give them and it is a tax regime that those opposite stand against." [Emphasis added]*

31 It is evident that the intended benefits described above have achieved their purpose, as can be seen by a continued increase in the amount of foreign funds that are managed by Australian fund managers. The MIT regime has also been promoted by State Governments as part of the Federal Government's Asset Recycling Policy[7] to encourage foreign direct investment by pension and sovereign wealth funds in

---

[7] Federal Government 2014/15 Federal Budget

unlisted Government asset privatisations. These privatisations include some of the largest transactions in Australia. Moreover, the ATO has released draft Framework documents which contemplates the use of stapled structures and the MIT concessions in the context of privatised Government assets.

32 The following table is a sample of the major privatisation and infrastructure transactions that have been implemented using a combined flow through staple and MIT over the past four years. It demonstrates that foreign institutional investors have been significant participants in key privatisation transactions in recent times:

Table 1: Privatisations 2013 - 2017

Privatisation	Consortium	Date	Value
AusGrid	IFM, Australian Super	October 2016	$16 billion
Port of Melbourne	Global Infrastructure Partners, OMERS, CIC Capital, Korean National Pension Service, Future Fund, Queensland Investment Corporation	September 2016	$9.7 billion
TransGrid	CDPQ, ADIA, Kuwait Investment Authority, Spark Infrastructure, Hastings Funds Management	November 2015	$10.3 billion
Queensland Motorways	Transurban, Australian Super, ADIA	April 2014	$7 billion
Port Botany & Port Kembla	Industry Funds Management (IFM), Australian Super, QSuper, ADIA.	April 2013	$5 billion

33 The MIT regime has also been used by foreign institutional investors, including foreign pension and sovereign funds to make direct investments into critical Australian growth sectors such as agriculture, renewable energy and services real estate, with the objective of providing secure income streams to fund pension liabilities.

34 Even though these investments extend beyond the traditional concept of REITs, the investment characteristics are fundamentally the same. The investments have a strong connection to land (hence them being often described as ‘real assets’) and they require long-term capital in order to generate moderate levels of returns over the long-term. These returns are expected to be more than government bonds and less than listed equities.

35 For completeness, it is noted that the MIT withholding regime does not provide a "level playing field" between foreign and domestic pension funds in all aspects of an investment. For example, investments in trading businesses are taxed at a rate of approximately 30% for foreign pension funds (whilst superannuation funds retain the 15% rate through the ability to utilise franked dividends). On the other hand, foreign pension funds are eligible for a 0% interest withholding tax rate on debt investments (subject to thin capitalisation rules), however, a 0% rate would equally apply to interest paid to a non-resident lender that qualifies under the section 128F exemption (or is exempt under the relevant double tax treaty).

36 For investments in passive land intensive assets, a 15% tax rate should be maintained as it makes Australia a competitive global market and removes tax arbitrage from investment decisions in Australian assets.

Commercial advantages to trusts and staples

37 The ATO have flagged the proliferation of stapled structures beyond the original policy intention, and the corresponding threat to Australia's corporate tax base[8]. Accordingly, Treasury is seeking to understand the aspects of Australia's framework for the taxation of foreign investors that may have contributed to the use of stapled structures.

38 We have identified a range of policy, administrative and commercial factors that have played a role in the desire by foreign investors to use either or both "transparent" trust entities or "stapled structures". These factors are briefly touched on below given the compressed consultation paper timeline. However, we would be pleased to elaborate on these factors as part of Treasury's further consultation process.

Tax policy and administration

39 The tax policy and administration factors that have contributed to the use of stapled structures are as follows:

- Changes to Division 6C in 2008 to include a deeming rule and safe harbour in respect of moveable property and income that are incidental to, customarily supplied in connection with and ancillary to the ownership and use of land. This arguably expanded the scope of trusts that met the definition of "eligible investment business".
- Changes to Division 6C in 2008 to expanded scope of permitted financial arrangements that qualify as "eligible investment business".
- Repeal of Division 6B, which was originally enacted as an attempt to stymie the ability of a taxpayer to erode the so-called classical system of company taxation by substituting a trust for a company[9]. The repeal followed Treasury's acknowledgement that, as a result of the introduction of the imputation system and the capital gains tax regime, the classical system of company taxation is no longer the norm[10]. The repeal of Division 6B and concurrent introduction of the non-arm's length income rule was consistent with the Board of Taxation's proposal to abolish Division 6B.[11]
- The reform of sections 974-70 and 974-80 of the *ITAA 1997* in 2015 as part of the Board of Taxation's review (including clarification of its application to stapled structures by way of examples published as a legislative instrument).
- The restrictive view of the ATO's interpretation of the application of section 254T of the *Corporations Act 2001, (*being that the payment of a dividend is subject to that company having current year profits), in contrast with the restricted ability to pass franking credits through to investors solely through franked dividends, which may result in trapped dividends and / or

[8] Presentation to the Australian Taxation Office's Infrastructure Event on 22 March 2017

[9] Second reading speech to the *Income Tax Laws Amendment Act (No. 3) 1981* (Cth).

[10] Explanatory Memorandum to the *Tax Laws Amendment (Managed Investment Trusts) Act 2015*, paragraph 9.6.

[11] Board of Tax, (2009, August), *Review of the Tax Arrangements Applying to Managed Investment Trusts*, Recommendation 42.

franking credits, resulting in a double taxation by a foreign investor. This has been only recently exacerbated by the release of Taxpayer Alert 2015/1 which flagged integrity concerns with the use of funds from capital raising to pay franked dividends to shareholders. The combination of the existing law with tax policy and administration have encouraged the use of trust structures for property and Included Infrastructure investments, which are heavily reliant on free cash flow being repatriated.

- The ATO's administration of Division 6C, including the issuance of draft Framework Documents. The Commissioner has issued a number of Interpretive Decisions and Private Binding Rulings (**PBRs**) in respect of the definition of "eligible investment business" in section 102M and the deeming rules in section 102MB. The following are just some examples of instances where the ATO has contributed to the development of the meaning of eligible investment business by:

  – expanding the meaning given to "other securities" in paragraph 102M(b)(ii) in: *ATO ID 2001/50* - to securities lending arrangements, *ATO ID 2006/233* - to full or associate membership interests in the Board of Trade of the City of Chicago Incorporated, ATO ID 2008/1 - to equity mortgage arrangements, *ATO ID 2010/17* - to participating loans

  – accepting that capital growth of investment is not fatal to that investment constituting an eligible investment business in ATO ID 2010/128, nor is the prospect of capital gain on exit from an investment *PBR authorisation number 1012033819775*

  – holding that the activities of demolishing and constructing a new building for the purposes of renting it out is also an eligible investment business in *PBR authorisation number 73192*

  – holding that water entitlements are "incidental to and relevant" to the renting of land for the purposes of carrying on an eligible investment business in *PBR authorisation number 1012592243899*

- The ATO has also issued specific guidance in relation to the use of stapled structures as part of the State Government Asset privatisations. This guidance is set out in Chapter 2 of the draft Privatisation and Infrastructure –Australian Federal Tax Framework (January 2017). Additionally, the ATO has introduced and executed Tax Deeds with investors and signed off on the integrity of such structures by way of private binding rulings and the Foreign Investment Review Board (**FIRB**) process. This administrative approach by the ATO has signalled to domestic and foreign investors alike that the use of stapled structures in areas such as Government asset privatisations and Included Infrastructure were – until the release of the Consultation Paper - acceptable structures in these asset classes.

Modernisation of legal concepts

40 Within Australia's common law system, legal concepts and definitions continue to evolve with each new judgment on a particular issue of law. By design, this allows Australia's legal system to evolve and adapt to changes in society, technology, and other circumstances.

41 As the definition of "eligible investment business" leverages legal concepts such as "interest in land" and "rent" the modernisation of such terms through the Courts has also had a bearing on the scope of investments that qualify as "eligible investment business".

42 Examples of such developments over time include:

- Changes to the meaning of "rent" which historically reflected the medieval notion of rent as a thing issuing from the land. However, over time the expression "contractual rent", used by way of contrast to "true" rent has gained currency as Mahoney J observed in *Commissioner of State Revenue (Vic) v Price Brent Services Pty Ltd* [1995] 2 VR 582, at 585.

- Changes in the traditional meaning of 'leases' in light of modern business arrangements - see for example: *Swan v Uecker* [2016] VSC 313 which ruled that a tenant under an AirBnB Agreement had "exclusive possession" of the property despite the short term nature of the arrangement. By

extrapolation, this development means that short term real estate service arrangements - such as student accommodation – should qualify as an “eligible investment business”.

43 It follows that the legislative approach taken to the definition of “eligible investment business” means that non-tax developments such as those outlined above can have an impact on the scope of investments that qualify for flow through taxation and concessional MIT rates.

Financing benefits

44 The use of flow through unit trusts as part of a stapled structure enhances the bankability of an infrastructure project. Effectively, critical financial metrics to the senior lenders are enhanced, which optimises the quantum of project debt. Optimising the gearing level optimises the price that the bidder can pay. More detail on this is as set out below.

45 To optimise the price payable for an infrastructure asset, a bidder seeks to minimise its Weighted Average Cost of Capital (**WACC**). Sources of project funding typically consist of senior project debt whose recourse is limited to the project assets and subordinated debt or equity. As senior debt funds are less expensive than subordinated debt or project equity, the maximisation of senior project debt funding will optimise WACC.

46 When senior lenders are assessing a project’s credit metrics, one of the key ratios is the Debt Service Cover Ratio (**DSCR**). Broadly, a measure of the available cash to service the debt (i.e. pay interest and repay principal) in each period. In the ordinary course, where it is incurred at the project level income tax would be treated as an operating expense that has to be met before the bank debt can be serviced. However, this is not the case where the tax liability arises outside of the bank’s security net at the investor level. A project that has the incidence of taxation at the investor level, rather than the project vehicle level, will optimise senior debt capacity.

47 It is important to note that the ATO as a creditor in respect of the payment of taxes is always subordinated to senior lenders, as senior lenders are a secured creditor rather than an unsecured creditor. The benefit of the tax being paid at the investor level, is that that tax expense is outside of the bank’s security net, so that the ATO would not become a creditor in the security net. Senior lenders would have control over enforcement of their security rather than risk acceleration of enforcement to a time that a third party creditor, such as the ATO, is entitled to make a demand for payment of taxes.

48 The optimisation of senior debt optimises WACC and hence increases asset prices or reduces availability/offtake prices resulting in benefits to consumers and households. Having the incidence of tax payable at investor level also has the advantage of:

- limiting the involvement of senior lenders in tax due diligence processes (often seen as an “equity issue” and not a “bank issue”);
- limiting the risk of senior lenders having a taxation review event or default event that may trigger freezing of equity cash flows, equity injections or enforcement action;
- investors are far more likely to receive foreign tax credits for taxes that are paid as withholding taxes of the investor, rather than as project taxes paid by a downstream consortium vehicle in which the investor may have a minority interest.

49 The senior debt benefit and WACC benefit from having a tax flow through structure is effectively paid away or priced into the transaction. Therefore, any change that increases the payment of taxes in the bank security net, even if it does not increase the overall level of taxation of the project, will cause a reduction in senior debt levels, and hence a need for an injection of more expensive equity into the project. This will significantly decrease the value of current equity in the project or an investor’s purchase / bid price for an asset where the equity IRR needs to remain constant.

50 To illustrate this point we have undertaken a high level sensitivity analysis to determine the impact on a project where the project entities are liable to taxation at the 30% corporate income tax rate compared to the typical scenario where the passive investment trust is treated as a flow through entity.

51 We observed the following changes in our sensitivity analysis:

Criteria	% reduction
Senior debt funding	~6.7%

52 To put these percentage changes into context, assuming a privatised asset value of $10 billion that is geared at 65% using a stapled structure (the base case), becomes subject to taxation at the 30% corporate income tax rate, the following changes would result:

Criteria	$ reduction
Reduction in debt funding	~$438 million*
Reduction in equity funding	~$162 million
***Reduction* in purchase price**	**~$600m**

**$10 billion x 65% x 6.7%*

53 Another way to consider the implications, is where there is an existing asset and the investor cannot reduce the value of its investment or its desired equity return. In this case, the investor will be required to increase its revenue to maintain its return. In these sectors in which stapled structures are traditionally used, this increase will result in the cost of non-discretionary expenditure for consumers increasing. For example, this would result in increased gas or electricity prices, or increased road tolls, or increased food prices.

54 Given increases in non-discretionary expenditure have a greater impact on economically disadvantaged members of society, any changes that will have an impact such as this need to be considered among a broader policy context than simply taxation of foreign direct investment.

55 Please note that these indicative values are based on sensitivities run across internal financial models. We would be pleased to work with Treasury to develop an indicative model that can be used to estimate this impact on a larger scale across a range of projects and assets.

Foreign tax credits

56 Foreign tax credits are a fundamental feature of global taxation that facilitate a fair and level playing field for global direct investment by mitigating double taxation. The ability for foreign investors to claim a foreign tax credit in their home jurisdiction for Australian taxes paid is important to ensure that they are not paying tax twice on the same underlying income or profit. This is typically a key issue for investors (other than tax exempt foreign pension funds) when considering the investment structure.

Foreign tax credits for foreign investors

57 As flow-through vehicles, the unitholders of an Australian unit trust (rather than the trust itself) are assessed on the amount of net income to which they are presently entitled. In the case of non-resident beneficiaries the trustee will be liable to withhold 30% of the net income of the trust.

58 In the circumstances where a foreign investor is directly assessable on the income and liable for the associated Australian taxes, the foreign investor generally has a better opportunity to claim a foreign tax credit for the Australian taxes paid in their home jurisdiction.

59 This can be contrasted to a distribution from a company where the company has paid Australian corporate income tax at 30% and distributes a fully franked dividend to the foreign investor. Depending on the foreign investor's home jurisdiction and the interest it holds in the Australian corporate the foreign investor may be taxable on the post-tax dividend in their home jurisdiction *without* the ability to claim a foreign tax credit for the franking credit attached to the dividend distribution.

Foreign tax credit from an Australian perspective

60 As investment vehicles, trusts have a 'flow through' tax treatment in respect of any income and gains they derive. This, in effect, aligns the tax treatment of an investment held directly or indirectly through a trust. For Australian flow through trusts, the trust's taxable income is assessed in the hands of the unitholder and each component of income retains the same character the income had when it was derived by the trust. As a result, foreign tax credits derived by an Australian trust may be distributed to its investors such that the credits become available for use against the assessable income in the hands of the trust beneficiaries.

Dividend traps under the Corporations Law

61 Investment in infrastructure assets is attractive to investors with a desire to access stable or low risk cash flows over a long term period. A critical requirement for these investors is the ability to access free cash flows in the project entities on a periodic basis. Structures which present a risk of trapping cash, such as corporate vehicles, are typically unattractive to long term passive investors.

62 Additionally, certain investors – such as domestic superannuation funds – treat franking credits generated through Australian taxes paid by a corporate entity as partially equivalent to cash. The ability for corporate entities to therefore distribute franking credits to investors on a consistent basis is also important to long term investors.

63 However, the release of franking credits to shareholders is subject to that company's ability to pay dividends. Relevantly, section 254T of the *Corporations Act 2001* restricts the circumstances under which dividends can be paid.

64 Dividend payments were historically governed by a "profits test," in that a company could only pay dividends from its profits. In 2010, however, section 254T was amended. As a result of those amendments, a company must **not** pay a dividend unless it meets all of the following three criteria:

- the assets of the company exceed its liabilities, and the excess must be sufficient for the payment of the dividend;
- the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and
- the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

65 The ATO has expressed that their view of the application of section 254T is somewhat more restrictive as it requires that a company have current year profits in order to pay a dividend to shareholders.

66 For example, a company with sufficient net assets but insufficient profit can now pay a dividend. If, however, a company has generated taxable profits but does not have a suitable net asset or accounting profit position, it is prohibited from declaring a dividend.

67 As a consequence, franking credits generated through profitable activities can become trapped within the corporate structure. This creates a material valuation issue for investors who may be unable to access the franking credits.

Franking traps due to differences between accounting and tax timing

68 Double taxation for investors can arise where a greenfield infrastructure project is held in a corporate entity. This is principally due to the timing differences between accounting and taxable income. Factors that can drive differences between these two categories include for example:

- Capitalisation of interest during the construction phase for accounting purposes (which is deductible on an accruals basis during the construction period for income tax), or
- Accelerated tax depreciation or building allowance claims for income tax.

69 The result of the above typically means that accounting profits in a corporate entity arise before taxable profits. As a consequence, the progressive distribution of this accounting income – to satisfy the investors requirements for stable cash flows – can result in investors being assessable on "unfranked" dividends in the early project years.

70 However, as the amounts referred to above are merely timing differences, it is expected that for a specific infrastructure asset (with a defined life or concession period) these timing differences to unwind in the later income years – in which case the taxable profits will exceed accounting profits. As a consequence the project company would generate franking credits in excess of available profits.

71 On the basis the company cannot distribute these credits to the investors under the imputation rules, the credits would effectively become "trapped" at the Australian company level. Unless this entity can subsequently join an Australian tax consolidated group belonging to the shareholders in that company, the investors would effectively suffer double taxation on part of the project returns.

72 This is obviously an inefficient outcome which may be part of the investors decision to use a trust structure, over a corporate entity – particularly on greenfield projects.

Investment restrictions on "control" of trading business

73 Certain foreign institutions have restrictions placed on their investment activities to ensure that they do not control any entity carrying on an active business (i.e. where that entity has employees undertaking activities that is more than the investment and holding of assets). As a result, PwC has seen examples where the ownership of passive investment assets has been separated from the operating business to allow the foreign fund to hold more than 50% of the investment assets without breaching investment restrictions.

74 See for example Section 59 of the *New Zealand Superannuation and Retirement Income Act 2001*.

Agri-business perspective – market practice and asset protection

75 It is common place for rural agricultural land to be leased directly to third party operators in return for rental income, and conversely for operators to carrying on operations on leased or agisted land.

76 This can be evidenced in third party transactions in the market where:

- A cattle operator leases properties from third parties or acquires cattle on a standalone basis, or
- A property company acquires land from a vendor and the livestock, plant and equipment owned by the vendor is acquired by a third party.

77 In addition to separation being common across the agri-business industry as a whole, it is common practice for many integrated operators in the agri-business industry to separate the ownership of the operating business from the underlying landholdings.

78 The separation of land from operating businesses is typically driven by:

- **Asset protection** - to protect the landholdings in the event of a trading failure caused through market or climate conditions (such as an insolvency event) or operational liability issue created in the operating entity.

- **Managing succession planning** - as it is commonplace for the family to reward family members who operate the active agricultural business with an ownership interest, which is separated from passive family members who maintain an interest in the landholdings of the family.

79 In our experience, limited liability in particular is a critical factor for agri-business operator's decision to separate land from operating assets. For example, to mitigate the potential assets over which a claim could be made where cattle contracted a disease and liabilities arose. It is noted that limited liability as a key purpose for a structure is accepted in a range of other contexts, such as professional services and should therefore have equal application and weighting in an agri-business context.

80 For these reasons the separation of ownership between land and operating assets is, and is expected to continue to be, a common feature in the agri-business sector. We encourage Treasury to consider this commercial requirement as part of any holistic review of stapled structures.

3 Better targeting concessions – *Concerns with Treasury options*

81 Treasury has identified three (3) options to remove the tax advantages of stapled arrangements on page 14 of the consultation paper. These options are as follows:

- **Option 1** - Disallowing certain deductions for cross-staple payments by companies or Division 6C trusts (including rentals, interest, royalties and synthetic equity payments) to flow through trusts and treating the income as non-assessable non-exempt for the trust

- **Option 2** - Taxing either the trustee of foreign recipient of cross staple payments (including rentals, interest, royalties and synthetic equity payments) at a rate equivalent to the Australian company tax rate

- **Option 3** - Deeming stapled entities to be consolidated for tax purposes

82 We have identified a number of critical issues with each of these options in the context of Australian stapled structures - particularly those used in the infrastructure regime. We have briefly explained these concerns below given the compressed timetable for submissions; however we would be pleased to provide further information as part of the detailed consultation process.

Option 1 - turning off the tap on all cross staple payments

Operating company will become a franking trap

83 The operating company will account for the cross-staple outgoing when determining its accounting income or loss, however it will not be able to claim a tax deduction for this payment. Consequently, the operating company's accounting income under Accounting Standards will be lower than its taxable income. Moreover, a large permanent difference is likely to arise for tax accounting purposes which would distort the financial reporting of the operating company.

84 As a result, the operating company will generate franking credits in excess of the accounting (and cash) profits required to pay a dividend under the Corporations Act 2001 (Cth). Under the current imputation rules this would mean that the operating company cannot distribute the excess franking credits to the ultimate owners. This would create a material valuation issue for both Australian superannuation funds (as they are unable to obtain a refund for trapped franking credits) and foreign institution investors (as the passive income will be taxable at Australia's 30% corporate income tax rate).

Operating company could become insolvent

85 Due to the proportion of the operating company's cash flow which is typically dedicated to the payment of its cross-staple obligations (be it rent, interest, or otherwise) the operating side of the staple would have an inflated tax liability as a result of the denied deduction. This liability could, in some instances, endanger the solvency of the operating company which could in turn create issues for the Directors and creditors of operating company.

Banks will be adversely impacted

86 Turning off all cross-staple payments for tax purposes could cause the operating entity to breach the banking covenants on the Senior Secured debt facilities and therefore cause an Event of Default. This could lead to higher financing costs or trigger a requirement to refinance substantial debt facilities, which would negatively impact on returns to equity investors.

For further details on the banking consequences, refer to our banking considerations comments under the Transition and Grandfathering rules in section 5 below.

All "stapled" structures will be impacted

87 This proposed change is a 'blunt instrument'. That is, all stapled structures - regardless of whether they are contrived or part of the original policy intention or considered to be low compliance risk from a ATO perspective - could be negatively impacted (ie. REITs, Included Infrastructure and privatised assets would be impacted). On the other hand, adopting a rigid definition may provide opportunities to circumvent the provisions by adopting a substantially similar arrangement without triggering the application of the measures. This option is therefore an inappropriate, and potentially ineffectual, response to the risks identified in the discussion paper to the revenue base.

Foreign investors will lose the foreign tax credit

88 As noted above, under this option, the operating side of the staple would have an inflated tax liability as a result of the denied deduction. However, as the operating entity is likely to be a corporate entity (rather than a flow through trust) a foreign investor is unlikely to be entitled to claim a foreign tax credit in their home jurisdiction for taxes paid by the Australian company. As a result, double taxation outcomes may arise.

89 For these reasons we recommend Option 1 is not implemented - especially by way of announcement in the 2017/18 Federal Budget.

Option 2 - taxing the recipient on all cross staple payments

90 The key issue with option 2 in the Consultation Paper is again that all "stapled" structures will be impacted. We have provided comments in this issue above. Given the ATO has acknowledged that it is only contrived stapled structures which are of concern it would seem inappropriate to impact all payments to foreign investors from a stapled structures.

91 It is worth noting that this option (compared to options 1 and 3) should have minimal impact on cash flows, finance, and accounting as it allows for cash to flow across and out of the structure. As a result, we would expect there to be less of an impact on banking arrangements and finance covenants as well as less distortion on the accounting and tax differential recorded in both the property and operating entities.

Option 3 – deem a tax consolidated group

Banks will be adversely impacted

92 Assuming that the consolidation regime employed in the case of a cross-staple group is similar to that of corporate income tax consolidation, the project entities (i.e. property trust) will become liable for the tax liabilities of the operating company. This could potentially trigger a breach of the banking covenants on the senior secured bank facilities and in turn trigger an event of default. This could have significant effects for investors.

93 Refer to the comments under Option 1 above for the reasons why this option should not be implemented.

Implementation will be extremely complex

94 Since its introduction in 2002, the tax consolidation regime has been, and continues to be, subject to excessive reforms to address integrity concerns in the regime. An imposition of the existing tax consolidation rules to stapled entities raises an inordinate amount of complexity and uncertainty, including requiring consideration of the mechanics of any such tax consolidation calculation and consideration of how tax attributes of the entities (e.g. existing franking credits, tax losses, capital losses, offsets etc) would be preserved. We would caution against the use of a consolidation regime given the complexities involved with implementing this model from a legislative perspective.

95 For these reasons we recommend Option 3 is not implemented by Treasury - especially by way of announcement in the 2017/18 Federal Budget.

Scope of stapled structures

96 Treasury is seeking to determine the scope of the “stapled” arrangements impacted by the proposed options - i.e contractual staples or other arrangements under common ownership. In this light, there are a range of potential “staples” including for example:

- Formal contractual staples where the units and shares are bound by a Deed.
- Other contractual staples where units and shares cannot be separately traded under the terms of a Unitholders and Shareholders Agreement.
- Informal staples where no contract exists but the entities have the same owners.

97 It follows that defining non contractual staples is likely to be more challenging. This is because any defined threshold for common ownership - say for example a bright line 80% common ownership test - may provide opportunities for inappropriate planning and abuse (for example fragmentation of ownership to play within “safe harbours”, or the use of swaps or synthetic upstream arrangements to equalise ownership). These issues are likely to be similar to the issues that are currently being considered in the context of what constitutes “control” for the purposes of the public trading trust provisions in Division 6C.

98 Despite these difficulties, some form of definition of non-contractual stapled arrangements will be necessary as this will set the parameters of any rules designed to limit the benefits associated with cross staple transactions (such as our suggested changes for royalty and synthetic staples outlined above). As part of this process, consideration should also be given to whether the definition should include non-traditional arrangements that may nevertheless be “stapled” (for example staples within corporate structures that may arise through holding different classes of shares).

99 We recommend that any definition of stapled structures is carefully considered after extensive consultation.

4 **Better targeting concessions –** *Alternative policy options*

PwC commitment to reform

100 PwC is committed to taxation reform and securing Australia's future prosperity. PwC participated in the consultation process surrounding the *Re:Think Tax Discussion Paper* in 2015 with two submissions, one which considered the need for tax reform in Australia and the process through which it can be achieved, and a detailed submission that responded to almost all of the specific questions and issues raised in the *Re:Think Tax Discussion Paper*. Additionally, since 2013, PwC has released the following publications in relation to tax reform in Australia:

- Why we need to talk about tax (July 2013)
- How do we fix a tax system (April 2014)
- The 2015 Intergenerational Report – A snapshot (March 2015)
- The case for dividend imputation in Australia (March 2015)
- GST reform packages: a baseline analysis (September 2015)
- GST and personal income tax reform: the yin and yang of tax policy (October 2015)
- We can afford GST reform (November 2015)
- A Corporate Rate Reduction: the case for and against (December 2015)
- What are the implications of changing housing tax benefits? (February 2016)
- Bracket creep: do we treat the symptoms or cure the disease? (March 2016)
- Priorities for an incoming Government (July 2016)

101 In addition, PwC also contribute to relevant articles in the Tax Institute of Australia's Alternative Assets feature in the monthly Blue Journal. These articles may provide additional reference material in relation to the reform or technical application of the "eligible investment business" definition in Division 6C of the Act and the managed investment trust rules. We would be pleased to share selected articles with Treasury if required.

Policy considerations for the future of stapled structures

102 As noted earlier, stapled structures have been used extensively in Australia for over 20 years. However, their prevalence has increased in line with significant increases in foreign institutional investment into Australian property, infrastructure, agriculture and renewable energy asset classes.

103 This influx of foreign capital into these sectors has been influenced by a range of factors including:

- Australia's foreign investment and taxation policies
- Australia's asset recycling program

- Australia's Renewable Energy Targets and support provided by the Clean Energy Finance Corporation

- Australia's position as the food bowl of Asia

- Foreign institutional investors desire for long term returns linked to the growth of the Asia-Pacific region with the benefit of the political and regulatory stability of Australia.

104 There are a number of key elements which underpin Australia's taxation policies and framework in relation to attracting foreign investment into real property, and foreign institutions willingness to invest. These are:

1. certainty and transparency
2. competitiveness, and
3. compliance costs.

105 Ensuring that these three elements continue to be at the forefront of any policy considerations is essential to maintaining and even improving Australia's position as a safe and attractive place for foreign institutions to invest. Given this significance, we have briefly touched on these elements below.

Certainty and transparency

106 In the vast majority of cases, stapled structures are used by foreign institutions to hold capital intensive assets to generate stable cash flows over a long term period. Investors often perform substantial amounts of due diligence on the assets and anticipated cash flows before committing to an investment. One of the key factors considered during this period is sovereign risk, including certainty over investment and taxation policies and law.

107 Uncertainty and volatility in the tax system can increase perceived sovereign risk, and in turn potentially impact the flow of foreign capital for critical Australian projects. This is particularly true in the current global environment where institutional capital is mobile and there is strong competition from developed countries to attract this capital for private investment into key sectors such as economic infrastructure (roads, ports, airports, etc) and renewable energy.

108 The ATO's release of Taxpayer Alert 2017/1 and subsequent Consultation Paper from Treasury has created significant uncertainty among foreign institutions which, if left unattended, could impact investment decisions by foreign institutions.

109 Accordingly, any changes to policy or law in relation to the MIT regime or stapled structures should be made after appropriate consultation with key stakeholders, and should also provide appropriate transitional measures.

Competitiveness

110 Given the mobility of foreign capital and associated financial services jobs, Australia must remain competitive with other developed countries to ensure a continued inflow of foreign direct investment.

111 One of the key objectives of the MIT regime is to provide a level playing field between Australian superannuation funds and foreign pension funds when investing in Australian assets. This is achieved through the 15% withholding tax rate applicable to payments made to qualifying foreign investors.

112 Any prospective policy should seek to maintain the level playing field between foreign and domestic investors (i.e Australia should not regress to a 30% corporate tax rate on foreign investment into Australian real property assets such as REITs and Included Infrastructure).

Compliance costs

113 Simplicity and clarity with respect to tax and investment compliance costs is also a key element. Investment structures should be easy to set up, with an efficient, clear and transparent process for

gaining the necessary approval from authorities and government regulators such as the Foreign Investment Review Board and the ATO.

Policy options

114 In light of the above, we have outlined two broad alternative policy options:

> **Option 1** - Retain "staples" but amend the "eligible investment business" regime to better target the concessions
>
> **Option 2** - Limit "staples" to REITs and use a designated infrastructure vehicle for concessional infrastructure

115 We have outlined these potential policy options at a high level below for Treasury's consideration. We would also be pleased to work with Treasury following this initial consultation period to further develop these options. We reiterate that the options below should be considered as part of a comprehensive consultation process with interested stakeholders to ensure that any revised policy and law has a long term and positive impact on Australia's prosperity.

116 The existing tax law already provides extensive integrity measures for finance staples to ensure that any risk to Australia's revenue base is sufficiently protected. As such, finance staples should be excluded from any policy review of stapled structures. These integrity measures are as follows:

- the non-arm's length income rule in Subdivision 275-L of the *ITAA 1997*
- sections 974-70 and 974-80 of the *ITAA 1997;*
- the exposure draft legislation released in October 2016 regarding the proposed new related scheme rules to be included in Division 974 and the repeal of section 974-70 and 974-80 (including draft legislative instruments setting out a number examples of how the proposed rules apply to stapled structures)
- the application of the thin capitalisation rules in Division 820 of the *ITAA 1997;*
- the general anti-avoidance rule in Part IVA of the *ITAA 1936*.

117 We consider that these integrity measures are sufficient to ensure that any risk to Australia's revenue base in respect of these arrangements is adequately protected. As such, a holistic review of finance staples should not be included as part of a broader policy review of finance staples.

118 The recommendation for extensive consultation on these policy options can be distinguished from our recommendation for more immediate policy changes to prevent the inappropriate use of royalty staples and synthetic staples, which may currently be impacting Australia's revenue base.

Option 1: Amend the existing "eligible investment business" regime

119 This option would not involve a significant overhaul of the current regime for taxing stapled structures. Instead, the existing machinery in Division 6C of the *ITAA 1936* and the MIT regime could be modified to ensure that the provisions continue to encourage investment in sectors which are considered to be important to Australia's future prosperity. This reform of the existing "eligible investment business" definition would also help to address existing uncertainty for industry and the ATO.

120 Under this approach, modifications to the existing framework could include:

Removal of the all or nothing test in Division 6C

121 Under current rules, where **non** eligible investment business income is derived, a flow through trust loses its tax flow through status and is considered a trading business, such that the trust is taxed like a

company, (ie income is taxed at the corporate tax rate). Consideration should be given as to whether this is the intended outcome and appropriate to address Treasury's concerns. An alternative to this that may better target the intended concessional tax treatment afforded to MITs is to tax ineligible income at the corporate tax rate, allowing eligible investment income to continue to access benefits.

Expand the definition of eligible investment businesses and related safe harbours to accommodate modern day REITs, including services real estate:

122 This could be achieved by changing the definition of "rent" to a payment for the "use of space", and increasing safe harbour limits for income that is not considered eligible investment business. This should be targeted at ensuring that the activities of the current day real estate market, including "services" real estate continue to be eligible for the tax outcomes associated with stapled structures in conjunction with the MIT rules. Examples include car parks, student accommodation, hotels, residential parks, manufactured home estates and retirement villages.

123 Amending these rules may in fact mean that REITs can in future be structured in a single trust vehicle, reducing administrative burden of managing multiple vehicles. For further detail refer to our REITs comments above.

Limiting the scope of rental staples that are eligible for MIT withholding benefits:

124 This could be achieved by reducing the scope of the concessional MIT withholding regime as it relates to income derived from cross staple payments. The concessional 15% MIT withholding could be limited to cross staple rental income to income from specific assets or industries that are included as part of a modified eligible investment business definition.

125 The assets which could qualify for this concession include:

- Privatisations
- Included Infrastructure
- Real property where a third party or common observable rental market exists
- REITs, expanded to include payments for the use of space (discussed below).

126 As a starting point, "Included Infrastructure" could be defined similarly to

- "Infrastructure facilities" per section 93L of the *Development Allowance Authority Act 1992* (refer Appendix A), or
- The UK definition proposed under the *UK Corporate Interest Restriction in the Finance Bill 2017* (refer Appendix B).

These definitions includes transport (roads, tunnels, bridges, airports, etc), ports, electricity generation (which would include renewable energy source, transmission and transmission facilities), gas pipeline assets, water supply assets, sewage and wastewater facilities. If necessary this definition could be broadened to include specific classes of assets that are considered important to the national interest (e.g. assets constituting the National Broadband Network or similar, renewable energy, agriculture).

127 Additionally, the test for determining whether a common observable market exists would need to be determined. However, the general concept should be that where a third party business invests solely in a land asset for the purpose of deriving passive income, a single investor should not (subject to integrity rules mentioned below) be prevented from investing in this asset class on the same basis, whilst deriving some or all of the income form a related entity. An example of this could be a hotel or agri-business.

128 By limiting the assets that can access concessional rates of withholding tax from stapled structures to a particular definition, other forms of cross-staple income would be excluded from the concessional

regimes and treated in a similar manner to our recommended interim legislative changes for royalty and synthetic staples (ie. subject to trustee withholding at the rate equivalent to the company tax rate).

Specific anti-avoidance rule targeted at "fragmentation"

129 Provisions similar to the former Division 6B could be introduced to prevent flow through taxation and MIT withholding tax benefit for businesses in corporate structures that are fragmented into stapled structures.

No specific changes for cross stapled interest payments

130 For completeness, we do not consider that specific policy changes are required in relation to cross staple interest payments. The debt equity rules, MIT non-arm's length income rule, thin capitalisation provisions, and general anti avoidance rules should adequately address the inappropriate use of cross staple financing.

131 In our view, the benefits of pursuing the above policy design include:

- A more targeted set of rules that ensure that the benefits associated with stapled structures and MIT withholding are appropriately afforded at genuinely aggregated land based businesses and sectors of national importance (Included Infrastructure, renewables, agri businesses).
- More clarity and certainty - Narrowing the scope of cross staple payments that are eligible for MIT withholding helps ensure that there is consistency between the law and policy objectives of this regime.
- Minimised disruption to the existing regime and existing arrangements. By targeting the concessional withholding tax rate (rather than the availability of cross staple deductions, or flow through status of trusts), other important commercial aspects of stapled structures can be retained. In addition, less complex and wide ranging transitional provisions will be required under this approach (as it will be unlikely to require significant restructuring of existing businesses).

132 However, the risks or issues associated with the proposed policy design, that would need to be carefully considered as part of the detailed consultation process, include:

- Drafting of the relevant definitions to ensure that the revised scope of eligible investment businesses and qualifying rental staples are not too narrow (excluding assets or arrangements that are within the policy intent), and not too broad (increasing the risk to Australia's revenue base).
- The requirement to regularly review and update the definitions to ensure that the corporate tax base continues to be appropriately spent, as the priorities for Australia's future prosperity shift.
- Potentially denying MIT withholding tax benefits to for certain cross staple transactions will require non-contractual staples to be defined (e.g. what level of common ownership would constitute a non-contractual stapled structure). This may open up the possibility for the concessions to be inappropriately applied through structures targeted at circumventing the provisions.

Option 2: designated infrastructure vehicles

133 An alternative approach would be to change the framework to a "designated infrastructure vehicle" regime. Under this model the Government, or a delegated body such as Infrastructure Australia, could control the list of projects or assets that can access concessional taxation treatment by mandating an application and approvals process with clearly defined assessment criteria.

134 Such a system could be structured in a similar manner to the Designated Infrastructure Project (DIP) entities initiative. This regime was introduced in 2013 and provides DIPs with the ability to index tax losses in line with a long term bond rate, and to use losses without applying the loss recoupment tests.

135 The benefits of such a framework include:

- Certainty of where the "corporate tax base" is being spent (as only approved vehicles will be eligible).
- Reducing the risk of unintended structures benefiting from the concessions.

136 However, such a framework is unlikely to achieve all of the key elements outlined above (certainty, competitiveness and compliance costs). In particular, the risks or issues associated with the proposed policy design include:

- To the extent that such a system is not quick, easy, and investor friendly, it is likely to be viewed as uncertain, and potentially render Australia a less desirable jurisdiction for foreign capital. This is typically the case for any regime that requires Government pre-approval and is not a self-assessed framework.
- As the designated infrastructure vehicle will only be available to approved projects or assets, with all other projects potentially being subject to a 30% corporate income tax rate, it is likely to impact the competitiveness of Australia as an investment jurisdiction for mobile foreign capital.
- Increased compliance costs for foreign institutions as they will need to receive approval from the Government or a regulator before being eligible to access the concessions (ie. increased red tape). This is evident from the DIP regime which has had minimal take up[12] to date due to the lengthy application and approval process associated with the DIP (this is despite the effort made by the Government, Treasury and industry groups to design and legislative this regime).
- The requirement for specific approval for each instance of granting the concession is likely to give rise to a less efficient allocation of resources (determined by government), rather than a market based which is driven by foreign investors being put on a level playing field for critical investments .

The importance of stakeholder engagement

137 Stapled structures are now used by:

- over 60 entities listed on the ASX,
- institutional investment into privatised Government assets ($60bn in FY16 alone)
- institutional investment into renewable energy
- institutional investment into agri-businesses

---

[12] This is also noted by Treasury at page 16 of the Consultation Paper

- institutional investment into "services" real estate, etc

138 Accordingly, there is a large pool of strategic stakeholders and committed capital (financial returns) that are exposed to policy changes. Any decision to reform these rules must not be taken lightly. We therefore encourage the Government to undertake proper consultation and stakeholder engagement over an appropriate period of time (and before changes are announced or implemented).

5 Transitional measures – *Movement with certainty*

139 As set out in the Re:think Tax discussion paper of March 2015:

> *Transitional arrangements are important. While tax reform needs to be focused on the long term, the impacts of the transition process from existing policy to new policy needs to be understood and carefully addressed so that changes balance the interests of different groups. Tax changes can impact negatively on individuals and businesses, for instance, when they have made long-term decisions based on previous arrangements. Some tax changes can also have significant implications for system administration and government budgets.*

Transitional issues

140 The Government should limit any changes to the tax system in the short term to those required to restore the integrity of the existing system. The changes announced as part of the 2017/18 Federal Budget should not reflect an overhaul or major change in policy direction. Our recommendation is that any immediate changes are targeted at royalty staples and synthetic staples designed to "recharacterise" trading income, but exclude any comprehensive policy and law change until further consultation and assessment of alternatives can take place.[13]

141 Transitional issues will also be a critical aspect of the consultation. Transitional measures need to be specifically designed in the context of the eventual policy change and law that is designed. Accordingly it is difficult to be definitive on what form the transitional rules should take until the broader consultation process has been undertaken. That said, we have outlined below some broad considerations regarding how transitional provisions should be designed and factors that should be considered.

142 The key sensitivity will be the impact on Australia's sovereign risk. Where limited transitional rules are provided, we expect this impact to be high; whereas extensive transitional rules (including grandfathering of privatised assets) should mean there is a low impact on Australia's sovereign risk.

Key requirements of transitional reform

143 A fundamental concern for investors will be the impact the proposed tax reform has on the value of their existing investments, particularly those investing in long term infrastructure.

144 To minimise disruption and ensure current investment partners continue to consider Australia as a stable investment environment, we would encourage the Government to consider comprehensive transitional provisions. Consideration should be given to:

---

[13] Refer Treasury's policy option 2 on page 14 of the Report (trustee withholds at a rate equivalent to the Australian company tax rate)

- An extended transitional period for structures that become subject to a higher trustee level withholding on distributions to foreign investors (for example if the 15% MIT withholding tax rate is increased to 30% for certain payments). This could be a five year period to allow existing structures to better plan for the increased tax cost.

- Where the law changes requires a more comprehensive restructure of the project vehicles, we would recommend grandfathering of existing land rich staples, such as REITs and privatised infrastructure. This is on the basis that these structures are:

  – consistent with the original policy intent

  – subject to high restructure costs (such as stamp duty)

  – mature business with complex banking arrangements

  – considered to be low compliance risk from the ATO (see Taxpayer Alert 2017/1)

  – at the greatest risk of impacting Australia's sovereign risk

  – subject to a Tax Deed with the ATO

- The potential for any policy changes that result in higher costs to investors in privatised assets, due to increased tax liabilities, restructure costs, reduced debt funding / higher WACC, etc to be passed onto Australian customers in order to maintain returns to equity. That is, operators of the privatised assets charge more for services to increase revenues. The flow on effect of this could result impact the economic prosperity (due to higher energy costs) or higher costs of living for Australian communities.

145 The transitional rules could also consider allowing investors to elect into the new regime, should those investors have concerns under the existing tax laws (eg. Part IVA).

Evidence of grandfathering by Australia

146 Australia has a history of grandfathering assets where there has been a significant shift in tax policy. Prominent examples of assets that have received the benefit of grandfathering include:

- Capital Gains Tax (**CGT**) assets acquired before the introduction of the CGT regime - with assets acquired before 20 September 1985 being exempt from CGT on disposal. Note, a special conversion rule in Division 149 of the *ITAA 1997* was introduced in 1998 (some 13 years after the introduction of the CGT regime) to deem an asset to become a 'post CGT asset' where a majority change in the beneficial interests had occurred.

- Mining rights acquired or granted before the introduction of the Uniform Capital Allowance (**UCA**) regime on 1 July 2001 continued to be excluded from the treatment as a "depreciation asset" - with licences in existence before this date unable to qualify as a depreciating assets unless the assets (licences) were acquired by an unrelated party through an asset acquisition (ie. a majority change in the beneficial interests in the company owning the pre-UCA mining rights did not cause the asset to become a post-UCA or deprecating asset in this case).

147 In both these examples the grandfathering was linked to the relevant "asset".

148 We submit that a similar approach could be taken in relation to assets which, as a result of a change in tax policy, cease to be qualify as an "eligible investment business". Given the necessary legislative machinery already exists in the Act from previous grandfathering arrangements Treasury should be able to implement an appropriate legislative transitional regime in a short period of time (see for example section 40-77 of the *Income Tax (Transitional Provisions) Act 1997* and section 702-1 of the same Act in relation to mining licences).

149 In addition to the grandfathering of "assets", we would encourage Treasury to consider the potential grandfathering of entities. However, we acknowledge the integrity concerns associated with grandfathering entities, including for example the potential for that entity to evolve overtime through the acquisition of unrelated businesses or assets, yet retain the grandfathered status.

150 One way to potentially deal with this integrity concern would be similar to the loss trading rules for companies. For example, Treasury could replicate tests similar to the "same business test" in Division 165 of the Act or newly enacted "similar business test". Such tests would effectively operate as anti-stuffing rules to ensure that only the grandfathered business continues to benefit from the flow through taxation and MIT concession available under the current laws (ie. before a change in the tax policy).

Evidence of financial impacts on banking arrangements

151 Consideration should also be given to the impact that any law change and transitional measures could have on financing arrangements for existing structures. Many long term, capital intensive assets that are held in stapled structures are significantly debt funded through syndicated facility agreements. It is common for financiers to include clauses which trigger a "tax review event" if there are law changes, or changes to the anticipated tax treatment of project vehicles.

152 Typically such clauses provide that a tax review event will occur in instances where project entities become subject to tax (for example due to the application of Division 6C of the *ITAA 1936*).

153 Where a tax review event is triggered, the funding of the project is reviewed based on a revised project model. In some instances, this can lead to a reduction in some or all of the funding provided by financiers, affecting the viability of long term projects that are already under construction/operational.

154 Accordingly, any changes to the tax treatment of existing stapled structures (including transitional provisions) should be carefully drafted to minimise the triggering of tax review events. One of the reasons that we have recommended changes to withholding tax rates where possible, rather than changes to tax status of project vehicles, is because withholding tax rate changes are typically less likely to trigger tax review events, and therefore should have less adverse impacts on the viability of existing projects putting the funding of existing projects at risk.

155 To evidence the terms of these arrangements and support the statements above, we have included sanitised extracts of the covenants as requested by financiers in Appendix B.

6 Preserving the REIT regime - *Eligible investment business*

Reasons to retain the existing REIT framework

156 Australia's mature REIT sector was established in the 1980s and regulation has been fortified through ongoing consultation among government, Treasury, the ATO and industry over the previous eight years. The AMIT tax regime only came to fruition on 1 July 2016, and all parties have invested significant time and resources to prepare for that implementation including the "arm's length" integrity rule to address concerns voiced about cross-staple transactions. There has been significant investment and development of the existing system for REITs; it is robust, global best practice, and in our view does not require further change other than the expansion of the definition of eligible investment business and the safe harbour threshold.

157 The key factors as to why the existing REIT framework is sufficient and does not require material amendment are as follows:

- REITs are not integrated trading businesses
- Arm's length rule protects the corporate tax base
- Services real estate operations are outsourced to third parties
- Mature REIT regime
- Efficient utilisation of Treasury resources
- Effect on the market

158 These factors are further explained below.

REITs are not integrated trading businesses

159 The Commissioner's key concern regarding staples was outlined in paragraph 1 of *TA 2017/1. Specifically:*

> *We are reviewing arrangements which attempt to fragment integrated trading businesses in order to re-characterise trading income into more favourably taxed passive income. Our concern arises where a single business is divided in a contrived way into separate businesses. The income that might be expected to be subject to company tax is artificially diverted into a trust where, on distribution from the trust, that income is ultimately subject to no tax or a lesser rate than the corporate rate of tax.*

160 Further, the Rental Staple example provided by the Commissioner in in the Alert states:

> *The nature of the business is such that the transactions to divide the business in this manner are not transactions that third parties acting at arm's length would usually enter into, and it is often also the case that the business is not one capable of division in any commercially meaningful way.*

161 This is not a valid concern in the context of the real estate industry. This is because the assets in a REIT are not an "integrated trading businesses" and thus the Alert and the consultation process should not apply. Stapling of the entities that hold passive property and operate an active business simply

aggregates two businesses together. This is typical in the listed REIT space where active type businesses (such as funds management and property development) can be aggregated with passive property ownership and ultimately be internally managed.

162 In the services real estate asset space, it is commonplace that an operator will either own or lease the premises from a third party to operate their business. There are therefore two distinct business, one which is the passive ownership of the land and buildings, and the second being the services business that is operated in and from those facilities. This reflects the distinction in the market between property owners or business operators.

163 Typically, investors which have the capital to invest in real estate do not share the same risk profile, skills, or resources as an investor in an active trading business. Similarly, operators of active businesses do not typically have the capital to invest into land holdings and tying up capital in property holdings is not traditionally part of their business mandate. Accordingly, the acquisition and disposal of an operating business or the property upon which the business operates commonly occurs independently of one another.

Arm's length rule protects the corporate tax base

164 The Commissioner acknowledges in *TA 2017/1* that there are businesses ('third party use of building' businesses) operated through a stapled structure where:

- Asset Trust leases buildings of a traditional real estate nature to Operating Entity
- Operating Entity makes those buildings available for use (typically as a dwelling) by independent end-users, albeit not in the form of a lease (such as a temporary licence to occupy the dwelling), and
- A common observable market or practice already exists in that industry for building owners like Asset Trust to lease those types of buildings to unrelated third parties to carry on the same type of business Operating Entity carries on with the buildings.

165 The Commissioner has already noted in TA 2017/1 that in this instance that the staple structure is not of concern but that he will be focusing "on the arrangements between the entities…(such as making sure Operating Entity retains a sufficient share of the profits)".

166 Accordingly, arrangements of this nature were effectively 'carved out' from TA 2017/1. This carve out typically applies to services real estate asset structures such as hotels, student accommodation, aged care facilities/retirement living and manufactured housing.

167 The existing framework, which includes the non-arms length income rule for MITs in Subdivision 275-L of the *ITAA 1997* and the general anti-avoidance rule in Part IVA of the *ITAA 1936*, therefore already protects the corporate tax base.

168 We see no reason for the treasury consultation process to significantly impact the current regime that operates for REITs. As noted below, we would in fact recommend broadening the regime to reduce uncertainty that currently exists in relation to asset classes that should fall within the taxing regime for REITs.

Services real estate operations are outsourced to third parties

169 Services real estate operations are typically outsourced to third party operators (eg. hotel operators). Ultimately, the economic outcome for passive owner of these types of assets will be the same whether they engage with an operator directly or via a lease with a stapled entity who then engages the operator. The arrangements between the trust and the stapled operator entity are always at arm's length. In the case that a third party operator is not engaged, the operating activities are carried on in a corporate entity which is paying corporate level tax.

170 The key reason for staple structure is because most operators in the services real estate sector prefer to enter into licence and/or management agreements rather than leases and a passive trust cannot derive income from these agreements for Division 6C and MIT purposes (i.e. a passive trust can only derive rent from a lease).

171 Subject to appropriate arm's length pricing between stapled entities, we see no mischief in using staple structures for service real estate assets and is a key reason why the existing REIT framework should be retained. We have however recommended that the definition of 'eligible investment business' be expanded to include income derived from these types of assets. If that were to occur, then staple structures would not be required. Refer below for further comments in this regard.

172 For completeness, it is noted that even where the service business is not outsourced, the ultimate ownership of both parts of the business by the same investor should not be a concern as there is no policy reason to disadvantage the investors from investing in a horizontally integrated business. As long as the two parts of the business are appropriately taxed (which is achieved through existing integrity rules such as the non-arm's length income rule), there should be no policy reason for investors in an integrated business to be subject to differential taxation.

Mature REIT regime

173 Australia's REIT market is the third largest in the world. Investment in Australian REITs impacts the majority of Australians either through direct investment or indirect investment such as through their superannuation funds.

174 The Australian REIT market has been developed over years from the introduction of new legislation to encourage foreign investment (MIT regime) and improving this legislation to provide greater clarity and flexibility in the market (AMIT regime). Currently, the Division 6C Working Group is working towards providing certainty regarding key issues that Division 6C poses for the REIT market in order to continue to provide domestic and foreign investors with greater legislative certainty.

175 Notwithstanding the clarification that is required on certain Division 6C issues, the existing REIT regime is robust, mature and familiar to both the domestic and foreign markets. Material amendment to this regime would result in significant and unnecessary market disruption and investor uncertainty. Further, costs associated with restructuring existing REITs such as legal costs, capital gains, and stamp duty, would be material.

Efficient utilisation of Treasury resources

176 As previously discussed in this Submission, we consider that the principle areas of concern of the ATO in the context of "re-characterisation" of income is in regards to royalty staples and synthetic staples. However, we consider other traditional forms of stapled structures, such as rent from real property, to generally be within the original policy intention, and as noted above, the risk to Australia's revenue base are adequately managed by existing law.

177 Accordingly, we consider it a more efficient use of Treasury resources to focus on the key mischief and practices currently conducted by royalty staples and synthetic staples, rather than the REIT market.

Effect on the market

178 Adverse changes to the REIT sector will create uncertainty for jobs, housing supply and urban investment and development. Housing affordability and urban infrastructure investment is critical to the creation of sustainable buildings and cities, and encouraging stronger communities. Uncertainty created by the terms of the Treasury Paper consultation, and any eventual changes on a short term and unplanned basis, may have an impact on the level of ongoing investment and potential new transactions in critical property projects.

Expanding the scope of eligible investment business

179 We consider that the original definition of an eligible investment business, being the "investment in land for the purpose, or primarily for the purpose, of deriving rent" is creating too much ambiguity in the modern real estate market. The modern REIT market is no longer comprised of 'traditional' real estate being land and commercial buildings that were perhaps contemplated when the original definition was legislated. For example, we consider that the modern REIT market now includes, in addition to land and commercial buildings:

- Tourism accommodation including hotels and serviced apartments
- Student accommodation
- Aged care facilities and retirement living
- Multi-family residential dwellings
- Manufactured housing
- Car parking
- Storage facilities
- Warehousing facilities

180 Due to the ambiguity that surrounds these asset classes, the REIT market has defaulted to the utilisation of stapled structures to mitigate the unintentional application of Division 6C and facilitate on-going foreign investment. We have discussed below how the expansion of the eligible investment business definition and the safe harbour definition should mitigate the need for staples in REIT context in the future.

181 The globalisation of Australia, particularly in regard to tourism and higher education, has resulted in the significant growth of the hotel and student accommodation sectors. In regards to hotels, per the Tourism and Hotel Market Outlook - 2017 (Deloitte), international arrivals for tourism increased by 11% over the course of 2016. This is more than twice the 3.9% growth rate for global outbound travel and still above the 8.4% growth in international tourism across the Asia-pacific region. Consequently, the demand for tourism accommodation such as hotels is increasing.

182 As at 27 March 2017, there were more than one million students enrolled in universities across Australia with international education being Australia's largest service export. Consequently, the demand for student accommodation has exponentially grown. In respect of aged care and retirement villages, the number of Australians aged 65 years and over is "forecast to more than double over the next 40 years". Further, consistent with this trend, "it is estimated that 76,000 new residential aged care places will be required by 2024 to meet demand".

183 These modern asset classes are exponentially growing and increased investment into these asset classes is largely driven through the injection of foreign capital. However, whether the income streams derived from these classes fall within the existing definition of an eligible investment business is subject to a degree of ambiguity as technically, the income may not be considered 'rent' in the traditional interpretation of the word. Currently, the definition of "investment in land" is considered to be so narrow that without the implementation of a stapled structure for these asset classes, the level of risk that Division 6C would apply is such that foreign investors would be unwilling to invest in these asset classes.

184 Accordingly, we recommend that the definition of 'eligible investment business' is expanded to include the investment in an asset to derive income from the **use of physical space**. Making available physical space (either under a lease, licence or management style arrangement) should, in our view, fall within the definition of eligible investment business. The income derived is passive in nature and can

vary from a short term let (such as tourism accommodation) to longer terms (such as student accommodation, retirement villages and manufactured homes).

185 The expansion of the definition would provide greater certainty to the REIT market and continue to encourage foreign investment into these modern asset classes.

186 We consider that the expansion of eligible investment business would encourage on-going foreign investment into these asset classes and increase Australia's competitive stance in the international REIT market.

Increasing safe harbour thresholds

187 As noted earlier, REITs typically enter into stapled structures to avoid any technical ambiguity associated with the modern day types of passive income that are derived from the use of space. Broadening the definition of eligible investment business can help clarify this point and reduce the need for stapled structures (allowing REITs to instead structure their prospective investments in single trust vehicles.

188 The expansion of the safe harbour thresholds in Division 6C of the *ITAA 1936* would also help to reduce the circumstances in which REITs need to enter into stapled structures.

189 Currently, the safe harbour threshold requires that the income be incidental and relevant to the renting of the land, or ancillary to the ownership and use of the land. This narrow interpretation prevents the REIT from deriving any material income from other sources, regardless of whether they are passive in nature. In the US, UK, Canada, Germany, Hong Kong and Singapore, the threshold for income that is allowed to be derived outside of income earned on real estate, is 25%. Further consideration would need to be given as to the appropriate threshold in an Australian context. The definition of the income that can be included in the 25% threshold varies. However, per Appendix 1 of the Consultation Paper, none of the definitions are as restrictive to as Australia's and at the very least, they enable the derivation of other income streams that are not solely incidental and relevant to the renting of land.

190 The threshold of non-rental income (in the traditional sense of the word) is so low compared to foreign REIT regimes, that a stapled structure is typically utilised to ensure the taxation of the 'traditional' rental income stream is protected and Division 6C is not gratuitously applied. As acknowledged by Treasury, *"the more restrictive thresholds in the Australian regime may have contributed to the use of stapled structures in Australia in the property investment market to prevent the application of Division 6C".*

191 Consequently, we consider that the expansion of the safe harbour threshold to enable the derivation income streams connected with the provision of a physical space would align Australia's REIT regime with the broader foreign REIT market.

192 The level of expansion should be agreed through further consultation, however we would typically recommend that the safe harbour is increased to somewhere between 20% and 25%, consistent with foreign jurisdictions (comparable foreign jurisdictions are discussed further below)

Staples in the housing affordability policy

193 Housing affordability is a growing concern in Australia as house prices in Sydney and Melbourne continue to grow at an exponential rate. The Treasurer Scott Morrison has indicated that this is a focus area for the Government in the upcoming Federal Budget, with the aim to "*remove obstacles that restrict supply responding to genuine demand.*"

194 It is understood that Treasurer Scott Morrison has been considering policies adopted by other countries to address housing affordability, including the UK's "build-to-rent" policy that is aimed at luring private investors into affordable housing. "Build-to-rent" models are also common in the United States and in Europe, but there are a number of factors (in addition to low yields) that have prevented large scale private investment in residential real estate in Australia. In a recent address to the Australian Housing and Urban Research Institute, the Treasurer noted that:

“attention must also be paid to how rented residential real estate can be better structured to provide more opportunities for institutional involvement. This would diversify the base of ownership and inoculate risk, while potentially delivering greater stability and certainty as well as greater innovation in product offerings.”

“As with any new emerging asset class this will need to be fundamentally driven by the private sector. It will require new liquid investment vehicles, greater investment scale, new players and partnerships, appreciation of the longer term investment horizon, ***the creation of more conventional asset management structures for residential real estate that institutional investors are accustomed to in other property investments sectors*** *and a more sophisticated information and research base to support investment allocation models.”* [***emphasis added***]

195 Stapled structures (or a flow through trust structure that provides for a broader range of eligible income as described above) should provide a vehicle that is well known and understood by institutional investors, and contain features that will make this structure attractive to such investors (for example, tax transparency, concessional tax rates for foreign investors) whilst enabling investors to maintain control of the operational aspects of the investment via the business carried on by the corporate side of the staple.

196 It is noted that at present, residential housing in Australia is not currently viewed as an institutional asset class, unlike in some other developed countries in the world. This arguably impacts the amount of capital being invested in this market. However, the availability of institutional capital could go some way to addressing Australia’s issues in affordable housing, through an increase in the supply of residential housing. The ability for institutional investors to access flow through taxation and concessional MIT withholding tax rates could encourage investment into this sector.

197 Accordingly, maintaining the tax policy with respect to REITs should continue to encourage domestic and foreign investment in asset classes that are considered crucial to Australia’s future prosperity.

Aligning Australia with global REITs

198 The existing regime for taxation of Australian REITs is robust, mature and familiar to both the domestic and foreign markets. In our view, only minor modifications to the existing regime (noted above) is recommended. It is not necessary to implement an entirely new REIT regime.

199 If a new REIT regime was desired, practically it could only be based on the US REIT model. The US REIT model permits a REIT to invest in a taxable REIT subsidiary (“TR”) up to 25% of total asset value. This is being reduced to 20% from 2018.

200 In the context of Australian listed REITS (for which the data is publicly available) the ratio of the value held by the passive side of the staple to the corporate side of the staple varies. In the majority of instances, the value allocated to the corporate side of the staple is 20% or less. Accordingly, the US REIT regime would enable the activities performed by these corporate entities to be performed by the Asset Trust without triggering adverse tax outcomes.

201 In our view, this sort of safe harbour could be achieved by our proposed changes described above (broadening the definition of eligible investment business and increasing safe harbours). There is no need for a separate and new regime to tax REITs. This would only create additional uncertainty and complexity, with no obvious incremental benefit.

7 Alternative frameworks – *International comparisons*

202 Treasury has identified that, apart from Singapore and Hong Kong, stapled structures are not used by other developed countries, including as a means to encouraging foreign investment. However, Treasury has not considered the following as part of its review:

- the use of transparent entities (such as limited partnerships) for passively held investments
- the use of designated industry tax concessions or regimes
- the impact of lower corporate income tax rates

203 To make a reasonable comparison between Australia's tax policy and framework for encouraging foreign investment into real property and infrastructure assets, and establishing a level playing field between domestic and foreign capital sources, we submit that any review needs to also consider the above factors.

204 We have identified below a range of transparent entities available in the UK and the US which are used in, among other things, real estate and infrastructure investment. These regimes are designed to provide investors with similar flow through tax treatment afforded to non-residents investing in Australia through stapled structures. The commercial advantages in these jurisdictions are also comparable to Australia's stapled structures, with key motives being cash repatriation, foreign tax credits and financing arrangements, as discussed earlier in this paper.

205 From a tax perspective a critical advantage of transparent entities (even before any specific tax concessions are overlaid) is that non-resident investors may be eligible to access concessional withholding tax rates under the relevant Double Tax Agreement where the character of the return is something other than "business profits" (eg. interest, dividends, royalties).

206 However, the US and UK also offer specific tax concessions over and above the usual withholding tax rates to encourage foreign direct investment into transparent / flow through entities. These concessions are typically aimed at attracting foreign pension funds to invest their capital and include tax-free capital gains. We have touched on their concessions below.

207 In the short consultation period, we have provided high level information only in relation to the alternative frameworks and concession provided by other developed countries. We would be pleased to provide more granular evidence and analysis as part of the detailed Treasury consultation process

Transparent entities

208 We have identified certain transparent entities under the US and UK tax systems below.

United States

209 In the US these generally take the form of limited partnerships, including publicly traded master limited partnerships (MLPs) and REITs. While not necessarily transparent entities, Yieldcos have also emerged in the US to provide access to entities with long term cash flows, tax credits and asset depreciation over the class life of the asset (12 years for renewable energy assets), with a deduction for income taxes paid.

REITs

210 The Consultation Paper has already outlined some of the key characteristics of the US REIT regime. We have outlined some of the additional concessions available to foreign investors in REITs below. We have also enclosed with our submission PwC's "Compare and contrast, Worldwide Real Estate Investment Trust (REIT) Regimes November 2015" which summarises the REIT regimes of the US and other global tax regimes. We trust this will provide useful reference material for Treasury.

Limited partnerships

211 The US has a flow through limited partnership entity whereby the proceeds or returns are taxed in the hands of investors, for real property, securities investment, and other types of passive income. The benefits of a flow through entity, such as a limited partnership, are that investors can be taxed at their applicable tax rate (adjusted for losses or deductions from other investments or activities) and foreign investors specifically may access the benefits of Double Tax Agreements. Consistent with the commercial advantages of Australian trusts (discussed above) it also allows third party lenders to exclude the tax liabilities from the cash flows available to service the entities debt obligations (ie. lenders may not need to consider tax authorities as a creditor to transparent vehicles in a structure).

Master Limited Partnerships or MLPs (energy industry)

212 The flow through tax treatment of MLPs has been typically restricted to the natural resources sector. Under the US Internal Revenue Code MLPs require at least 90% of gross income to be from "qualifying" sources including:

- interest, dividends and capital gains;
- rental income and capital gains from real estate;
- income and capital gains from natural resources activities; and
- income from commodity investments.

213 Updated regulations released in January 2017 have amended the scope of those assets that can be included in the generation of "qualifying" income, in an effort to provide greater flexibility with respect to the consideration of natural resource assets within the MLP regime. "Mineral or natural resource" includes fertilizer, geothermal energy and timber, oil, gas, and oil-and-gas related products. Coal, lignite, potash, salt, aggregates, limestone, sand and many other hard rock minerals also qualify.

Yieldcos (renewable energy industry)

214 More recently, US "Yieldco" structures have also emerged as publicly listed alternatives to the MLP regime. They are designed to provide investor access to developed assets with long term steady cash flows, and Yieldcos have been used primarily to hold renewable infrastructure investments falling outside the existing MLP "natural resources" qualifying income requirements. Yieldco entities exhibit some similarities to MLPs, including that Yieldco structures pay out most of their consistent cash flow to shareholders, which income is generated under stable, long term (renewable energy) contracts.

215 Yieldcos are classified as corporations rather than partnerships and (unlike MLPs) a Yieldco is a taxable entity. Yieldcos are, however, structured to take advantage of current tax incentives - such as those in the renewable energy sector - to mirror the tax profile of MLPs and avoid the double taxation that would otherwise occur at corporate level for the company's earnings, and again when shareholders receive dividends. A Yieldco's underlying assets often hold or generate significant tax credits or operating losses, and those assets can be subject to accelerated depreciation for tax purposes. These effects create what is effectively a "tax shield" for investors when receiving cash distributions. Due to the Yieldco's tax profile, distributions to shareholders can often be characterised as a return of capital rather than a dividend, lowering an investor's cost basis for the investment.

United Kingdom

Limited partnerships

216 The UK has long provided transparent vehicles under the Limited Partnerships Act 1907, with the commercial and flow-through taxation advantages described above for trusts.

Tax transparent funds

217 UK tax transparent funds (**TTFs**) represent a relatively new form of collective investment scheme, which came into effect on 1 July 2013. Their introduction brought the UK into line with other European fund jurisdictions by creating a UK domiciled tax transparent pooling vehicle. TTFs provide the benefits of collectivised investment, alongside tax transparency. TTF features are attractive to many investors seeking to achieve the administrative and scale benefits of pooling, as well as to UCIT funds (undertaking for collective investment in transferable securities scheme) with similar strategies seeking to consolidate management into a single tax transparent master fund.

Designated concessions or regimes

218 There are many instances of tax incentives and concessions provided in different jurisdictions and to particular industries. (The examples provided below are very limited due to the timing available for response, however we would seek to provide more detailed information during a further consultation process):

- Designated tax regimes in comparable jurisdictions, designed to encourage foreign investment, continue to evolve. A recent example is the December 2015 US change to the Foreign Investment in Real Property Tax Act (**FIRPTA**) under the Protecting Americans from Tax Hikes (**PATH**) Act. The PATH Act, in part, modifies the application of FIRPTA, providing an **exemption** for qualified foreign pension funds from the 35% FIRPTA withholding tax regime relating to capital gains on real property investment transactions.

- For US investors there are various tax credit options available for investments in particular asset classes, (notably infrastructure and resources). For example, US renewable infrastructure concessions include project partnerships producing either production or investment tax credits, and allow developers to partner with tax equity investors for long term projects.

- In the UK, TTF taxation concessions include withholding and capital gains tax savings. TTFs allows investors to access the same double taxation treaty benefits that are available from investing directly. The management of a TTF is exempt from VAT, and that exemption may also extend to other related costs of administering the scheme. Transfer of assets into a TTF does not create any additional VAT cost, and should also be tax neutral (both with regard to capital gains tax and stamp duty).

Impact of lower corporate tax rates

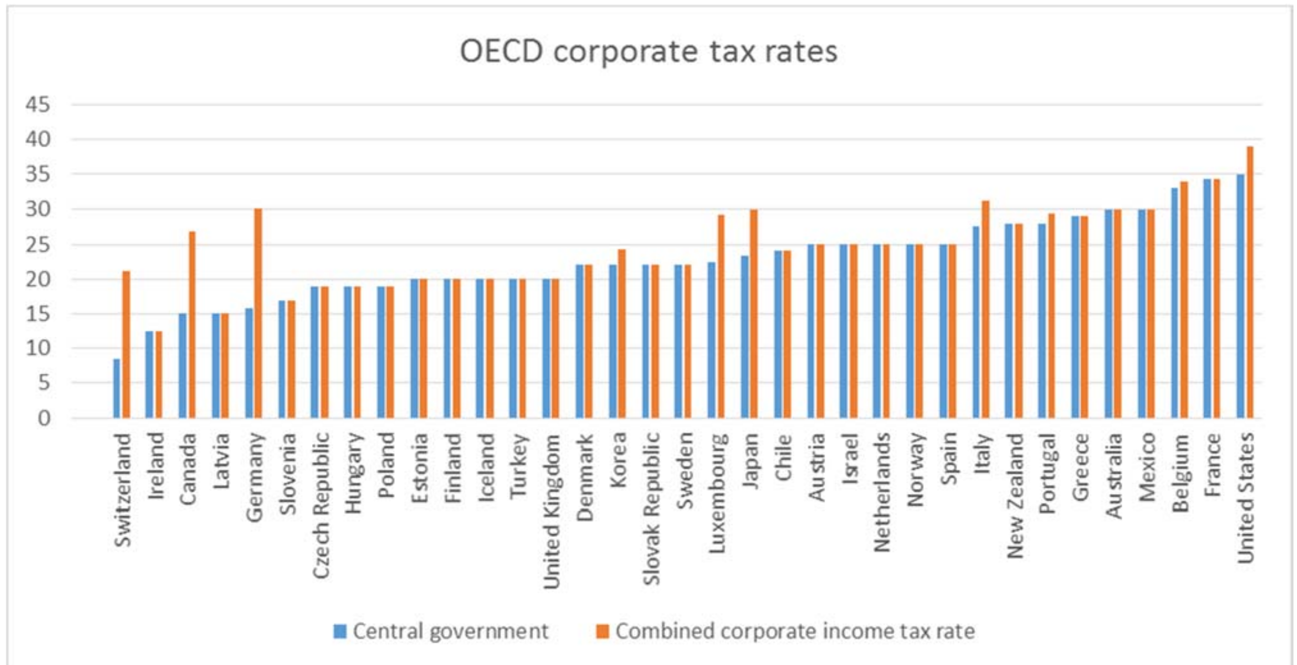
219 There are numerous studies attempting to quantify the impact of corporate tax rates on foreign direct investment. According to the World Bank,

> *"Studies within and across countries suggest that lowering corporate tax rates can increase investment, reduce tax evasion by formal firms, promote the creation of formal firms, and ultimately raise sales and GDP."*

220 Raising revenue, and anti-avoidance measures to prevent aggressive tax planning by multi-national enterprises, are some of the objectives of tax policy. However governments may also seek to attract inward investment.

221 Australia's comparatively high corporate income tax rate by OECD average, means that concessional regimes (such as the MIT regime) to attract mobile foreign capital to make passive investments into Australian real property and Included Infrastructure assets is important to the economic prosperity.

222 The following chart shows Australia's position against the OECD counties:



223 It is further noted that:

- For the year beginning 1 April 2016, the UK's normal rate of corporation tax is 20%, falling to 19% for the year beginning 1 April 2017, and to 17% for the year beginning 1 April 2020.
- Canada, a jurisdiction identified in the Treasury Paper as having dissolved their equivalent to Australia's stapled structure concept, has a central government corporate income tax rate of 15%.
- In the US, the Trump Administration has announced an election policy to lower the company tax rate, in order to encourage investment in Included Infrastructure and improve productivity. While a specific proposal is yet to be tabled, we encourage Treasury to consider alternative frameworks and concessions as part of a holistic consultation process.

8 Response to Treasury questions

No.	Question	Consultation Paper Reference	PwC Submission Reference
1.	How important are the non-tax reasons for using stapled structures? Please explain your view.	Page 6	Paragraphs 36 - 77
2.	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?	Page 6	Paragraphs 18-35, and 60-61
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.	Page 10	Paragraphs 197-219
4.	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.	Page 10	Paragraphs 197-219
5.	How important is tax in determining the international competitiveness of Australia as a foreign investment location for assets and activities typically places in stapled structures	Page 13	Paragraphs 27-35 and 97-108
6.	What would be an appropriate mechanism to remove the tax advantages of stapled structures?	Page 15	Paragraphs 13-17 and 109-131
7.	Are there any international models for removing such advantages that could work in the Australian context?	Page 15	Paragraphs 197-219 and 193-196
8.	What types of structures or arrangements, if any, should be excluded?	Page 15	-
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?	Page 15	Paragraphs 151-196
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?	Page 15	Paragraphs 109-131 and 151-196
11.	If the tax advantages of stapled arrangements are removed, does Australia need specific concessions for critical infrastructure investment?	Page 16	Paragraphs 128-131
12.	If Australia does need such concessions for critical infrastructure investment, what should be the form of those concessions?	Page 16	Paragraphs 128-131

No.	Question	Consultation Paper Reference	PwC Submission Reference
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.	Page 18	Paragraphs 78-90
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?	Page 18	Paragraphs 182-187
15.	Are there any specific sectoral impacts that should be considered?	Page 18	Paragraphs 120-121
16.	Would the impact be different for new and existing investment and entities? If so, how?	Page 18	Paragraphs 34-150
17.	What is the typical term of external third party finance for stapled groups?	Page 19	Paragraphs 44-54
18.	Should pre-existing structures and instruments issued prior to any new taxation laws be grandfathered?	Page 19	Paragraphs 134-150
19.	What is an appropriate transition period and transitional arrangements for existing staples?	Page 19	Paragraphs 138-140
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?	Page 19	Paragraph 139

Appendix A: Section 93L of the Development Allowance Authority Act 1992

Infrastructure facilities 93L DAA 1992

[7 kinds of facility]

(1) There are 7 kinds of infrastructure facility.

[Land transport facility]

(2) One kind of infrastructure facility is a land transport facility, that is to say, a road, tunnel, bridge, or railway line, or a combination of these, in Australia that is to be used for the transport of the public or their goods at a charge to them (whether the transport is by the member of the public concerned or by another person).

[Air transport facility]

(3) Another kind of infrastructure facility is an air transport facility, that is to say, a runway, and any associated taxiway and runway apron, in Australia that is to be used by aircraft transporting the public or their cargo at a charge to them.

[Seaport facility]

(4) Another kind of infrastructure facility is a seaport facility, that is to say, a wharf, or dock, in Australia for the public to embark or disembark, or for loading or unloading their cargo, onto or from seagoing vessels, where there is a charge to the public for the transport of the public or their cargo on the vessels.

[Electricity generation, transmission or distribution facility]

(5) Another kind of infrastructure facility is an electricity generation, transmission or distribution facility, that is to say, any one, or combination of 2 or more, of the following facilities:

(a) an electricity generation facility on land in Australia;

(b) an electricity transmission facility, where the electricity generation facility concerned is on land in Australia;

(c) an electricity distribution facility on land in Australia;

where the electricity generated, transmitted or distributed is to be principally for sale to the public either directly by the operator of the facility or indirectly through other persons.

[Gas pipeline facility]

(6) Another kind of infrastructure facility is a gas pipeline facility, that is to say, the whole or part of a pipeline that is to be used for transporting gas from a processing plant on land in Australia principally for sale to the public either directly by the operator of the facility or indirectly through other persons.

[Water supply facility]

(7) Another kind of infrastructure facility is a water supply facility, that is to say, any one, or combination of 2 or more, of the following:

(a) dams, weirs, reservoirs or tanks that are to be used for storing, and regulating the flow of, water for public consumption, or other use by the public, at a charge to them;

(b) bores that are to be used for extracting water for public consumption, or other use by the public, at a charge to them;

(c) channels or pipelines that are to be used:

(i) for supplying water for public consumption, or other use by the public, at a charge to them; or

(ii) for carrying water between dams or other storage places from which it is to be supplied through channels or pipelines for public consumption, or other use by the public, at a charge to them;

(d) pumps and associated structures that are to be used:

(i) in extracting water from bores covered by paragraph (b); or

(ii) for pumping water along channels or pipelines covered by paragraph (c);

(e) equipment and structures that are to be used for treating water that is to be supplied to the public through pipelines at a charge to them, to make it fit for the public to drink.

[Sewage or wastewater facility]

(8) Another kind of infrastructure facility is a sewage or wastewater facility, that is to say:

(a) equipment, excavations and structures that are to be used for treating, at a charge to the public, sewage, or other wastes in water, produced by the public:

(i) to reduce the damage caused by its disposal in the natural environment; or

(ii) to make any component of the things treated suitable for re-use; or

(b) channels, drains or pipelines for carrying sewage, or other wastes in water, produced by the public to or from the equipment and structures covered by paragraph (a); or

(c) both of these.

Appendix B: UK Corporate Interest Restriction in the Finance Bill 2017

In section 429 of the *UK Corporate Interest Restriction in the Finance Bill 2017*, infrastructure is defined to include:

- water, electricity, gas, telecommunications or sewerage facilities
- railway facilities [including rolling stock], roads or other transport facilities
- health or educational facilities
- training facilities for any of the armed forces or any police force
- court or prison facilities; and
- waste processing facilities

Appendix C: Simplified and redacted examples of tax review event clauses

Example 1

Tax Review Event

1. A “**Tax Event**” will occur (whether or not the relevant event is in the control of any Obligor) if any of:

    1. FinCo;

    2. Prop Co as trustee for Prop Trust; or

    3. Op Co as trustee for Op Trust;

receives a tax ruling or assessment applying, or otherwise becomes subject to the application of the thin capitalisation rules in Division 820 of the *ITAA 1997*; or

any of:

1. Prop Co as trustee for Prop Trust; or

2. Op Co as trustee for Op Trust; or

Receives a tax ruling or assessment applying, or otherwise becomes subject to the application of Division 6C of the *ITAA 1936*.

b) Following a Tax Event, the Base Case Model will be updated to take into account the effect of the Tax Event and FinCo must deliver that Updated Base Case Model to the Agent within 30 days of the Tax Event in accordance with clause 21.7(a) (*Base Case Model).* If, as a direct result of the Tax Event, the Updated Base Case Model forecasts the minimum ICR calculated for the seven year period beginning on the date the Updated Base Case Model is agreed in accordance with clause 21.7 (*Base Case Model*)(the “**Model Update Date”**) is less than 1.[xx]:1.00, that Tax Event will become a “**Tax Review Event**” on and from the Model Update Date.

c) If a Tax Review Event continues following:

1. The Obligers exhausting all their applicable rights of review or appeal against the tax ruling or assessment which triggered the Tax Event (a “**Tax Appeal**”);

2. The expiry of any prescribed period within which an application for any such Tax Appeal can be made;

3. The waiver by the Obligors of their rights to launch a Tax appeal; or

4. Notification by FinCo to the Agent that the Obligors will not be pursuing a Tax appeal in respect of the Tax Event, (the “**Tax Appeal End Date**”),

Then the Lenders will have the right to review the Facilities for a period of 60 days from the Tax Appeal End Date (the "**Tax Review Period**") in order to determine whether they should continue to participate in this Agreement and the other SFA Finance Documents. If a Tax appeal results in the Tax Event ceasing to subsist (a "**Successful Appeal**") then there will be no Tax Review Event in respect of that Tax Event, or, if a Tax Review Event already subsists in respect of that Tax Event, then the Tax Review Event will end on the date the Successful Appeal is confirmed (a "**Successful Appeal Date**").

d) If following a Calculation Date after the Model Update Date and during the Tax Review Period or while a Tax Appeal is on foot FinCo believes there may be an improvement in the forecast minimum ICR then it may deliver another Updated Base Case Model (updated to take into account the effect of the Tax Event) and if that Updated Base Case Model forecasts the minimum ICR calculated for the seven year period beginning on the date this further Updated Base Case Model is agreed in accordance with clause 21.7 (*Base Case Model)*(the "**Further Model Update Date**") is equal to or greater than 1.[xx]:1.00 the subsisting Tax Review Event will end on that Further Model Update Date (the "**Model Update End Date**").

e) If, during any Tax Review Period, a Lender notifies FinCo or the Agent of its refusal to consent to the Tax Review Event (a "**Tax Review Non-Consenting Lender**"), FinCo shall be entitled (but not obliged) to on five Business Days' prior to written notice to the Agent and the Tax Review Non-Consenting Lender, require the transfer (at par) of the participation of that Tax Review Non-Consenting Lender in the SFA Facility Agreement and the other SFA Finance Documents to another bank or financial institution selected by FinCo and willing to take such transfer, where such transfer is in accordance with, and subject to, clause 25.7 (*Replacement of Lenders*).

f) Upon the expiry of the Tax Review Period, and following the exercise by FinCo of its rights in accordance with paragagph € above, the Agent shall (if the Majority Lenders direct) do one or both of the following by notice to FinCo within five Business Days of the end of the Tax Review Period:

   1. Cancel all or part of the Total Commitments; and

   2. Declare that all amounts outstanding under the Facilities are due and payable, and FinCo shall pay such amounts to the Agent in full on the date specified in the notice, which must be a date falling no earlier than the date falling 90 days from the date of such notice.

g) On the sixth Business Day after the end of the Tax Review Period, if the Agent has not notified FinCo that the Majority Lenders wish to take any action under paragraph (f)(i) or (f)(ii) then the Tax Review Event will end on that date (the "**Tax Review Event End Date**").

h) A "**Tax Lock Up Event**" will subsist from the date of a Tax Event until the earlier of:

   1. A Model Update on which the Updated Base Case Model shows the minimum ICR for the seven year period beginning on the Model Update Date is equal to or greater than [xx]:1.00 (and therefore no Tax Review Event subsists);

   2. A Successful Appeal Date;

   3. A Model Update End Date; and

   4. The Tax Review Event End Date

Example 2 – sample clause since the release of TA 2017/1 and the Treasury Consultation Paper

Tax Review Event – notification

- Subject to paragraph (b) below, a Tax Review Event will occur if any Obligor becomes liable (now or at any time in the future) to pay any income tax (or interest thereon or related penalties) in circumstances that are not provided for in the Base Case Financial Model (in the form provided as a condition precedent to the relevant Financial Close), including if this occurs due to the Obligor becoming a "public trading trust" for the purposes of Division 6C of Part III of the Tax Act.

- Despite paragraph (a) above, no "Tax Review Event" will occur if:

  - A circumstance described in paragraph (a) above arises solely as a result of a Change in Law, provided that, for the purposes of this clause 15.2, a Change in Law will not include:

    - a change in law; or

    - a change in the interpretation, application or administration of a law,

    to address the circumstances expressly contemplated or foreshadowed in tax alert 2017/1 issued by the Australian Taxation Office or the Stapled Structures Consultation Paper (March 2017) issued by the Australian Government on 24 March 2017; or

  - the relevant Obligor:

    - has notified the CTD Agent of its intention to challenge an assessment or amended assessment in a manner contemplated by section 31 of the *TGaxation Administration Act 1953 (Cth)*;

    - has provided an opinion from a reputable Australian law firm or tax adviser in form and substance satisfactory to the Majority Creditors confirming that the proceedings being undertaken by the Obligor are not frivolous or vexatious; and

    - at all times following such a notice, the relevant Obligor is in good faith contesting its liability to pay such income tax (or interest thereon or related penalties),

    and provided further that, notwithstanding anything else in this deed, no Obligor is permitted to make any Distribution at any time when a Tax Review Event would be continuing but for the operation of this paragraph (b)(ii).

  - If any Obligor becomes aware of any circumstances that could reasonably be considered to give rise to a Tax Review Event occurring or suggest that a Tax Review Event is likely to occur, including receiving a Tax assessment or written notification from a Government Agency responsible for Tax that could reasonably give rise to a Tax Review Event, the Obligor must, as soon as reasonably practicable after becoming aware of these circumstances, notify the CT Agent.

Tax Revew Event – consequence

(a) If a Tax Review Event occurs, the Borrowers must promptly, and in any event no later than 30 days following the occurrence of the Tax Review Event update the Base Case Financial Model to reflect the updated forecast tax payable as a consequence of the Tax Review Event (but not revise the Base Case Financial Model otherwise (unless the CTD Agent acting on the instructions of all Financiers) and each Borrower agree))(The "**Revised Financial Model (Tax Review Event)**") and provide such updated Base Case Financial Model to the CTD Agent.

(b) No later than 15 days following receipt by the CTD Agent of the Revised Financial Model (Tax Review Event), but subject to the application of clause 24 ("Revising the Base Case Financial Model") and clause 25(Reference to Calculation Expert") the CTD Agent will:

a. In consultation with the Borrowers, calculate each Debt Sizing Amount on the basis of the Revised Financial Model (Tax Review Event); and

b. Deliver to the Borrower a revised Term Facility Repayment Schedule (B1), a revised Term Facility Repayment Schedule (B2) and a revised Minimum Amortisation Reserve Schedule (if applicable) based on the Revised Financial Model (Tax Review Event).

If, on the date on which each Debt Sizing Amount is calculated under clause 15.3(b)(i) ("Review Event Notice"), the total Commitments under the Construction Facility or Term Facility (as applicable and whether drawn or undrawn at the time) exceed the relevant updated Debt Sizing Amount calculated under clause 15.3(b)(i) ("Review Event Notice") (such amount, the "**Excess**"), then each Borrower must apply an amount equal to 100% of all Distributable Cash as a mandatory prepayment of the Principal Outstanding under the Construction Facility or Term Facility (as applicable) on each subsequent interest payment date for so long as is required to ensure that an amount (in aggregate) equal to the Excess has been so prepaid.

www.pwc.com.au

© 2017 PricewaterhouseCoopers. All rights reserved.
PwC refers to the Australian member firm, and may sometimes refer to the PwC network.
Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

At PwC Australia our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 223,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.au

Liability limited by a scheme approved under Professional Standards Legislation.

WLT 127048598