KPMG

Stapled Structures

Reforms to the Managed Investment Trust Regime

September 2018

The Government has introduced to Parliament the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 (the Bill).

The Bill has been released following an extensive consultation process and implements the stapled structures integrity package that was announced in March 2018 to address perceived risks to the tax base and limit access to tax concessions available to certain foreign investors.

As signposted by the Bill's provocative title, these measures will have a far-reaching impact on foreign investment into the real estate, residential property, infrastructure and agriculture sectors. In introducing the Bill, the Government released a media statement that surmises its purpose as to:

> *"crack down on foreign investors using complex arrangements known as stapled structures and accessing broader tax concessions on income from Australian investments so it is taxed at very low tax rates and, in some cases, almost tax-free.*
>
> *Foreign investors include foreign sovereign wealth funds and pension funds as well as those who invest in Australian agriculture and residential property. The measure will see hundreds of millions of dollars of revenue being kept in Australia. Left as is, the amount of revenue being foregone could grow to billions of dollars."*

These are fundamental changes that will significantly limit, or outright remove, many of the existing concessions that have underpinned foreign investment into these sectors. In particular, the scope of the Managed Investment Trust (MIT) regime, and its concessional 15 percent withholding tax rate, has been severely restricted.

An overview of the outcomes of a typical MIT structure under the existing legislation is set out at Appendix 1.

Over the following pages we have summarised the key sectors and stakeholders that will be most impacted by these changes, along with some observations of unresolved issues and ongoing considerations.

Key sector impacts

Infrastructure investments

New projects

Income derived by a MIT from a new infrastructure investment will be 'non-concessional MIT income' and taxed at the 30 percent corporate rate, unless it arises in the following limited situations where the 15 percent rate can still be accessed:

- income from an approved economic infrastructure facility – such facilities must be designated by the Treasurer as new, nationally significant infrastructure requiring capital expenditure of more than $500 million. These projects will be eligible for the 15 percent rate for a 15 year period; or
- rent from third party arrangements – where it can be shown that the stapled group is deriving rental income from third party customers (for example, under certain datacenter operating models), the 15 percent rate will be available indefinitely.

These measures substantially reduce the range of projects that qualify for MIT treatment in the future, with the availability of the concessions generally limited to nationally critical greenfield infrastructure developments. Along with this significant limitation on the availability of the 15 percent MIT rate, the Bill also contains two integrity measures that must be satisfied by otherwise eligible projects:

- for new economic infrastructure projects, a 'cross-staple rent cap" which broadly prevents more than 80 percent of the project's income being on-paid as cross-staple rent and
- a non-arm's length income rule, which applies to all projects and requires that cross-staple arrangements are at arm's length terms.

Applying this second integrity measure will continue to be challenging in practice, and guidance will be needed from the ATO to help taxpayers determine an appropriate methodology to set an arm's length rent, particularly where there is a lack of third party comparable data.

Existing projects

Owners of eligible existing infrastructure projects held at 27 March 2018 can elect to continue accessing the 15 percent MIT withholding rate for a transitional period. This election must be made to the Commissioner in writing before 30 June 2019, and will provide:

- a even year transitional period for non-economic infrastructure assets, preserving concessions until 1 July 2026. This is expected to cover many social infrastructure assets including Public Private Partnerships (PPP); or
- a 15 year transitional period for eligible economic infrastructure assets, preserving the concessions until 1 July 2034. This is anticipated to include most of the recently privatized assets such as ports and toll roads, along with energy infrastructure such as renewables developments.

In both cases availability of the 15% rate will be dependent on the cross-staple arrangement satisfying the arm's length income rule described above or demonstrating that the rent has been determined using an objective methodology that was in place at 27 March 2018. Guidance will be needed to assist taxpayers in assessing, and evidencing, an 'objective methodology'.

Whilst the Bill provides taxpayers with comfort that the Part IVA general anti-avoidance provisions should not apply during the transitional period to projects that have made a transitional election, there is still significant uncertainty outside of that period or for projects that do not elect.

Detailed additional guidance from the ATO will be required to provide taxpayers with certainty as to how the law will be administered in practice, particularly with respect to application of the non-arm's length income rule to the pricing of cross-staple arrangements in historic periods, along with their approach in future years once the transitional period has concluded.

Real Estate

Most importantly there has been no change to the current tax treatment of traditional real estate investments which can continue to access the 15 percent MIT withholding rate.

The new provisions do however significantly limit the availability of this rate outside of these traditional asset classes, with particularly significant impacts for the social and residential real estate sectors. In those sectors, income and capital gains derived by a MIT relating to residential premises will become non-concessional MIT income and taxed at 30 percent unless they relate to:

- affordable housing – which is limited to properties held for long-term rental and managed by an eligible community housing provider; or
- commercial residential housing – including hotels, boarding houses, serviced apartments and certain remote accommodation.

The final Bill makes explicit that student accommodation projects will not be eligible for MIT concessions, and whilst the carve-out for affordable housing does create a pathway for build-to-rent style developments to qualify, substantial challenges to the viability of that model remain. In particular, the non-affordable component of a mixed development will still be taxed at 30 percent, as will capital gains relating to an affordable housing asset unless the property has been held for rent for at least 10 years.

Similarly to infrastructure assets, transitional relief is available, and income arising before 1 October 2027 will remain eligible for MIT concessions if:

1. for student accommodation assets, the asset was held before 20 September 2018;
2. for all other residential dwellings, the asset was held before 4.30pm on 14 September 2017.

Access to transitional relief requires a commitment to acquire or create a dwelling on the land, not just entering a contract or holding the land. The later transition date for student accommodation assets appears to acknowledge that the loss of MIT treatment for that sector had not been previously announced.

The Bill did not make any amendments to the Division 6C trading trust provisions, ensuring that these assets are still capable of being held within a trust without triggering the trading trust provisions. However, in the context of any residential property investment a threshold question will continue to be whether the proposed activities involve holding land predominantly for the purpose of deriving rent or to derive development profits.

Agricultural investments

Income or capital gains derived by a MIT from 'Australian agricultural land for rent' (whether directly or indirectly) will become non-concessional MIT income and taxed at the 30 percent corporate rate. 'Australian agricultural land for rent' is a new, and very broadly defined term that includes any Australian real property that is used, or could be used, for carrying on a primary production business and is held primarily for the purpose of deriving rent. This broad definition, and in particular when a piece of land 'stops' being agricultural, will also be a key consideration for the tax consequences of real estate and infrastructure projects.

As noted above, the Bill did not change the definition of eligible investment business for the purposes of the trading trust provisions to exclude investments into agricultural land. This should enable agricultural land to continue being held within trust structures, which was a key concern for many domestic stakeholders.

A seven year transitional period applies for assets held at 27 March 2018, enabling access to the 15 percent rate for income earned prior to 1 July 2026.

Sovereign and Foreign Pension Fund investors

The availability of sovereign immunity and the interest and dividend withholding exemptions for foreign pension funds has been significantly restricted, removing the exemption where the investor has an interest above 10 percent in an entity or 'sufficient influence' over its activities.

For sovereigns, these tests will be applied on a 'sovereign entity group' basis, where interests held by a sovereign entity will be aggregated with those held by other sovereign entities at the same level of government - e.g. a federal sovereign will aggregate

with interests held by other federal bodies, but not with interests held by a provincial body. This aggregation requirement is likely to create practical challenges for sovereigns, particularly in situations where investors from the same country are operating under independent mandates without real-time public disclosure of all underlying investments.

For sovereign investments that will not be eligible for the exemption in the future, transitional relief will be available for assets held on 27 March 2018 that were the subject of a private binding ruling.

Transitional relief will be available until the later of:

– 1 July 2026; or

– the end date of the private ruling.

Foreign pension funds will be entitled to a seven year transitional period for impacted investments held on 27 March 2018, with the concessions continuing to be available for income derived prior to 1 July 2026. Where investments may otherwise fall due for refinance during this period, funds will need to carefully consider the benefits of doing this as against the tax concessions that may be foregone on the old instrument. As a final point, the Bill does helpfully confirm that a foreign pension fund can qualify for the broader sovereign concession (subject to satisfying the other qualification criteria).

What will it mean going forward?

Investors in impacted investments and sectors will be looking to the ATO to provide guidance on the issues noted above. However, a more fundamental question is how these measures may impact future investments and activity in these sectors:

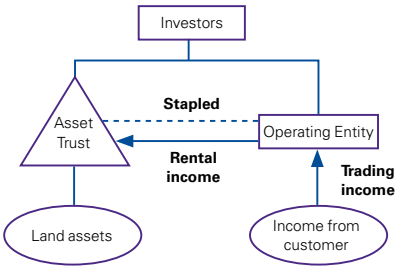
1. Traditional stapled REIT investments can continue to use stapled structures. Such REITs have a mixture of investment property assets and unrelated real estate businesses and the flow on impact of these measures is expected to be more limited.
2. Whilst new economically significant greenfield infrastructure projects are able to benefit from the 15% MIT withholding tax rate for a period of 15 years, the benefit of the lower tax rate is reduced given the expectation that these projects will have tax losses for an initial period due to the significant up-front capital investment required. Thus, the relative cost/benefit of investing into infrastructure via a stapled structure may change.
3. The manner in which the Federal and State Governments initiate new infrastructure projects may well change. To maximize availability of the MIT concessions, projects identified for eventual private sector investment may be offered to the private sector on commencement, rather than after an initial investment by Government.
4. These changes may impact the appetite of Governments to privatise existing infrastructure assets, particularly if buyer demand and anticipated sale prices are diminished as a consequence of these changes.
5. To what extent will investors in projects that qualify for transitional relief look to realise their investments prior to the end of the relevant transitional period? Clearly, the attractiveness of these investments for certain investor groups will diminish once the transitional period ends.
6. In the meantime, how quickly may these changes start to impact asset values for investments in impacted sectors?
7. Funds investing on behalf of foreign investors will require greater detail on the composition of fund payments including any non-concessional MIT income components. This will likely place additional on all trustees, even if their fund is not established as a MIT or does not ostensibly hold investments that would give rise to non-concessional MIT income.

Next steps

The Bill has been referred to the Senate Economics Committee for review, but is expected to be reintroduced to Parliament and passed this calendar year. The ATO has also commenced briefing stakeholders on their proposed approach to administering the new law, and detailed public guidance is expected in the coming months. KPMG will be hosting the ATO in our Sydney and Melbourne offices over the coming weeks, and any clients interested in attending should contact their KPMG contact below.

Appendix – Stapled structure

Stapled structures – An overview



- A typical 'rental' stapled structure is shown in the diagram above.
- The Asset Trust is established to hold land assets and to qualify for the concessional MIT withholding rate of 15 percent.
- The Operating Identity is established to conduct the business activities such as entering into third party customer contracts, be the employer entity and take the operational risk.
- The same investors own Asset Trust and Operating Entity.
- The Asset Trust will lease land to Operating Entity to be used in its business to derive active business income.
- This allows the Asset Trust to continue to be eligible for the MIT regime and in some cases continue to be a flow through vehicle.
- The ATO raised concerns over such arrangements in Taxpayer Alert 2017/1 as it considered some taxpayers were artificially fragmenting a single business into two and thereby allowing active businesses to inappropriately access the MIT regime.
- Following the release of the Taxpayer Alert, Treasury commenced its consultation process on stapled structures culminating in the release of the policy measures package discussed in this brief.

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