JULY 2018

TECHNICAL UPDATE

AUSTRALIAN TAX REFORMS IMPACT FOREIGN INVESTORS AND STAPLED GROUPS

THE FEDERAL TREASURER HAS RELEASED A PROPOSALS PAPER ON 28 JUNE 2018 OUTLINING THE CONDITIONS STAPLED ENTITIES MUST COMPLY WITH TO ACCESS THE INFRASTRUCTURE CONCESSION AND/OR TRANSITIONAL ARRANGEMENTS IN THE DRAFT LAW RELEASED EARLIER THIS YEAR. THE DRAFT LAW SEEKS TO ADDRESS INTEGRITY RISKS POSED BY STAPLED STRUCTURES AND ALSO LIMITS CONCESSIONS AVAILABLE TO FOREIGN PENSION FUNDS AND SOVEREIGN WEALTH INVESTORS IN NON-PORTFOLIO INVESTMENTS. THERE ARE ALSO MEASURE TO COUNTER DOUBLE GEARING IN THIN CAPITALISATION CALCULATIONS.

These proposed changes are included in exposure draft legislation (draft legislation) that was released on 17 May 2018. These changes where previously announced in a Policy Measures Package that was released on 27 March 2018. This Policy Measures Package included restrictions on non-residents investing in agricultural Managed Investment Trusts (MITs), however, the draft legislation does not include these measures but it expected they will also be released in due course.

TAXATION OF STAPLED STRUCTURES

Stapled trust groups with cross staple arrangements have been subject to scrutiny since the Australian Taxation Office ('ATO') released Taxpayer Alert TA 2017/1 on 31 January 2017 outlining their concerns regarding arrangements which attempt to fragment integrated trading businesses in order to re-characterise trading income into more favourably taxed passive income (usually rent) for non-resident investors (see diagram below). Stapled arrangements are broadly where the same investors hold 80 per cent common ownership in two or more entities irrespective of whether the ownership interests in these entities are bound together by a formal legal arrangement.

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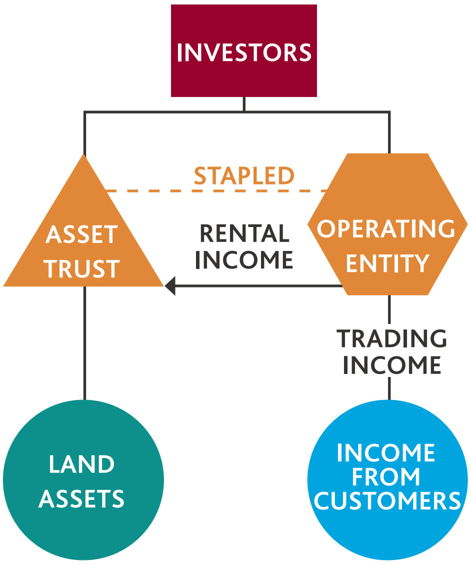
To minimise the impact of these changes on existing investments, the proposed amendments include transitional arrangements of seven years (for ordinary business staples) and 15 years (for economic infrastructure assets). The draft legislation does not include all the conditions that stapled entities must comply with in order to access the infrastructure concession and/or transitional arrangements which will be released in due course. However, on 28 June 2018 the Government released a proposal paper (June 2018 proposals paper) outlining the proposed integrity rules stapled entities must comply with to access the infrastructure concession and/or transitional arrangements.

TYPICAL RENTAL STAPLED STRUCTURE

Asset Trust is established to hold land assets to qualify for the concessional MIT withholding rate of 15%

Asset Trust leases land to the Operating Entity and is eligible for the MIT regime and to be a flow through vehicle



STAPLED STRUCTURES INVOLVING MANAGED INVESTMENT TRUSTS

Fund payments made from 1 July 2019 by a MIT to a foreign investor will be subject to MIT withholding tax at the top corporate tax rate (currently 30 per cent) instead of the 15 per cent MIT rate, to the extent they are attributable to non-concessional MIT income. Non-concessional MIT income is broadly income that is either an amount from certain cross staple arrangements (e.g. assessable income derived by MIT asset entity from a business operating entity in a stapled arrangement) or a distribution from an entity that carries on or controls a trading business.

There are exceptions including:

- Amounts attributable to a cross staple arrangement which are attributable to third party rent (i.e. not a stapled entity in the arrangement)
- A 5% of assessable income de minimis exception
- The 15 year 'approved economic infrastructure asset' exception (approved by the Federal Treasurer).

There are also transitional rules that delay the operation of these rules where:

- The stapled structure was in relation to the acquisition or creation of assets that was approved and publicly announced by an Australia Government agency and significant preparatory steps had been taken before 27 March 2018
- An entity entered into a contract before 27 March 2018 in relation to a stapled structure arrangement.

In these situations, the transitional rules will result in MIT fund payments being taxed at the current 15% for 7 or 15 years.

For non-economic infrastructure assets, the 7 year transitional rule will delay the new rules from applying until the later of 1 July 2026 or 7 years from day in which the asset is first used to generate assessable income, but not after 30 June 2031.

The June 2018 proposals paper indicates that the existing Non-Arm's Length Income Rule (NALIR) that applies to MITs is sufficient for staples eligible to access the 7 year transitional period, and does not propose additional integrity requirements. The NALIR requires a MIT receiving non-arm's length rent to pay 30% withholding tax on distributions to the extent the rent received exceeds the arm's length rent amount. The June 2018 proposals paper indicates that non-economic infrastructure staples, such as property and agriculture, would be able to identify the comparable Australian market pricing for the cross staple lease of their assets.

The 15 year transitional rule applies for economic infrastructure assets to delay the new measures until the later of 1 July 2034 or 15 years from when the asset is first used to generate assessable income, but not after 30 June 2039. However, the June 2018 proposals paper indicates that the NALIR is not a sufficient integrity measure for these staples because in many cases it would be difficult to identify an arm's length rent amount. Therefore, it is proposed to impose a rental cap summarised as follows:

- Where a lease agreement was in place by 27 March 2018 and a methodology for calculating rent under that lease (for example a percentage of the regulated asset base for regulated infrastructure) can be evidenced – the rental cap is based on that methodology
- Where a lease agreement was in place and no methodology can be evidenced – the rental cap is fixed at the pre-27 March 2018 rent uplifted annually for CPI
- Where no lease agreement was in place – the rental cap is determined as the amount necessary to ensure that no more than 80% of the combined taxable income (or tax loss) of the stapled entities for the year (ignoring carried forward losses) arises on the asset side.

AMENDMENTS TO THIN CAPITALISATION RULES TO PREVENT DOUBLE GEARING

The draft legislation includes two measures from 1 July 2018 to target those structures that use "double gearing" in order to:

- Gear a structure in excess of what was intended under the thin capitalisation regime
- Access the lower 10% withholding rate for interest payments
- Decrease the overall effective tax rate.

This double gearing is currently possible where there are trusts or partnerships in a group that are less than 50% owned by the group, in which case the debt in those entities is not taken into account for the group's thin capitalisation calculations. To counter this, the exposure draft proposes there will be a reduction in the threshold at which a trust or partnership becomes an associate entity from ownership of 50% to 10% or more for the purposes of applying the thin capitalisation rules.

Secondly, there are amendments to clarify that for the purposes of determining the arm's length debt amount, the debt to equity ratios of any entities in which the entity has a direct or indirect interest is a factor that must be taken into account but only to the extent that would be a relevant consideration to both a prudent independent borrower and prudent and independent lender i.e. only to the extent it would be customary in third party lending due diligence assessments.

FOREIGN PENSION FUNDS WITH NON-PORTFOLIO INVESTMENTS WILL BE SUBJECT TO WITHHOLDING TAX

The draft legislation proposes from 1 July 2019 to limit the withholding tax exemption to foreign pension funds with portfolio-like interests, being those interests in entities that are less than 10% ownership interests and do not carry an ability to influence the entity's decision making. A superannuation fund for foreign residents will be liable to pay withholding tax on payments of interest, dividends or non-share dividends from an entity unless the foreign superannuation fund has a portfolio like interest in the entity making the payment and does not exert relevant influence over the entity.

There is a seven-year transitional rule for investment assets held by a pension fund for foreign residents on or before 27 March 2018 and payments of interest, dividends or non-share dividends made from such investment assets on or after 1 July 2026.

LEGISLATING THE TAX EXEMPTION FOR FOREIGN GOVERNMENTS INCLUDING SOVEREIGN WEALTH FUNDS

The proposed amendments enshrine in legislation the current sovereign immunity tax exemption, which is currently based on the International Law doctrine of 'sovereign immunity'. However, the legislative approach will limit the sovereign immunity exemption to income and gains from portfolio-like interests of less than 10% and only where the sovereign investor cannot influence key decision-making of the portfolio entity i.e. where the interests in the entity confers rights to vote at a meeting of its Board of Directors, participate in key decisions or deal with the assets of the second entity.

A sovereign entity will not be liable to tax on amounts paid by another entity if:

- The sovereign entity has a portfolio like interest in the entity making the payment
- The interest in the paying entity was not acquired in the course of carrying on a business activity
- The sovereign entity does not exert relevant influence over the entity.

These new rules will apply from 1 July 2019, however, investments in existence at 27 March 2018 will have access to a seven-year transitional period.

CONSIDERATIONS FOR INFRASTRUCTURE AND REAL ESTATE INVESTORS

Although the transitional rules for existing arrangements may mean there is no immediate need for most foreign investors to revisit existing structures, many could suffer negative impacts on their investment values. The changes to the foreign pension fund and sovereign immunity exemptions are likely to impact rates of return, which may mean that certain foreign investors will sell down their investments during the transitional period.

For these investors, the exit timeline and strategy may need to be considered in the coming months. Additionally, all proposed new investments will need to factor in the new rules when it comes to assessing the financial impact for investors.

However, Australian resident MIT investors have traditionally found it difficult to be competitive against foreign investors with access to the 15% MIT tax rate. The removal of this advantage may result in new Australian resident entrants into the Australian property market and counterbalance downward pressure on prices due to the increased tax burden faced by non-resident MIT investors. Foreign investors in new investments (other than in nationally significant infrastructure) will find competing with domestic Australian institutional investors more challenging. Traditional stapled real estate investment trusts in the commercial and retail property sectors with little to no cross-staple lease arrangements should not be too impacted by the changes although other real estate stapled structures with cross-staple leases (i.e. hotel structures) which are not generally a single unified business may still be impacted.

BDO COMMENT

BDO can assist with:

- Reviewing the current status of ongoing and planned projects - current investments will need to revisit existing structures to determine the impact of the changes on after tax returns and proposed new investments should factor in the new changes when assessing the financial and commercial impact for investors
- Planning for the changes proposed to be made to the thin capitalisation rules which apply as early as 1 July 2018 and considering the implications of the proposed changes on the cost of funding as soon as possible
- Assisting funds (or existing funds that still anticipate the incorporation of entities) with considering their use of MITs and stapled structures as MITs will still likely be the fund vehicle of choice, as funds should generally not be worse off than other vehicle choices
- Reviewing investor lists to determine if any pension or sovereign funds will be affected – the current practice is for sovereign funds to request rulings from the ATO but with the proposed codification the need for this process may no longer be required
- Interpreting any ATO guidance addressing the control issues, which plague the funds management industry, including in private equity and venture capital, that are not adequately dealt with in the draft legislation.

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