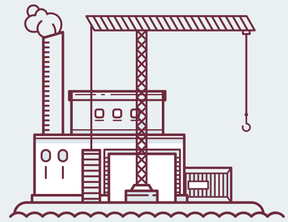
The application of Pt IVA to stapled structures



by Greg Davies, QC, Chancery Chambers, and Eugene Wheelahan, Barrister, Aickin Chambers

Abstract: The ATO released TA 2017/1 on the re-characterisation of income from trading businesses in 2017. This article examines some of the issues raised in TA 2017/1, and whether Pt IVA of the *Income Tax Assessment Act 1936* (Cth) might apply to arrangements which are said by the Commissioner to involve an artificial fragmentation of an integrated trading business in order to re-characterise trading income into more favourably taxed passive income. This article will also examine recent moves by the Commissioner to apply Pt IVA to upstream investment structures that utilise a mix of debt and equity. The authors conclude that, while the application of Pt IVA will always depend on the particular facts and circumstances of a given case, the mere fact that an infrastructure investment is acquired and held within a stapled structure will be insufficient to attract the operation of Pt IVA.

Introduction

In TA 2017/1, the Australian Taxation Office (ATO) states that it is reviewing arrangements which "attempt to fragment integrated trading businesses in order to re-characterise trading income into more favourably taxed passive income".[1] The alert identifies various provisions of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and the *Income Tax Assessment Act 1936* (Cth) (ITAA36) that may or may not be satisfied in respect of four different types of staple arrangements. The ATO states that, even if such arrangements are effective under the "substantive" provisions, it is concerned the arrangements are being entered into or carried out for the dominant purpose of obtaining a tax benefit so as to attract the operation of Pt IVA ITAA36.

This article examines whether, and if so how, Pt IVA might apply to the entering into and carrying out of a scheme under which an infrastructure investment is acquired and held within a stapled structure. In the authors' opinion, while the application of Pt IVA will always depend on the particular facts and circumstances of a given case, the mere fact that an infrastructure investment is acquired and held within a stapled structure will be insufficient to attract the operation of Pt IVA.

The Commissioner's rationale for the potential application of Pt IVA is that the stapled structure has the effect of fragmenting an "integrated trading business" and does so for the purpose of re-characterising trading income into more favourably taxed passive income.[1] In the absence of exceptional circumstances, that is an incorrect characterisation of the stapled product. Moreover, the application of Pt IVA itself is dependent on the application of the eight matters in s 177D(2) ITAA36 and not on notions of economic equivalence.

Staple arrangements

A staple arrangement is where two or more security interests are issued (by one or more entities) that cannot be traded separately. The restraint on the separate trading of the securities is usually enshrined in the articles and/or constitution of the issuing entity and is sometimes also formalised in a subscription agreement or separate "stapling deed".

The first staple arrangement to appear on the Australian Securities Exchange (ASX) was the creation of an Australian real estate investment trust (A-REIT) by the Stockland Group in 1988.[2] A further A-REIT using stapled securities was listed in 1994.[3] In 1996, the stapled structure was first issued for infrastructure assets. In that year, stapled securities were issued by both Transurban and Macquarie Infrastructure. Envestra followed in 1997 and, in 1997, Mirvac listed another stapled A-REIT.[2]

In 1998, changes to the regulation of investments structures introduced by the *Managed Investments Act 1998* (Cth) prompted a sharp increase in the use of stapled structures for both A-REITs and infrastructure funds. This was exacerbated by a marked increase in privatisation activities involving the sale by state governments of a range of infrastructure assets, including ports and electricity assets, as well as the rise in public private partnerships for the construction of roads and other infrastructure.

Within a decade, 93% of all listed A-REITs and 95% of all listed infrastructure funds utilised stapled structures.[3]

By 2014, stapled securities accounted for approximately 10% of the total Australian equity market capitalisation.[3]

Over this period, stapled structures started to emerge in a wider variety of investment types, including agriculture and mining.[4] Banks also began creating complex financial instruments involving stapled securities and businesses holding valuable intellectual property rights began implementing what are now referred to as "royalty staples".

Consideration by the courts of schemes involving stapled securities

Since their introduction, there have been only two occasions when the courts have had to consider the application of Pt IVA to a scheme involving the issue of stapled securities – *Macquarie Finance Ltd v FCT*[5] (*Macquarie Finance*) and *Mills v FCT*[6] (*Mills*). Both involved hybrid debt/equity instruments issued by banks.

Macquarie Finance Ltd v FCT

Macquarie Finance concerned stapled securities issued by the Macquarie Bank

Group in order to raise tier 1 capital for the purposes of the minimum capital requirements prescribed by the Australian Prudential Regulation Authority. The securities consisted of a preference share in Macquarie Bank Ltd (MBL) and an interest-bearing debenture note issued by one of its subsidiaries, Macquarie Finance Ltd (MFL). Under the arrangements, MBL could require that interest payments that would otherwise be payable by MFL to the security holders be redirected to it. MBL would then be required to pay corresponding dividends to the security holders. If this occurred, the security holders would no longer be entitled to a return of the principal sum advanced under the notes.

The issues before the Full Federal Court were: (1) whether the interest payments made by MFL to the security holders were deductible; and (2) if so, whether Pt IVA applied to a scheme involving the issue of the stapled securities.

While the payments were ultimately found not to be deductible, Hely J (with whom French J agreed) held that Pt IVA would not have applied to the scheme had they been deductible. In so finding, Hely J accepted that the scheme had an element of artifice or contrivance about it.[7] His Honour also accepted that a reason why the scheme was structured in the way it was was to enable MFL to obtain a tax benefit in the form of the deductions (which would not have been available if MBL simply issued equity). However, his Honour considered it important that the scheme also secured other non-tax advantages; relevantly: (1) financing by way of a debt-like instrument that was cheaper than equity; and (2) flexibility in relation to the management of the moneys raised.[8]

In light of these matters, Hely J concluded that the objectively ascertained purpose of those who participated in the scheme having regard to the s 177D(b) factors was to raise capital by an instrument which had the commercial advantages which flow from debt financing, but with features which would also qualify it as tier 1 capital.[9]

Mills v FCT

Mills also concerned the issue of stapled securities by a bank for the purposes of raising tier 1 capital. The securities were known as “PERLS V” and comprised a preference share issued by the Commonwealth Bank of Australia (CBA) and a subordinated unsecured note issued by the bank’s New Zealand branch.

The Commissioner had made a determination under s 177EA(5)(b) ITAA36 denying franking credits on a distribution to be made to a holder of the stapled securities. The matter was run as a test case for all remaining PERLS V security holders. The issue for the court was whether, “having regard to the relevant circumstances” of the arrangements for the issue of PERLS V, it would be concluded from the perspective of a reasonable person that the bank entered into and carried out those arrangements “for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling [a taxpayer who is a holder of PERLS V] to obtain [a franking credit]” for the purposes of s 177EA(3)(e).[10]

Section 177EA was introduced, broadly, to address schemes that abuse the imputation credit system.[11] The purpose test in s 177EA(5)(b) has a lower threshold than the dominant purpose test under s 177D. The “relevant circumstances” are also extensive and include the matters set out in s 177D(2).[12]

The Commissioner appears to have been concerned that the PERLS V stapled securities provided returns for investors that bore characteristics of interest but were frankable. Moreover, the moneys raised from the issue of the securities were to be deployed by the CBA in its New Zealand branch to derive income that would not be subject to Australian tax.

The High Court accepted that the CBA had a purpose of enabling the security holders to obtain franking credits.[13] Gageler J (with whom the rest of the court agreed) noted (with reference to the various “relevant circumstances”) that the proposed franking of distributions was not only disclosed in the prospectus, it was integral to the calculation of the distribution on the notes (s 177EA(17)(f)), integral to the calculation of yield to investors (s 177D(b)(ii) and (iv)) and integral to the calculation by the bank of its after tax cost of capital (s 177D(b)(ii), (iv) and (vi)). However, his Honour nevertheless held that the purpose of enabling the security holders to obtain the franking credits was an “incidental purpose” within the meaning of s 177EA(5)(b). Critical to his Honour’s conclusion was the fact that the CBA needed to raise tier 1 capital and all the means by which it could have done so would have involved it franking distributions to the same extent.[13]

Relevance to infrastructure funds

While these cases did not concern the use of stapled securities for infrastructure funds, their significance lies in the fact that they involve the attribution of a purpose to promoters who are structuring a financial instrument that will be attractive to investors in order to raise capital. In that context, the courts have acknowledged that the cost of raising such capital and flexibility in its deployment are major considerations for those that enter into and carry out such schemes.

Moreover, the courts have acknowledged the role that tax considerations can play in such a scenario. In both cases, the courts held that the scheme participants had a purpose of obtaining the relevant tax benefit[14] but considered that purpose to be subsidiary to the overriding objective of raising capital on favourable terms. In *Macquarie Finance*, Hely J cited[15] the now well-known statement by Gleeson and McHugh in *Hart v FCT*[16] (*Hart*) where their Honours said:

> “[T]he fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with its adoption does not of itself mean that there must be an affirmative answer to the question posed by s 177D. Taxation is part of the cost of doing business, and business transactions are normally influenced by cost considerations. Furthermore, even if a particular form of transaction carries a tax benefit, it does not follow that obtaining the tax benefit is the dominant purpose of the taxpayer in entering into the transaction.”

Gageler J noted in *Mills* that a purpose of obtaining a tax benefit may be incidental (and therefore not the dominant purpose for entering into and carrying out a scheme[17]) “even where it is central to the design of the scheme” if that design is directed to the achievement of another purpose. His Honour said:[18]

> “Indeed, the centrality of a purpose to the design of a scheme [i.e. the purpose of obtaining the relevant tax benefit] directed to the achievement of another purpose [e.g. the raising of capital on the most favourable and cost-effective terms] may be the very thing that gives it a quality of subsidiarity and therefore incidentality.”

In *Macquarie Finance*, Hely J also referred[19] to the following statement by Lee J in *Eastern Nitrogen Ltd v FCT*:[20]

> “To show that a business which depends upon financiers to provide the recirculating capital needed for the operation of the business, has

> obtained that finance at a net cost, after taking into account provisions of the Act, that is less than the net cost of obtaining finance by another method, will not, in itself, show that the dominant, ruling or supervening purpose of the operator of the business is to obtain the tax benefit constituted by the extent to which deductible outgoings incurred in respect of that borrowing will be greater than the deductible outgoings that would have been incurred under another method of obtaining finance."

Use of stapled securities for investment in infrastructure

Of the four different types of staples identified in the Commissioner's TA 2017/1, the "rental staple" is the one most commonly used for investments in infrastructure. Typically, it involves the stapling of units in a trust with shares in a company (or an entity that is taxed as a company). The trust will own the infrastructure assets (which are commonly affixed to land) and lease them to the operating entity which will derive revenues from operating and maintaining them. Sometimes there will be a finance element whereby the trust also lends funds to the operating entity at interest to fund its establishment and operational costs. Thus, a "finance staple" is overlaid on the "rental staple".

The fiscal consequences of the structure are broadly as follows. The income derived by the operating entity from the exploitation of the assets is offset by the deductible rent and interest payments made to the trust. Assuming Div 6C ITAA36 does not apply — which must be assumed if Pt IVA is to apply — the trust is assessed on a flow-through basis under Div 6 ITAA36 such that the income derived by the trust is ultimately taxed at the investor level.

If all of the investors were residents of Australia, there would seem to be no reason why these arrangements should cause any concern for the Commissioner. Ultimately, investors will pay tax at their marginal rates on the cash flows that make their way into their hands. A notable feature of the scheme is that every dollar that is claimed by the operating entity as a deduction is included in the trust's assessable income and ultimately taxed in accordance with the relevant provisions applying to the taxation of trusts.

Where there is scope for some tax arbitrage is where the investors are non-residents.[21] Depending on the applicable treaty, non-resident investors will generally be liable to withholding tax on the interest income derived by the trust at a rate that is lower than the corporate tax rate. Further, where the trust qualifies as a managed investment trust (MIT) under the MIT regime introduced in 2007, the withholding tax applying to the rental income is subject to a concessional rate. While originally set at a rate of 30%, the Commonwealth Government reduced the rate of withholding tax on distributions from Australian managed funds to non-resident investors of information exchange countries to 15% from 1 July 2008.[22] The rate fell further to 7.5% from 1 July 2009, although was returned to 15% with effect from 1 July 2012,[23] where it remains currently.

> *"… there is nothing intrinsic about the use of stapled structures in infrastructure projects that ought to attract the operation of Part VIA."*

Additionally, non-resident sovereign funds and foreign pension funds are generally immune from withholding tax altogether (this is particularly advantageous to such entities given they are also often tax exempt in their resident jurisdictions). Thus, the Commissioner asserts in TA 2017/1 that the effect of the stapled structure is to "re-characterise trading income into more favourably taxed passive income".[1]

Identifying the tax mischief in this way leaves the potential application of Pt IVA somewhat obscure. Much will depend on the identification of the scheme, the counterfactual and the particular tax benefit that is said to result. Before turning to these matters, it is necessary to explain some of the commercial reasons for using a stapled structure for infrastructure investments.

Commercial reasons for stapled structures

Access to cash flows

Infrastructure projects require significant upfront capital expenditure to either build or acquire the physical assets required. The ultimate object of any infrastructure project is to recover these upfront capital costs and generate a profit. However, this will not occur for many years — often decades.

In order to make infrastructure projects attractive to investors, promoters look to create a form of investment that will promise regular and predictable returns over the life of the project. These characteristics are particularly attractive to superannuation, pension and other institutional funds. The promoters of infrastructure projects are usually able to promise such returns because, on the construction or acquisition of the assets, they gain access to a stable stream of cash flows. This usually takes the form of fees, tolls or rent for the use of the asset — often regulated because of the monopolistic elements of the undertaking.

Because of accelerated depreciation, the builder or acquirer of infrastructure assets will inevitably be in accounting losses for an extended period. That makes it difficult for a company to offer returns to investors. Prior to 28 June 2010, s 254T of the *Corporations Act 2001* (Cth) specifically prohibited the payment of dividends by a company in the absence of profits. The revised s 254T prohibits a payment of a dividend unless there is an excess of assets over its liabilities sufficient for the payment of the dividend, the dividend is fair and reasonable to shareholders as a whole and the dividend payment does not materially prejudice the company's ability to pay its creditors. However, as the New South Wales Court of Appeal has noted, there may still be a general law principle that dividends may only be paid out of profits.[24] At the very least, the ability of a company to make distributions to investors is impeded because of considerations such as solvency and net asset requirements.

These problems are circumvented in a stapled structure by the use of the trust vehicle. The use of a trust permits cash flows to be more easily distributed to beneficiaries prior to the recognition of accounting profits from the project.[25]

Lower cost of capital

In acceptance of the above proposition, the Commissioner might posit that the entire project be housed within a single trust without any bifurcation of the project activities into passive investment activities and trading activities. In such a scenario, the trust would, of course, not be carrying on a business consisting wholly of eligible investment business for the purposes of Div 6C and would, if it were a public trust, be taxed as a company. It is at this point that the tax considerations intersect with the commercial considerations. By having tax paid at the investor level, the stapled structure increases the ability to borrow within the project structure, thereby lowering the overall cost of capital.

It is well accepted that debt is a cheaper form of capital than equity. This is not just because interest payments on debt are tax deductible. It is because: (1) debt promises a return of the sum loaned which can be secured by the assets of the undertaking, whereas there is no certainty that an investor will receive a return of their equity investment; and (2) debt promises regular returns that are generally not dependent on the generation of profits. For these reasons, debt instruments command a much lower rate of return and are a cheaper form of finance for the issuer.

In order to package together an investment opportunity that is attractive to investors, and in order to increase the amount of capital that can be raised (and thereby the price that can be offered for the assets in a competitive market), a promoter will seek to maximise debt funding to the extent possible.

Generally, senior lenders will examine the projected cash flows to be generated by the project when determining the amount and terms on which they will lend. Commonly, the project's borrowing capacity will be evaluated by reference to its debt service coverage ratios (DSCRs). The senior lenders will look to implement "cash flow waterfalls" that control the flow of funds within the project and under which they obtain priority in payment over certain other project costs and returns to investors. Where tax is required to be paid within the project structure, it trumps the lenders' access to the cash flows and the DSCRs are adversely affected. Consequently, the project borrowing capacity is reduced and the promoters must look to fill that gap with more expensive equity. This has the effect of: (1) reducing the rate of return for investors; and/or (2) reducing the amount of capital that may be raised and therefore the amount that may be offered in a competitive tender or proposed acquisition.

Investor preferences

It is important to recognise that the commercial advantage of increasing the fund's borrowing capacity and thereby lowering the cost of capital is obtained regardless of the tax profile of the individual investors. By way of illustration, if every investor were an Australian resident company paying tax on distributions at the corporate tax rate, it would still make commercial sense to utilise a stapled structure to improve the DCSRs and yet no less tax would be paid overall.

Nevertheless, it must be acknowledged that there is a pool of investors that promoters would seek to attract that will benefit from concessional regimes offered under the Australian tax system. As mentioned, these include foreign investors benefitting from withholding tax regimes and/or MIT concessional rates. Sophisticated investors in these positions will perceive a benefit in obtaining direct access to pre-tax cash flows via the use of a stapled structure. By offering the ability to invest in infrastructure in this way, promoters are able to compete with more traditional funds investing in property and shares.[26]

In this respect, it should be observed that the ability to package up an investment in such a way as to increase its attractiveness to a portion of the investing community is, for the scheme participants, a commercial consideration.

Behavioural biases

Commentators have also recognised another important aspect of the use of stapled structures which is that they exploit the behavioural biases of investors.[27] As noted above, if all of the investment and trading activities of an infrastructure project were carried out within a single project vehicle, there would, initially, be no profits generated from which distributions could be made. Any amounts returned to investors during this initial phase would necessarily be a return of their principal investment. Indeed, this is what occurs in a stapled structure as well, albeit that it is somewhat obscured by the complexity of the structure. Initial distributions from the trust are often labelled by the promoters as "tax deferred" distributions. This refers to the fact that the payment is in fact a return of capital. It therefore reduces the investor's cost base of their units in the trust which will only have an impact on the disposal by them of their securities.

The notion that one would depart with a principal sum only to have it returned by way of regular payments is, prima facie, unappealing. Through the complexity of the stapled structure, promoters frame the investment as one that gives the investor access to cash flow streams. In so doing, the promoter is able to exploit a behavioural bias of investors to regard these cash flows as the "yield" on their investment.

How might the Commissioner seek to apply Part IVA?

The significance of TA 2017/1 is its departure from the ATO's position as set out in chapter 4 of its earlier draft document titled "Privatisation and infrastructure – Australian federal tax framework".[28] That document stated:

> "As a general proposition, a taxpayer's decision to establish a business using a particular type of entity, such as a trust rather than a company would not attract the attention of the ATO – even if that decision was, at least in part, driven by tax considerations.
>
> A stapled structure is simply another example of a type of vehicle through which a business may be carried on. As such, the ATO does not see stapled structures as being inherently high or low risk.
>
> The ATO acknowledges that the proliferation of stapled structures is the consequence of a policy decision by Government to allow passive income derived from certain investments to be taxed in the hands of the ultimate investors, even where those investments are in assets that are used in the active business of a related party.
>
> What matters, when assessing whether a stapled structure presents a compliance risk, is:
>
> - The kinds of transactions entered into by the stapled entities;
> - The reason for entering into those transactions; and
> - The tax consequences that arise from those transactions."

The document then identified particular types of transactions that would be taken to be high risk, including where rental payments under a lease from the trust are calculated to substantially capture the profits of the operating entity or where the trust and the operating entity have unequal levels of gearing. The documents stated that the ATO may review some of these arrangements to determine, among other things, whether Pt IVA applies.

At the time of releasing TA 2017/1, the ATO amended the draft framework document to remove the above section. The amended draft now refers the reader to TA 2017/1.

As mentioned, TA 2017/1 is mostly concerned with how the substantive provisions may operate to tax the trust as a company or deny the deductions claimed by the operating entity. There is little analysis as to how Pt IVA might apply to an infrastructure staple. The Commissioner elucidates a concern that the stapled structures "attempt to fragment an integrated trading business in order to re-characterise trading income into more favourably taxed passive income".[29] That reference to the fragmentation of an integrated trading business suggests that the Commissioner now views the establishment of the stapled structure as a device to reduce the tax payable at the project level (and have it payable at the investor level) and/or to overcome the operation of Div 6C.

With this in mind, we turn now to consider the elements of Pt IVA.

Application of Part IVA

Elements of Part IVA

In order for Pt IVA to apply:

- there must be a "scheme" as defined in s 177A ITAA36;
- a taxpayer must have obtained, or would but for s 177F ITAA36 have obtained, a tax benefit in connection with the scheme; and
- it would be concluded (having regard to the matters in s 177D(2)) that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling one or more taxpayers to obtain a tax benefit in connection with the scheme.

Scheme

It is likely that, in formulating his case under Pt IVA, the Commissioner would identify a scheme consisting of all of the steps involved in establishing the stapled structure. This would likely include the formation of the relevant entities, the acquisition by those entities of the various assets and the entry into the leasing arrangements and any cross-staple loan.

The identification of the scheme in this way would be uncontroversial.

Tax benefit

In TA 2017/1, the Commissioner states:

> "But for these structures [being structures that attempt to fragment an integrated trading business in order to re-characterise trading income into more favourably taxed passive income], it would be reasonable to expect the trading income to form part of the taxable income of a corporately taxed entity."

It is assumed, therefore, that in working out the tax benefit under s 177C ITAA36, the Commissioner would postulate that, absent the scheme, a single entity would have both held the assets and carried on the operating business. If that entity were a public trading trust, it would be taxed as a company under Div 6C.

Assuming this counterfactual, it is necessary to consider what tax benefits might arise from it.

Tax benefit for investors

Evidently, one of the Commissioner's chief concerns with the use of stapled structures is that foreign investors are able to access lower withholding tax rates on their returns. However, even under the counterfactual of a single entity both holding and operating the assets, the tax payable by the foreign investors will not be altered in any material way.[30] Instead, tax will have been paid at the corporate tax rate by the project vehicle holding and operating the assets. Accordingly, it does not appear possible to identify any tax benefit that would be obtained by the investors under the Commissioner's counterfactual.

Non-inclusion of trading income in the trust

One option for the Commissioner might be to identify the tax benefit as being the non-inclusion of the income derived by the operating entity in the assessable income of the trust. However, such a tax benefit would be of no consequence unless the Commissioner were able to apply Div 6C to the net income of the trust. Otherwise, there would be no material difference in the ultimate tax payable. The rental income derived by the trust would be removed as a compensating adjustment and the tax payable on the net income of the trust would be worked out by reference to the beneficiaries' entitlement and not the liability of the trustee.

Division 6C operates only in respect of net income of a "public trading trust" and there has to be considerable doubt as to whether Pt IVA can operate so as to treat what is not a public trading trust as a public trading trust. Section 177F entitles the Commissioner to determine that the amount of the tax benefit be included in the taxpayer's assessable income. The benefit is an amount and does not include a characteristic. The amount will be included pursuant to s 6-5 ITAA97. Although the trust is a taxpayer for the purposes of Pt IVA (s 177A), s 177F does not empower the Commissioner to treat or determine what is not a public trading trust to be a public trading trust.

Denial of deductions claimed by the operating entity

For the reasons set out above, it is more likely that the Commissioner would seek to identify the tax benefit as being the deductions for the rental and any interest claimed by the operating entity. Those deductions would not have been claimable by *any* entity under the counterfactual.

In relation to schemes that were entered into or carried out prior to the introduction of s 177CB ITAA36, a taxpayer might seek to argue that such a counterfactual is unreasonable because it would deny the scheme participants the various commercial benefits outlined above. Accordingly, the taxpayer would argue that it would have entered into or carried out a scheme that was substantially similar to the one in fact entered into or carried out so as to ensure the scheme secured these commercial benefits.

Following the introduction of s 177CB, it is unlikely that there would be any scope for argument that a tax benefit in the form of the rental and interest deductions claimed by the operating entity was not obtained in connection with the scheme. The argument, then, would focus on purpose — which is considered below.

Compensating adjustments

Before turning to purpose, it should be noted that, even under the Commissioner's counterfactual of a single entity both holding the assets and carrying on the trading business, it is likely that such an entity would be deeply in losses for many years. If the Commissioner were to make a determination under s 177F(1) that rental and interest paid by the operating entity to the trust shall not be allowable as deductions, one would expect that he would be required to make compensating adjustments to take account of the fact the same entity would have been entitled to claim depreciation deductions and deductions for interest on the senior lending that would have been claimed by the trust. Alternatively, if the Commissioner's alternative postulate is that a different entity would have held and operated the assets, he would be required to make compensating adjustments to remove the revenues derived by the operating entity from its assessable income. Either way, the entity would likely be in losses such that no tax would be payable.

Presently, it is the practice of the Commissioner to not make any compensating adjustments until the application of Pt IVA has been finally determined. Paragraph 176 of PS LA 2005/24 states:

> "Any action to make or give effect to compensating adjustments (for example, amendment of assessments) should not as a general rule be undertaken while the application of Part IVA is subject to objection or review."

The Commissioner has adopted the practice set out in para 176 in reliance on the decision in *ANZ Banking Group Ltd v FCT* (*ANZ Banking Group*).[31] In that case, the taxpayer challenged the validity of assessments issued to give effect to Pt IVA determinations on the basis the Commissioner had failed to make compensating adjustments where he was alleged to be aware that they were required to avoid "double counting". The taxpayer relied on the following statement by Hill J in *FCT v Jackson*:[32]

> "[O]nce a s.177F(1) determination is made, the making of that determination leads to the making of a determination, if appropriate, under s.177F(2). It also requires the Commissioner to consider the question of the making of compensatory adjustments under s.177F(3), by way of further determinations. It is true that if the Commissioner does not act under s.177F to make compensatory adjustments, a taxpayer not being the taxpayer whose tax benefit was the subject of the s.177F(1) determination, and perhaps the taxpayer himself, may at any time request the Commissioner to make a s.177F(3) determination, and is given rights if dissatisfied with the Commissioner's decision in respect of that request to object and appeal. But this does not exclude the Commissioner's obligation to consider the issue of the making of such adjustments once he has made the s.177F(1) determination."

The application in *ANZ Banking Group* did not succeed. Kenny J said:[33]

> "The Act, however, provides for the procedures of objection, review and appeal, and it also provides that a compensating adjustment under s 177F(3) can be made at any time. In these circumstances, having regard to the operation of Pt IVA, especially s 177F(1)(a) and s 177F(3), I accept, as the Commissioner submits, that the matter falls properly to be judged at the conclusion of the objection, review and appeal processes and not earlier."

Subsequently, in *FCT v Futuris Corporation Ltd*,[34] the High Court confirmed that an assessment will not be invalid on account of the fact it is issued in the knowledge that it is excessive.

The Commissioner's practice of not making compensating adjustments until the application of Pt IVA is finally determined gives rise to the perverse situation that taxpayers can be forced to defend assessments that are issued to it in circumstances where, on the counterfactual on which they are premised, there would have been no liability to tax.

Purpose

It is next necessary to examine whether, having regard to the eight matters set out in s 177D(2), it would be concluded that a scheme participant had a dominant purpose of obtaining a tax benefit.

There is a difficulty in considering the eight matters set out in s 177D(2) in the abstract. The application of Pt IVA will always depend on the particular facts and circumstances under consideration. However, in the authors' view, there are some basal propositions which can be stated in relation to the use of stapled structures for infrastructure projects that are relevant for the purposes of s 177D.

First, there is nothing intrinsic about the use of stapled structures in infrastructure projects that ought to attract the operation of Pt IVA. Stapled structures facilitate, in a commercially acceptable manner, the construction or acquisition, and subsequent operation, of public infrastructure. The structure is widely accepted as bringing commercial benefits to both promoters and investors.

Second, there is a difficulty in attributing to the scheme participants a purpose of enabling the operating entity to obtain deductions for rental or interest. As mentioned above, if all of the security holders were Australian resident corporations, these amounts would still be deductible and yet there would be no overall tax advantage in entering into and carrying out the scheme. Moreover, one would expect, objectively, that promoters would still seek to structure the investment in the same way so as to reduce the cost of capital. That is because, by having tax paid at the investor level, the DSCRs are more favourable, allowing the project entities to raise more funds through debt which is cheaper than equity.

Third, there is nothing unusual or artificial about separating the asset holding functions from the operating functions within a group of entities working in concert for a common commercial aim. Corporate groups often establish separate entities to perform such functions. Tax considerations may be a factor in deciding to do so without attracting the operation of Pt IVA. This is particularly so where, in the case of infrastructure, there are often landholdings involved and a natural division between such functions lends itself. The decision to separate these functions is similar to the decision to rent, as opposed to own real estate, for the purposes of carrying on a business enterprise.[35]

Fourth, and relatedly, in many cases where a promoter is seeking to raise capital in order to make an investment in infrastructure, there will not be any pre-existing "integrated trading business". Often the stapled structure is formed to construct the assets or to acquire them from the state (where they will not have been held and operated as part of any business). The notion that infrastructure assets should be owned and operated in an "integrated trading business" appears to proceed from an a priori assumption about how such investments should be structured. As set out above, there are non-tax reasons why a promoter might not want to establish an integrated trading business.

Having laid down these basal propositions, it must be recognised, again, that Pt IVA ultimately depends on a consideration of the eight matters set out in s 177D(2) as applied to the facts in question. Of particular importance will be the manner in which the scheme is entered into and carried out. For example, if the promotional material for the stapled securities placed particular emphasis on the tax benefits to be obtained by the structure, that might be a matter that would operate in favour of Pt IVA applying. Similarly, if the stapled structure were set up outside of a capital raising and in circumstances where there was no change in ownership or opportunity for a restructure, closer scrutiny would need to be given to the result in relation to the operation of the Act and the changes in financial position of the relevant entities (including investors) and any other consequences.

In most cases, however, it is likely that the approach adopted by the Full Federal Court in the *Macquarie Finance* case should be followed. That is, it should be accepted that *a purpose* of the scheme participants was that the rental and any interest should be deductible to the operating entity, since the deductions will affect the after-tax costs of the fundraising. It is likely, however, that that purpose is no more than an incidental purpose and, when regard is had to the factors specified in s 177D(2), it would be objectively concluded that it was not the dominant purpose of any of the scheme participants.[36]

The putative "separation of an integrated trading business" is premised on the notion that there is a preferred or default way in which an investment of the kind considered ought to be organised. It ignores the legitimate choices available to taxpayers as to how they may structure their affairs. As the High Court observed in *FCT v Spotless Services Ltd*,[37] tax laws affect the shape of nearly every business transaction and adoption of one particular form over another may be influenced by revenue considerations.

The stapled structure can be seen to be taking advantage of the flow-through taxation treatment of trusts — *to the extent permitted* by the Act. Resort is only had to Pt IVA because the scheme complies with Div 6C in that the asset holding entity is carrying out eligible investment business and does not control the operations of the operating entity. In the authors' opinion, the choice to structure a capital raising so as to ensure that tax is paid at the investor level — which, in turn, reduces the cost of capital, increases the amount that can be bid for an acquisition or spent on construction, and makes the investment more attractive to the market — is not, without more, one to which Pt IVA ought to apply.

Conclusion

In the authors' opinion, while the application of Pt IVA will always depend on the particular facts and circumstances of a given case, the mere fact that an infrastructure investment is acquired and held within a stapled structure will be insufficient to attract the operation of Pt IVA.

Greg Davies, QC
Chancery Chambers

Eugene Wheelahan
Barrister
Aickin Chambers

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7. *Macquarie Finance* at [217].
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10. *Mills* at [7].
11. Para 8.7 of the explanatory memorandum to the Taxation Laws Amendment Bill (No. 7) 1997 (Cth).
12. S 177D(b) ITAA36.
13. *Mills* at [75].
14. Or imputation benefit in the case of *Mills*.
15. *Macquarie Finance* at [230].
16. *Hart v FCT* [2004] HCA 26 (*Hart*) at [15].
17. This follows from his Honour's later statement that the parenthesised words in s 177EA(3)(e) make clear that a dominant purpose of enabling a holder to obtain a franking credit is sufficient but not necessary for the requisite jurisdictional fact to exist.
18. *Mills* at [66].
19. *Macquarie Finance* at [214].
20. *Eastern Nitrogen Ltd v FCT* (2001) 108 FCR 27 at [18].
21. There may also be some scope for arbitrage where the investors are resident superannuation funds or other resident entities that are taxed at less than the corporate tax rate.
22. S 4(1)(a) of the *Income Tax (Managed Investment Trust Withholding Tax) Act 2008* (Cth).
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30. Save that their return might be lower such that the tax payable by them would be less.
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