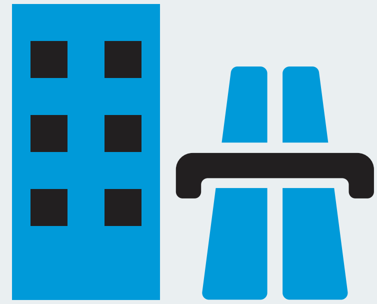
Stapled structures and foreign investor measures

by Stuart Landsberg, FTI, Christina Sahyoun and Angeline Young, PricewaterhouseCoopers



It has been a long journey on the road of the review of stapled structures, but we are nearly at the final destination.

On 20 September 2018, the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 (the Bill) was introduced into parliament to give effect to the government's proposal to reform the tax treatment applicable to stapled structures and certain foreign investors.

This Bill reflects the culmination of a long process which began with the Australian Taxation Office seeking to address the use of staple structures with TA 2017/1 released in January 2017, and which may almost be resolved with legislative change.

The Treasurer announced that the Bill will assist the government to "better guarantee the essential services and vital infrastructure that Australians rely on, by ensuring foreign investors pay their fair share of tax". The Bill includes measures that seek to:

- subject converted trading income to managed investment trust (MIT) withholding at the corporate tax rate;
- ensure that investments in agricultural land and residential property, including student accommodation (other than affordable housing), are subject to MIT withholding at the corporate tax rate;
- prevent double gearing through thin capitalisation changes;
- limit the foreign pension fund withholding tax exemption for interest and dividends to portfolio-like investments; and
- create a legislative framework for the sovereign immunity exemption.

These measures may *significantly* impact the commercial and financial outcomes for investors across a wide range of industry segments, including the infrastructure, real estate (including residential property and student accommodation) and agricultural sectors. Importantly, the changes within this Bill are not limited to those who invest in stapled arrangements.

The Bill was referred to the Senate Economics Legislation Committee with a final report received on 9 November 2018. The authors supported the referral to the Senate Economics Legislation Committee as it was hoped there may be a recalibration of the legislation as the current drafting of the Bill may have unintended consequences, such as the distortion of the market in the agricultural sector, investment bias against the student accommodation sector and restriction in access of immunity for sovereign investors.

Unfortunately, the Senate Economics Legislation Committee did not recommend any changes to the Bill and it is likely that it will be passed as drafted (although the authors note the Labor Senators' additional comments recommending caution in respect of the build-to-rent, student accommodation and agricultural sectors).

Accordingly, the near-certain, significant shift in tax policy represented by the Bill will impact a large number of stakeholders, including state and territory governments, a range of foreign institutional investors, Australian superannuation funds and Australian Securities Exchange listed entities including real estate investment trusts.

The Bill that was introduced into parliament on 20 September 2018 is largely the same as the exposure draft legislation released on 26 July and 7 August 2018. However, there have been some notable changes to the taxation of foreign investors in residential housing (in particular student accommodation), agricultural investments and also changes to the sovereign immunity and foreign superannuation fund exemption. These changes are outlined below.

MIT residential housing income

In relation to the treatment of MIT residential housing income, the changes made to the exposure draft fall into the following categories:

- introduction of the definition of "residential dwelling asset" which includes premises used primarily to provide accommodation for students;
- new transitional arrangements applying to student accommodation, resulting in dual transition dates for MIT residential housing income; and
- treatment of indirect capital gains relating to Australian residential dwelling assets (discussed separately below).

The first amendment makes it clear that income derived from student accommodation assets will be treated as non-concessional MIT income, and subject to MIT withholding at the corporate tax rate. As this change will impact any investments made from the date when the Bill was introduced into parliament (ie 20 September 2018), this is expected to have an immediate impact (subject to certain transitional provisional measures, discussed below) on foreign institutional investors investing in Australian university housing projects. Tertiary education is one of Australia's greatest assets and growing exports and the provision of student accommodation is an integral part of that sector. With this in mind, it's no surprise that the impact on student accommodation was discussed by a number of participants in the Senate Economics Legislation Committee, and it is disappointing that no substantive changes are likely to arise from these well-reasoned submissions.

Transitional measures for MIT residential housing income

The "MIT residential housing rules" apply to fund payments made by an MIT in relation to an income year if the fund payment is made on or after 1 July 2019 and the income year is the 2019-20 or a later income year.

However, the rules include transitional measures effectively providing a ten-year transition period to affected assets if, broadly, the facility was held at the relevant transition time. The transition time generally for residential investments is 14 September 2017, or 20 September 2018 for certain student accommodation investments (excluding financial arrangement residential dwelling assets).

The transitional rules provide certainty to investors for existing investments by ensuring that investments held at the time of the announcement (ie 27 March 2018) are unaffected by the changes for the transitional period (ie relevant amounts continue to enjoy a concessional 15% MIT withholding rate).

Under the current drafting of the Bill, an issue arises where land has been acquired, but for which construction contracts have not been executed, because the revised explanatory memorandum makes it clear that land is not a facility. As this is a growing sector in Australia, there are a number of investors that have acquired land and committed to the development of student accommodation projects but have not yet executed construction contracts.

As a result, the higher MIT withholding tax rate should apply to these assets as soon as these new buildings are constructed and tenanted (even though a number of these projects were based on the assumption in their financial models that the concessional 15% MIT withholding tax rate would be available).

Capital gains from membership interests

The treatment of capital gains in relation to both residential dwelling assets and Australian agricultural land for rent remains consistent with the exposure draft legislation (ie both should fall within MIT residential housing income and MIT agricultural income, respectively, and are denied the concessional MIT tax rate).

The Bill also contains measures to specifically include capital gains as either MIT agricultural income or MIT residential housing income where the amounts are attributable to a capital gain that arises in relation to a membership interest held (directly or indirectly) in an entity that holds one or more assets that are:

- agricultural land for rent; and/or
- residential dwelling assets.

This should ensure that there is consistency between the tax treatment of the sale of a direct or indirect interest in an entity and the sale of the underlying asset, by treating the resulting capital gain as being taxable at the corporate tax rate. Notably, the transitional rules described above should also apply to these rules, such that the disposal of existing membership interests will continue to be subject to the concessional MIT withholding tax rate up to 1 October 2027.

The distinct change in the tax rates applicable to capital gains from disposals of these assets (on 30 June 2026 and 1 October 2027 for holders of agricultural land and residential dwelling assets, respectively) creates the possibility that the market for these assets may be impacted in the periods up to the relevant dates, as MITs realise gains at the concessional tax rate. To the extent that there is an effect, it could be exacerbated for agricultural assets given the relatively shallow market for many subsectors of agricultural assets. Any consequential impacts, including, for example, impacts on loan to value ratios for agricultural borrowers could add to the distortions.

Submissions had previously been made on the exposure draft to recommend that the capital gains tax (CGT) measures should operate so that affected assets have a deemed market value as at 1 July 2026 for the purpose of determining capital gains post-1 July 2026. That is, gains which accrued between the acquisition time of the relevant asset and 1 July 2026 should be taxed at 15% (even where the relevant capital gains tax event occurs after 1 July 2026), with any gains in excess of the 1 July 2026 deemed market value cost base being taxed at the corporate tax rate. This approach would have been consistent with the sovereign immunity measures in the Bill. This message was reiterated at the Senate Economics Legislation Committee by one of the authors.

Where a gain on a membership interest is attributable to both agricultural land for rent and residential dwelling assets, the Bill contains measures to attribute the capital gain as wholly agricultural land or residential dwelling assets, based on the market value of the relevant assets just before the time of the CGT event. Interestingly, this could create issues for taxpayers regarding valuation of the underlying assets, including the appropriate market valuation that should be adopted, and whether a consistent valuation methodology needs to be adopted across both asset classes at that time. There is no such attribution methodology for gains on membership interests which may be attributable partially to eligible transitional land and partly attributable to land acquired after the transition time — which could also prove problematic.

Foreign superannuation fund exemption

The Bill modifies the exemption from withholding tax for foreign pension funds by inserting s 128B(3CA) of the *Income Tax Assessment Act 1936* (Cth), which limits the operation of the existing exemption from withholding tax for foreign superannuation funds. The new section operates to exempt a foreign superannuation fund from withholding tax only if:

- the foreign superannuation fund satisfies the portfolio interest test (broadly, has a less than 10% interest) in the test entity (broadly, the payer of the amount, or the trust estate distributing the amount) at the time the income is derived and throughout any 12-month period that began no earlier than 24 months before that time and ended no later than that time;
- the foreign superannuation fund does not have influence of a kind specifically defined by the Bill; and
- the income is not non-assessable non-exempt income of the foreign superannuation fund because of Subdiv 880-C of the *Income Tax Assessment Act 1997* (Cth) (or its equivalent transitional provision).

The first of these three requirements is broadly the same as that in the exposure draft. However, the exposure draft only dealt with the concept of the paying entity, whereas the Bill has clarified the operation of this provision (and the transitional rules) where the relevant income is derived by way of distribution from a trust estate. This is a welcome change, providing clarity. Importantly though, the rules continue to require the foreign pension fund to hold a portfolio interest in the trust (ie test entity), rather than the underlying investment to access the withholding tax exemption.

The second and third requirements represent more material changes from the exposure draft.

The second condition — the type of "influence" that the superannuation fund may have over the test entity — is designed to ensure that withholding tax is payable where the superannuation fund has a portfolio interest but still can influence the relevant Australian entity by virtue of other arrangements (eg the appointment of directors).

The general architecture of this condition has remained constant. However, the Bill includes a clarifying exception which operates so that a superannuation fund will not be deemed to have the required "influence" if that influence only arises as a result of the breach of terms of a debt interest. The authors understand that this clarification was the result of submissions which pointed out that many "step-in" rights under debt arrangements could result in deemed "influence", even where such influence would not arise in the ordinary course.

The third condition broadly clarifies that the withholding tax exemption will not apply to non-assessable non-exempt income of the foreign superannuation fund because of the operation of the sovereign immunity provisions (ie because the superannuation fund is a covered superannuation fund).

Sovereign immunity

In codifying and legislating the tax treatment for sovereign wealth funds (which was previously administered based on agreed sovereign immunity doctrine with the ATO), a number of the following ancillary changes have been made to sovereign immunity. A number of these changes appear to be mechanical in nature to give effect to the proposed intent of the rules. However, the following are notable changes to the position under the Bill which will need to be carefully considered by sovereign investors:

- the Bill has also included (in addition to the requirement that the entity is funded solely by public moneys) that *all returns* on the entity's investments are public moneys. The practical application of this test will be critical for many sovereign wealth funds; and
- in a welcome change, there is no longer a carve-out for foreign superannuation funds from the definition of "sovereign entity". However, whether this technical change results in a change to the classification for a foreign superannuation fund will depend very much on whether it can satisfy other aspects of the "covered sovereign entity" definition, including the tighter public moneys requirement discussed above.

Stuart Landsberg, FTI
Partner
PricewaterhouseCoopers

Christina Sahyoun
Director
PricewaterhouseCoopers

Angeline Young
Senior Manager
PricewaterhouseCoopers