

1 June 2018

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

By email: stapledstructures@treasury.gov.au

Dear Sir/Madam

Exposure Draft – Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018

1. Introduction

The Taxation Committee (**Committee**) of the Business Law Section of the Law Council of Australia is pleased to provide our comments on the exposure draft of *Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018 (Bill)* released on 17 May 2018.

In this letter, references to **paragraphs** are references to paragraphs of Schedule 1 of the *Taxation Administration Act 1953 (Cth)*, and references to **sections** are references to sections of the *Income Tax Assessment Act 1936 (Cth)* or the *Income Tax Assessment Act 1997 (Cth)* as relevant.

2. Executive Summary

2.1 We have comments and suggestions in relation to the following issues, each of which is discussed in detail below.

Sovereign immunity

- (a) transitional arrangements;
- (b) inclusions in taxable income;
- (c) aggregation of holdings by different sovereign entities;
- (d) sovereign entities – commercial activities; and
- (e) clarification of participation rights;

Stapled structures

- (f) calculation of portion of Managed Investment Trust (**MIT**) distribution attributable to rent;
- (g) capital gains arising on cross-staple disposal of assets;
- (h) deductions for cross staple rent payments;
- (i) clarification of term "economic infrastructure asset"; and
- (j) carve out from general anti-avoidance provisions.

3. Transitional arrangements for sovereign entities – definition of sovereign entity

- 3.1 Transitional arrangements apply if a sovereign entity acquired an asset on or before 27 March 2018, and on or before that date the Commissioner gave the sovereign entity a private ruling to the effect that the investment asset qualifies for sovereign immunity.
- 3.2 The potential issue is that the term *sovereign entity* is now defined in proposed section 880-55, but the term was not defined at the time any private ruling would have been granted, and therefore an entity with a private ruling may no longer qualify as a sovereign entity.
- 3.3 For example, private rulings conferring sovereign immunity status have been given to foreign government backed superannuation funds. Such funds would no longer qualify as sovereign entities, because a superannuation fund for foreign residents is specifically excluded from being a sovereign entity.
- 3.4 On a strict reading, such an entity would not qualify for transitional relief, because while it may have a private ruling, it is not a sovereign entity.
- 3.5 We submit that transitional relief was intended to apply to such entities, and the wording of the provisions should be amended to reflect this. Our drafting suggestion is this (relevant changes underlined):

Part 2 – Application and transitional provisions

4 Application

. . . (2) Despite sub item (1), the amendments made by this Schedule apply on or after 1 July 2026 in relation to an investment asset of an entity if:

- (a) the entity acquired the asset on or before 27 March 2018; and
- (b) on or before 27 March 2018, the Commissioner gave the entity a private ruling to the effect that the entity is a sovereign entity, and that the investment asset qualifies for sovereign immunity . . .

- 3.6 Similar drafting changes could be made to the remainder of the transitional provisions.

3.7 The definition of sovereign entity requires that the entity is not a "public financial corporation" nor a "public non-financial corporation". These terms are worked out by reference to the Australian Bureau of Statistics (**ABS**) concepts in Australian Government Finance Statistics. We submit that it would be better law design and would reduce compliance cost if there was a standalone definition in the tax legislation (which may be extracted from the current ABS concept) that does not link to the ABS concepts. This will give greater upfront certainty for sovereigns making investments that sovereign immunity is available and will not be subject to future changes made by the ABS in its concepts guide (which does not apply to foreign sovereigns *per se*).

4. Extended transitional arrangements for sovereign entities – requirement for ruling

4.1 Transitional relief granted to a sovereign entity can only be extended beyond 1 July 2026 where the entity has a private ruling that applies beyond 1 July 2026.

4.2 It is submitted that a "ruling" in this context should encompass other means by which the ATO had confirmed sovereign immunity status. For example, the Australian Taxation Office (**ATO**) has from time to time communicated sovereign immunity status by way of a letter.

4.3 It is also submitted that if an asset was held at 27 March 2018 by a sovereign entity, and was not covered by a ruling, but materially identical other assets were held by the entity and were not covered by a ruling, the asset should also be considered to be covered by a ruling. The reason for this submission is that where a ruling is expressed to cover only specifically identified assets, it was not uncommon for a sovereign entity which acquired materially identical assets after the date of the ruling to refrain from seeking a new or updated ruling, on the basis that similar assets held by the same entity should be taxed on a similar basis.

4.4 Finally, it is submitted that where there has been a restructure in a foreign country, so that the sovereign entity holding the asset at 27 March 2018 is not the same sovereign entity that obtained the ruling, the sovereign entity holder at 27 March 2018 should be treated as holding an asset covered by the ruling granted to the previous sovereign entity holder.

5. Transitional arrangements for sovereign entities – timing issue

5.1 Where transitional relief is granted to a sovereign entity, and relief is extended beyond 1 July 2026 because the entity has a private ruling that applies beyond 1 July 2026, the amendments are stated to come into effect on and after the day before the private ruling ceases to apply.

5.2 In our view, the amendments should come into effect on the day after the private ruling ceases to apply.

5.3 If a private ruling applied until the income year ended 30 June 2030, sovereign immunity should last until 30 June 2030, and the new rules should apply from 1 July 2030.

5.4 But the current wording would mean that the new regime applies from 29 June 2030, so that any income derived on 29 June or 30 June 2030 would be caught, which

would include year-end disposals, distributions, payments of interest, and potentially distributions of trust income for the entire year.

6. Sovereign entity's taxable income

- 6.1 Under proposed section 880-105(1)(e), a sovereign entity will be taxed on interest, dividends or trust distributions if the relevant debt interest, shares or units were acquired in the course of a *trading business* as defined in Division 6C of the *Income Tax Assessment Act 1936* (Cth).
- 6.2 There are two issues with this requirement.
- 6.3 The first is that investing or trading in such assets is *eligible investment business* as defined in Division 6C (refer paragraph (b) of the definition in section 102M), and is therefore excluded from the definition of *trading business* (defined in the same section)
- 6.4 The second issue is that even if the clause is replaced by one that removes the sovereign exemption for securities held for trading purposes or short term holding periods, the test is imprecise, in marked contrast to the other tests for sovereign immunity which are very clear. How will a sovereign entity, or a payer of a dividend or interest amount or trust distribution, know if the security has been purchased for trading purposes? In our view, it would be administratively easier, and reduce potential for disputes, if this test was removed.

7. Aggregation of sovereign holdings

- 7.1 In proposed section 880-105(1)(d), the total participation interests of the sovereign entity, and of any other sovereign entity of the same foreign country as the first sovereign entity, are aggregated to determine if the 10% limit has been breached.
- 7.2 Where a sovereign entity is an entity of a state or provincial government, rather than a national government, and another sovereign entity is an entity of another state or provincial government from the same country, it is submitted that it is not appropriate that the interests of the two entities are aggregated.
- 7.3 Each state or province has independent sovereign status, and aggregating the interests of an entity of one sovereign state with those of an entity of another sovereign state, if they both happen to be from the same country, seems arbitrary.
- 7.4 For example, sovereign immunity status has been granted to entities owned by state governments in the United States, and entities owned by provincial governments in Canada. It seems odd that two independent investments by two entities from separate state or provincial governments would be aggregated if they are both from the same country, but not aggregated if one is from the United States and one from Canada.
- 7.5 It is also submitted that even where there are two sovereign entities that are owned by the same national government, it is unfair to aggregate the holdings, where it can be demonstrated that the two entities run independently of each other, and are not acting in concert in securing a stake of in excess of 10%.

8. Sovereign entity – commercial activities

- 8.1 Under the previous administrative concession system, sovereign entities undertaking commercial activities did not qualify for the sovereign immunity exemption.
- 8.2 The current exposure draft provides at proposed paragraph 880-105(1)(c) that for income to be non-assessable non-exempt (**NANE**), the sovereign entity must derive, receive or make the amount from its holding of membership, debt, or non-share equity interests in the entity. This is generally in line with previous ATO guidance which provided that passive equity and debt investments did not constitute commercial activity.
- 8.3 However, the new legislation does not address whether a sovereign entity that is earning both income from commercial activities and income from passive investments will qualify for the exemption for the income from passive investments. Presumably, based on current drafting, the portion of income earned in relation to passive equity or debt investments will qualify as NANE (provided all the other conditions are satisfied). However, specific clarification, at least in the explanatory memorandum, would be welcomed.

9. Sovereign entity and offshore superannuation fund participation rights

(a) Deemed 10% interest

- 9.2 A sovereign entity (and an offshore superannuation fund) will be deemed to have a 10% stake in a company or trust where the investor has certain rights to vote, participate in key decisions, or deal with assets, of the investee company or trust.
- 9.3 The current drafting of the proposed relevant sections is particularly broad and may capture a number of unintended situations. We draw attention to the following underlined phrases:
- (i) . . . vote at a meeting of the Board of Directors (or other governing body) of the second entity . . .
 - (ii) . . . participate in making financial, operating and policy decisions in respect of the second entity . . .
 - (iii) . . . deal with the assets of the second entity

- 9.4 Without further clarification, the above phrases could have the effect of:

- (a) capturing entities who are able to vote at meetings of bodies which are merely advisory bodies, rather than bodies which have any control over the entity;
- (b) capturing entities with positions on boards even where the position does not provide enough votes or influence to obtain real control over the financial, operating and policy decisions of the entity; and
- (c) capturing investors who hold standard commercial creditor's rights to deal with assets under certain circumstances. For example, it is not uncommon for debt holders to require consent before a significant transaction (e.g., disposal

of material asset) takes place. How does such rights fit within the above definition?

- 9.5 The deeming rules appear to be based on the 2011 Proposals Paper for “*Options to codify the tax treatment of sovereign investments*” (**Sovereign Paper**). The provisions as set out in the Sovereign Paper were not intended to apply in respect of equity investments. Instead the 10% limit itself was considered to be an appropriate indicator of a passive versus non-passive investment and “*eliminates the need for any facts-and-circumstances considerations*”. The application of section 128B(3CB) and section 880-105(2) (in particular paragraphs (b)(ii)) add the uncertainty of the facts-and-circumstances investigation that will now be required for what is likely to be little benefit.
- 9.6 From a commercial perspective it is difficult to see what form of influence a sub 10% investment could provide the offshore superannuation fund or sovereign entity in practice where their voting and economic rights are restricted at that level. Even if the offshore superannuation fund or sovereign entity is allowed input in particular matters it is difficult to see why the nature of such limited input should preclude the availability of the exemption.
- 9.7 Furthermore, in the context of many Australian funds there are standard investor protections including rights to sit on investor committees or vote on certain material matters. The fact that a minority investor who has a less than 10% interest in a fund should have those protections or rights should not automatically mean that they should be deemed to have a non-portfolio interest in the relevant fund. This is further accentuated by the requirement to test the relevant interest at the fund level which pays no regard to the nature of any underlying interests that the fund may have in the underlying entity that makes the payment of the relevant interest or dividends.
- 9.8 Further clarification of and consideration of the need for the above sections would be welcomed.
- (b) *Level of testing for participation interest*
- 9.9 New section 128B(3CA) requires that the participation interest of the foreign superannuation fund is tested in the entity from which the relevant fund derived the relevant income. From a policy perspective it would seem that this interest should be tested at the level of the entity that originated the payment of the interest or dividend and not at the level of the first entry point into Australia (a look-through basis). This is because it could lead to anomalous outcomes in certain circumstances, particularly in a fund context. For example, in situations where a foreign superannuation fund (or sovereign entity) might have directly made a loan to an Australian entity and have no participation interest in that entity (and absent any of the rights set out in section 128B(3CB)(b)) it would be expected that interest paid under such arrangement would be eligible for the exemption. However, if the foreign superannuation fund (or sovereign entity) instead invested in an Australian debt fund that made loans to Australian entities (in circumstances where the Australian debt fund did not have a participation interest in any of those entities), and the foreign fund held a 10% or greater interest in that Australian debt fund, then such payments would not be exempt.
- 9.10 Adopting such an approach will therefore create a significant disincentive for foreign superannuation funds and sovereign entities to use Australian asset managers or invest into Australian assets via Australian funds.

10. Economic infrastructure asset definition

- 10.1 The proposed definition of *economic infrastructure asset* proposed to be inserted in section 995-1 relies on the concept of infrastructure being used for *public purposes*.
- 10.2 The Explanatory Memorandum (**EM**) currently does not provide a definition of the phrase *public purposes*, but instead provides examples of public purposes, which refers to availability for use by the public, provision of services to the public, or use for transport of goods for public use or sale. The list is non-exhaustive and broad, leading to significant uncertainty. For example, it would seem, from the Explanatory Memorandum, that a road or rail link on private property that is used to transport goods to a port is not for public purposes, but the port that loads the same goods is for public purposes. Further definition of this phrase would therefore be useful.
- 10.3 Further to the above, the approval process for *economic infrastructure assets* provided for in the proposed subsection 12-450(3) requires approval of assets yet to be built, and *substantial improvements to existing assets*. Further clarification of what constitutes a substantial improvement as opposed to, for example, modification or maintenance, should be clarified.

Use of the term "asset" in drafting

- 10.4 The reliance on the term "asset" for the purposes of the operative provisions itself also provides some uncertainty. In particular, many arrangements are made up by a combination of assets which will naturally be added to over time. We also note that the difficulties in relying on a single concept of asset are evident in draft taxation ruling TR 2017/D1 which considered issues such as whether composite assets were single or separate assets and the effect of modifications. The draft ruling refers to comments that in many cases it will simply be left to a taxpayer to make judgement calls.
- 10.5 Defining the term asset by reference to groups of assets that operate in an integrated manner rather than requiring a separate examination and identification of specific assets would provide more clarity i.e. defining by reference to groups of assets that operate in an integrated manner.

11. Attribution of fund payments to non-concessional MIT income

- 11.1 Proposed paragraph 12-435 provides that the extent to which a fund payment made by a MIT is attributable to non-concessional MIT income is, in the case of a non-Attribution Management Investment Trust (**AMIT**), so much of the net income of the MIT as is attributable to non-concessional MIT income.
- 11.2 This wording may not achieve its intended purpose.
- 11.3 We would recommend replacing the words "*so much of the net income of the MIT*" with "*so much of the share of the net income of the MIT that is distributed to the recipient of the fund payment*".

12. Capital gains from cross-staple transactions

- 12.1 Currently, the definition of *non-concessional MIT income* in subsection paragraph 12-440(1) captures gains from the transfer of Capital Gains Tax (**CGT**) assets across

a staple (with an exception for assets that are not *taxable Australian property* in paragraph 12-405).

- 12.2 It is common for a property trust to subdivide and transfer a portion of land to the company side of a staple for development to ensure that the property trust does not become subject to Division 6C. We do not consider that a cross-staple transfer of CGT assets will generally convert '*active business income into passive income*', and as such, should not be included in the definition of *non-concessional MIT income*.
- 12.3 We have not been able to identify any integrity concerns that would arise from such an exception. However, as a 'safety net', the definition of *non-concessional MIT income* could specifically cover any amount received from the disposal of a CGT asset where that amount is received, either directly or indirectly, from an entity other than the *asset entity* or *operating entity*.

13. Timing of deduction for rent

- 13.1 Proposed section 12-453 provides that an operating entity in a cross staple arrangement is entitled to a deduction for rent in an income year if a stapled asset entity derives or receives the amount of rent in the same income year, provided the rent was otherwise deductible, and provided each stapled entity has made a choice in writing.
- 13.2 There are three issues with this paragraph that need to be resolved:
- (a) Is it intended that the deduction for rent otherwise allowable under section 8-1 is disallowed unless paragraph 12-453 is complied with? If so, it is not clear how this is achieved.
 - (b) If the recipient of the rent derives the rent in a different income year to the year the rent is received (e.g. the recipient is an accruals basis taxpayer and rent is accrued but not received as at 30 June) in which year is a deduction available to the payer of the rent?
 - (c) What is the purpose of the choice? Is it a choice to claim a deduction?

14. Carve out of general anti-avoidance provisions

- 14.1 In the Integrity Package announced by the Treasurer before the release of the draft legislation, it was stated that the provisions of Part IVA would not apply where a taxpayer has chosen a stapled structure in order to obtain a deduction in respect of cross staple rent during the transition period.
15. It appears that new section 12-453 has been drafted to achieve this outcome by providing an express choice to taxpayers, allowing them to fall within the exceptions to tax benefits provided in subsection 177C(2). However, this drafting may not be sufficient to achieve the objective of "switching off" the application of Part IVA in respect to the choice of a stapled structure.
16. There is, however, significant uncertainty relating to the existing operation of section 177C(2) - in particular the two conditions that must be satisfied to access this exception. The second of these conditions is that the scheme was not entered into for the purposes of creating the necessary state of affairs to allow access to the

particular choice, election etc. There are a series of cases which highlight this being a key issue of debate and contention.

17. It would give taxpayers greater certainty as to the operation of the transitional arrangements if the non-applicability of Part IVA was enshrined in legislation. In particular, if it were amended to provide that the establishment and use of an Asset Entity and Operating Entity in a cross-staple arrangement the subject of the relevant election, insofar as it relates to cross-staple payments, cannot be subject to a Part IVA determination by the Commissioner. This protection should be provided for arrangements both within and outside of the transitional provisions.

18. Explanatory memorandum – minor error

- 18.1 Paragraph 1.73 of the EM refers to an asset which is not an economic infrastructure asset. In fact, the paragraph is applicable to an asset which is an economic infrastructure asset.

Thank you for the opportunity to provide this submission.

Please contact Clint Harding, Chairman of the Taxation Committee of the Business Law Section on (02) 9226 7236 or charding@abl.com.au, in the first instance should you have any queries.

Yours sincerely



Rebecca Maslen-Stannage
Chair, Business Law Section