TaxTalk—Insights
Corporate Tax

Stapled structures and foreign investor measures - the final step of the journey is near

26 September 2018

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In brief

On 20 September 2018*, Treasury Laws Amendment (Making Sure Foreign Investors 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.

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 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 will impact the commercial and financial outcomes for investors in Australian infrastructure, real estate (including residential property and student accommodation) and agricultural sectors, and not just those who invest in stapled arrangements.

In detail

The measures that are now before Parliament (*Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* and consequential Bills) give effect to the proposed integrity measures for stapled structures that were previously announced on 27 March 2018 and follow a period of consultation. Most recently, on 26 July 2018, Treasury released the second stage of exposure draft legislation and explanatory material (as discussed in our previous TaxTalk Alerts of 18 May 2018 and 31 July 2018). On 7 August 2018, Treasury released exposure draft legislation and explanatory material dealing with additional integrity measures to apply to stapled entities that elect into the transitional arrangements or seek access to the infrastructure concession.

The Bill 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.

What's changed and what's new?

MIT agricultural income

The Bill broadly follows the exposure draft's blueprint for dealing with agricultural land held by MITs. Essentially, the Bill sets out that income (and capital gains) from agricultural land will be non-concessional MIT income, and then sets out certain transitional arrangements that may apply to existing investments so that income from assets held (or contracted) before 27 March 2018 can continue to be concessionally taxed until 1 July 2026.

In relation to the treatment of MIT agricultural income, the changes made to the exposure draft fall into three broad categories:

1. definition of 'Australian agricultural land'
2. transitional arrangements - particularly as they apply to indirect holdings; and
3. treatment of indirect capital gains relating to Australian agricultural land.

The changes to the definition of 'Australian agricultural land' and to the transitional arrangements are reviewed immediately below, with the changes to the treatment of indirect capital gains (which are also relevant to residential housing income) considered later in this alert.

The definition of 'Australian agricultural land' was changed with the introduction of some new concepts and the refinement of certain matters which the exposure draft had left uncertain.

The definition of *Australian agricultural land for rent* still turns on the concepts of:

- whether the asset is used, or could reasonably be used, for carrying on a primary production business; and
- whether the asset is held primarily for the purposes of deriving or receiving rent.

However, the concept of the relevant 'asset' to which these tests apply is modified.

Broadly, while the exposure draft used the concept of 'real property' as the building block of the definition of *Australian agricultural land for rent,* the Bill introduces a new defined term, *Division 6C land* in place of the common law term 'real property'. This change appears to extend the definition of *Australian agricultural land for rent* by including certain moveable property, which would be taken to be land under section 102MB of the *Income Tax Assessment Act 1936*. Moveable property would not generally be real property and therefore would not have been included within the definition included in the exposure draft.

The other change to this definition, which would likely be welcomed by taxpayers, is the introduction of an ordering rule between the *economic infrastructure facility* concept and the concept of *Australian agricultural land for rent*.

This ordering rule was required because:

- the common law definition of land includes fixtures (such as economic infrastructure facilities), and
- land can be '*agricultural land'* if it '*could reasonably be used for carrying on a primary production business'* - even if the land is not actually used for that purpose, and, for example, was instead used to hold an economic infrastructure facility. For example a wind farm located on land capable of being used for agricultural purposes.

The ordering rule helpfully stipulates that, if an *economic infrastructure facility* is a fixture on *Australian agricultural land for rent,* one should treat the economic infrastructure facility as being separate from the land, and treat the facility as **not** being *Australian agricultural land for rent*. This ordering should generally be welcomed by taxpayers as the agricultural provisions are generally more detrimental in their application. This clarification should mean that that economic infrastructure facilities built on agricultural land,(eg in the the renewable energy sector), may now be able to access the 15 year transition period (rather than the seven-year period) and may be eligible to apply for the go forward economic infrastructure concession.

The transitional rules have also been modified from the exposure draft - generally in ways which would be welcomed by taxpayers. As well as certain stylistic changes which improve the efficacy of the transitional measures, the key substantive changes to the transitional arrangements relate to:

- when the MIT acquired the relevant asset, and
- income derived by a MIT indirectly through a second entity.

In respect of the first of these changes, the transitional arrangements in the exposure draft only applied where the MIT (or another entity, for the purposes of the indirect income rules) *held the asset* before 27 March 2018. This was stricter than the transitional arrangements for cross-staple income in the exposure draft - those measures looked to whether a contract had been entered into, or the asset was held. The Bill clarifies that the transitional arrangements for *MIT agricultural income* will apply where the MIT (or second entity) *'held the asset'* **or** *'entered into a contract for the acquisition or lease of the asset'* before 27 March 2018. This is a welcomed change that appears to correct an unintended error.

The second of these changes also corrects what would otherwise have been an unintended outcome in respect of income derived by a MIT indirectly by way of a second entity. The exposure draft applied so that the transitional arrangements would be available for income derived, received or made by a MIT because another entity held the asset (i.e. the *Australian agricultural land for rent*) through the transitional period (i.e. from 27 March 2018 to when the other entity derived, received or made the other amount) only if the MIT held a total participation interest of 100 per cent throughout that period. This drafting unduly prejudiced MITs which had invested in agricultural land other than through 100 per cent ownership - including, for example, investors which had invested via a joint venture with Australian farmers.

Fortunately, the Bill corrects this issue. The transitional arrangements now operate so that where a MIT derives, receives, or makes an amount because another entity (the second entity) held the relevant asset, then the transitional arrangements should be available provided that:

- the second entity held the asset (or entered into a contract for the acquisition or lease of the asset) just before 27 March 2018, and
- immediately before 27 March 2018, the MIT held a total participation interest of greater than nil in the second entity.

If those conditions are satisfied, then the MIT should be able to avail itself of the transitional arrangements to the extent of its pre-27 March 2018 total participation interest. This is a welcome and sensible change made to the exposure draft.

MIT residential housing income

Similar to the approach taken for agricultural land, the Bill broadly follows the exposure draft's approach to dealing with residential land held by MITs, with a few key changes. In relation to the treatment of MIT residential housing income, the changes made to the exposure draft fall into the following categories:

1. introduction of the definition of 'residential dwelling asset' which includes premises used primarily to provide accommodation for students
2. new transitional arrangements applying to student accommodation, resulting in dual transition dates for MIT residential housing income, and

3. treatment of indirect capital gains relating to Australian residential dwelling assets (discussed separately below).

The Bill defines MIT residential housing income as any assessable income of a MIT that is attributable to a 'residential dwelling asset'. While the concept of a ‘residential dwelling asset’ is new, all assets captured under the second tranche of the exposure draft legislation released on 26 July 2018 continue to form part of the new definition. However, the key change is that the definition of a 'residential dwelling asset' now specifically includes an asset that is *premises used primarily to provide accommodation for students (other than in connection with a school (*within the meaning of the *A New Tax System (Goods and Services Tax) Act 1999).*

This 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 the Bill was introduced into Parliament (i.e. 20 September 2018), this is expected to have an immediate impact on foreign institutional investors investing in Australian university housing projects.

Importantly, as MIT residential housing income includes all amounts of assessable income of a MIT that are *attributable to* residential dwelling assets (including rent, capital gains and licence fees), a MIT may have MIT residential housing income even where the MIT itself does not hold a residential dwelling asset (either directly or indirectly), but where amounts of its assessable income are *attributable to* residential dwelling assets.

The continued use of the term ‘attributable to’ in the Bill reaffirms the policy intention that assessable income derived from a wide range of arrangements that may involve residential dwelling assets (including student accommodation) will constitute non-concessional MIT income (e.g. certain financial arrangements). In providing further clarification to this, the Explanatory Memorandum to the Bill notes that MIT residential housing income can also include income from derivative arrangements, such as an acquisition of a rental income stream derived from residential housing. Returns in the nature of interest should however continue to be excluded from non-concessional MIT income as they should not be considered as fund payments.

Transitional measures for MIT residential housing income

The MIT residential housing measures apply to fund payments made by a 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 MIT residential housing transitional income rules effectively provide a ten-year transition period if, among other things:

- the relevant amount is included in the assessable income of the MIT
- the relevant amount would be MIT residential housing income of the MIT disregarding this transitional rule because it is attributable to a facility that consists of, or contains, a residential dwelling asset
  the MIT (directly or indirectly through any participation interest in another trust) either held, or had entered a contract for the acquisition / creation of a facility that contains a dwelling prior to the relevant transition; and
- the MIT derived, received or made the relevant amount before 1 October 2027.

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).

Similar to the changes made for transitional rules in respect of MIT agricultural income, there are a number of changes made by the Bill as compared to the exposure draft concerning the transitional arrangements.

Firstly, the transitional arrangements in the exposure draft only applied where the MIT (or another entity, for the purposes of the indirect income rules) *held the asset* before the transition date. This has now been broadened to align with the transitional rules in other parts of the Bill which ensure that assets held *or contracted for* prior to the transition date will get relief. In addition, the law now applies to a 'facility' that contains residential dwelling assets - this change could allow improvements or expansions to the 'facility' after the transition date to access the rules.

A second change also corrects an anomaly that would otherwise have arisen in respect of income derived by a MIT indirectly by way of a second entity. The exposure draft applied so that the transitional arrangements would be available for income derived, received or made by a MIT because another entity held the asset through the transitional period (i.e. from 27 March 2018 to when the other entity derived, received or made the other amount), only if the MIT held a total participation interest of 100 per cent throughout that period. The new rules allow MITs to access the transitional rule to the extent it held *any* participation interest.

However, 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 in and of itself. As a result, the higher MIT withholding tax rate at the corporate tax rate should apply to these assets as soon as these new buildings are tenanted.

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

MIT agricultural income and MIT residential housing income - Capital gains from membership interests

The treatment of capital gains in relation to both residential dwelling assets and Australian agricultural land for rent remain consistent with the exposure draft legislation (i.e. 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 on one 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 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 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 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 per cent (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.

Where 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.

Foreign superannuation fund exemption

The Bill includes certain changes from the exposure draft regarding the modification of the foreign superannuation fund withholding tax exemption. These changes generally clarify the operation of the exemption, rather than changing its substance, and are therefore relatively non-controversial.

The Bill modifies the exemption from withholding tax for foreign pension funds by inserting section 128B(3CA) of the *Income Tax Assessment Act 1936* 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 per cent 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, and
- 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 Subdivision 880-C of the *Income Tax Assessment Act 1997* (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 (i.e. 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 (e.g. 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. We 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 (i.e. because the superannuation fund is a covered superannuation fund).

Sovereign immunity

In codifying the tax treatment for sovereign wealth funds, 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 monies) that *all returns* on the entity's investments are public monies. The practical application of this test will be critical for many sovereign wealth funds.
- 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 monies requirement discussed above.

Next steps

Debate on the Bill will commence when Parliament resumes in mid-October. The Bill has also been referred to a Senate Economics Legislation Committee for report by 9 November 2018.

In anticipation of the Bill being passed, PwC is liaising with the Australian Taxation Office on potential guidance that is required to assist impacted taxpayers implement the new measures.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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WL1270577