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TAX BRIEF

21 May 2018

Stapled Structures – Impact of proposed integrity measures on real estate groups

On 17 May 2018, Treasury released draft legislation (**ED**) to give effect to the March 2018 announcement of a package of integrity measures aimed primarily at stapled groups. The announced measures, discussed in an earlier Tax Brief related to:

- imposition of a 30% managed investment trust withholding rate to distribution of certain income from cross staple arrangements;
- restricting the sovereign immunity and foreign superannuation fund withholding tax exemptions to payments by entities in which the non-resident has a less than 10% interest;
- requiring thin capitalisation to be calculated on a look through basis for interests of 10% or greater (rather than 50% or greater); and
- limiting the tax concessions available to managed investment trusts holding agricultural land.

We have considered below how the measures in the ED will apply to the real estate sector.

Cross staple arrangements

The March announcement reflected a concern by the Government that certain land-rich businesses were being split into a land holding entity and an operating entity, with the relevant land leased to the operating entity. The land owning entity would be structured as a managed investment trust, which would entitle both resident and non-resident investors to access concessional tax treatment. The Government has concluded that, at least for non-residents, income derived from such cross staple arrangements should be subject to the full corporate rate of tax.

To give effect to this intention, net income derived by MITs from operating entities within a stapled group will generally be subject to 30% withholding tax when distributed to non-residents. This will exclude:

- amounts subject to other types of withholding (e.g., dividends, interest and royalties); and
- amounts not subject to MIT withholding (e.g., foreign source income).

As currently drafted, the ED would impose the 30% withholding rate on capital gains made by a MIT from sales of Australian real property assets to a stapled operating entity. It is not clear that this is intended given that such amounts do not represent active income that has been “converted” to passive income through a cross-staple payment.

The key matters of detail set out in the ED are:

- a stapled group will be any two or more entities with at least 80% common ownership. It is not necessary that there be a formal stapling arrangement
- there is an exclusion from the new measure for groups with de minimis cross staple dealings. This will be limited to entities with less than 5% of their gross assessable income from cross staple arrangements. In applying this test:
  - the calculation must be performed by reference to the prior year's income;
  - the calculation must be performed on an entity by entity basis. If one sub-trust in a group fails the 5% test, the income from that sub-trust will be tagged with a 30% rate as it flows through the structure;
  - the calculation generally takes into account all cross staple income (i.e., including interest); and
  - the calculation excludes capital gains from the gross income of the trust (i.e., the denominator) but does not appear to exclude Australian real property capital gains from cross staple dealings (i.e., the numerator).
- There is an exclusion for cross-staple rental payments that are themselves funded by rent where the operating entity: (a) leases land to a third party; and (b) the cross-staple rental payment does not exceed the underlying rental component from that third party. This should mean that many student accommodation staples will not be materially impacted by these measures provided that the underlying arrangements with students are genuine leases. Hotel staples however will be subject to these new measures as most of their income from third parties is a licence fee rather than rent.

Although interest is taken into account in applying the 5% de minimis test, the rate of withholding applied to interest will remain at 10% even if the de minimis test is failed.

Aside from cross staple arrangements, the ED also proposes that a 30% withholding rate applies to income derived through non-controlling interests in trading trusts or trading partnerships. This measure is aimed at structures in which several MITs hold non-controlling interests in a trust that conducts an active business (but is not a public unit trust and so Division 6C does not apply). Unlike the changes for sovereign immunity and foreign superannuation funds discussed below, this measure applies even if the interest is less than 10%.

The other key area of detail covered in the ED is the transitional rules. The basic commencement date for the measures is 1 July 2019 (i.e., they apply to payments after that date). However:

- for existing income producing assets, transitional protection will be available for 7 years (15 years for certain infrastructure arrangements) provided that:
  - the relevant stapled entities existed at 27 March 2018;
  - the relevant asset was acquired under a contract entered into before 27 March 2018; and
  - it is reasonable to conclude that a cross staple lease will be entered into in respect of the asset.

  Although the ED is not drafted clearly on this point, it would seem intended that the measure will cover both leases that existed at 27 March 2018 and renewals of such leases provided that it is reasonable to conclude that the renewal will occur. Clarification will be sought on this matter from Treasury.

- for assets that have yet to produce income transitional protection will be available for 7 years from the date that income commences to be derived or 1 July 2031, whichever occurs first (up to 15 years/1 July 2039 for certain infrastructure arrangements).

The transitional measures will only apply where an irrevocable election is made by 30 June 2020.

Somewhat unfortunately, the transitional provisions apply by reference to dates that distributions are made by a trust. This means that an investor could be subject to two different withholding tax rates in respect of the one income year.

Sovereign immunity and foreign superannuation fund measures

The exclusion from the foreign superannuation concession will apply where the entity has a 10% or greater interest:

- at the time the payment is made; or
- for a 12 month period in the 24 month period prior to the payment.

An entity will be deemed to have a 10% or greater interest if it has a debt or equity interest that confers a right to vote at a meeting of the Board of Directors, to participate in making financial, operating and policy decisions in respect of the second entity or to deal with assets of the second entity.

The transitional rule for this measure (providing protection to 1 July 2026) will apply to interests held by the relevant superannuation fund before 27 March 2018. That is, an instrument loses its protection if it is transferred to a new superannuation fund.

In respect of sovereign immunity, the ED proposes a wholesale codification of the concept with all sovereign entities (as defined) made subject to Australian income tax with certain types of income specified to be non-assessable non-exempt. The scope of NANE investments is broadly:

- the sovereign entity must have an interest of less than 10% (using the same test as for foreign superannuation funds);
- investments must not be acquired in the course of a trading business (it is not clear whether a trading business taints all investments made by the sovereign entity, or just the ones connected with the trading business);
- for investments in trusts, the trust must be a managed investment trust; and
- for investments in managed investment trusts, it would seem that the distribution by the trust is not otherwise subject to the new 30% rate for cross staple income, but this is unclear.

The basic start date for the sovereign immunity changes is 1 July 2019, but there is an extended transitional period for sovereign entities that had a private ruling in respect of their investment before 27 March 2018. The new rules do not apply to such entities until 1 July 2026 or the expiry of the private ruling.

There are certain market value cost base deeming rules for assets currently subject to a private ruling on sovereign immunity that become taxable under the new measures.

Thin capitalisation

The changes to the thin capitalisation measures expand the concepts of associate entity debt and associate entity equity to apply to interests in trusts and partnerships of 10% or more. This requires the gearing of the trust to be taken into account in determining the thin capitalisation position of the 10%+ unitholder.

The measures do not:

- make the trust an associate entity of the 10%+ investor generally (so an investor will not become an outward investor merely because the trust is an outward investor); and
- apply to interests in companies or public trading trusts.

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