

Stapled Structures

Integrity Measures Proposal Paper

June 2018



Treasury has released a consultation paper setting out proposed integrity rules for stapled structures eligible for transitional relief under the stapled structure exposure draft legislation (Integrity Proposal). These rules will impose additional conditions on pricing cross staple rent during the transitional period to prevent aggressive pricing. The consultation period ends on 12 July 2018. Should you wish to participate in the consultation, please contact a KPMG adviser listed below as soon as possible.

Overview

The Government previously released exposure draft legislation and explanatory material to address perceived imbalances in the way the Australian tax system taxes foreign investors.

Under the proposed tax changes, the concessional MIT withholding tax rates on cross-staple rental arrangements will continue to be available for transitional periods of:

1. 7 years for existing projects; and
2. 15 years for economic infrastructure assets.

Summary

Importantly, the general anti-avoidance rules will not apply in respect of a choice of a stapled structure to obtain a deduction on cross staple rent for the transitional period.

The Government has now released a Consultation Paper on the measures to prevent projects from adopting aggressive crossstaple pricing during the transitional period. The key aspects include:

1. All cross-staple arrangements eligible for the transitional measures will continue to be subject to the MIT non-arm's length income rule (**NALIR**).
2. Those projects subject to the 7 year transition will not have further safeguards imposed. However, the Paper highlights the importance of obtaining appropriate evidence to support the fact that the pricing is arm's length.
3. Projects eligible for the 15 year transitional relief will have a further cap on the rent eligible for the 15% MIT withholding tax rate, being either:
 - a. For existing arrangements using an objective methodology to set rent, that amount; and
 - b. For other projects, the additional cap is that the taxable profit of the Asset Trust cannot exceed 80% of the taxable profit for the project.

Please advise your KPMG contact of any issues that you would like raised during the process, as KPMG will be part of the consultation process.

Preventing aggressive cross-staple rental pricing

The Integrity Proposal seeks to prevent projects adopting aggressive cross-staple pricing eligible for transitional relief, and attempts to minimise impacts on commercial arrangements, by taxing excessive amounts at the 30% MIT withholding tax rate. What is considered an excessive amount of rent will depend on the type of transitional relief a project has access to.

Projects with access to the seven year transition rule

The Integrity Proposal states that as there should be sufficient comparable third party transactions for these projects (including property and agriculture staples). For this reason, the NALIR alone is considered sufficient to prevent aggressive cross-staple pricing for the seven year transition period.

Minor technical adjustments to the NALIR will be made to ensure it will apply to MITs subsequently acquiring an interest in crossstaple arrangements.

The NALIR is already operative for existing MITs and AMITs being:

1. For MIT arrangements existing prior to 1 July 2016, from the start of the 2018-19 income year; and
2. From 1 July 2016, for MITs established on or after this time.

The NALIR is therefore applicable before the transitional measures take effect on 1 July 2019, if the staples integrity legislation is enacted.

The Consultation Paper highlights the need to reference publicly available third party arrangements to support the pricing of specific projects. The adequacy of the supporting documentation is likely to be a compliance focus of the ATO when reviewing these MITs. This reflects the recent emphasis in transfer pricing of maintaining detailed evidence of comparable transactions or arrangements.

For many sectors, the ability to benchmark against comparable third party transactions may prove difficult. It is important to consider the comparability of benchmark transactions identified to the facts of a particular MIT and to review existing documentation prepared to support pricing decisions. If possible, we would recommend that projects analyse pricing decisions using more than one approach, to strengthen the support for the cross staple rental calculation method selected.

It remains to be seen whether these changes will attract technical guidance in relation to cross-staple rental pricing from the ATO, as has been released in relation to inter-entity debt pricing in PCG 2017/4.

Economic infrastructure projects

For economic infrastructure staples, the NALIR on its own is considered insufficient to safeguard against aggressive crossstaple pricing due to the lack of readily identifiable third party comparable transactions. Accordingly, the additional caps will need to be met for these projects in addition to the NALIR, to access the concessional MIT withholding rate during the transitional period.

The Paper highlights the difficulty of identifying comparable third party data for economic infrastructure in applying the NALIR for economic infrastructure projects. If market data is not available at a holistic level, projects should considering analysing whether elements of the transaction can be isolated and benchmarked so as to show that one or more key components are commercial.

Maintain existing arrangements

Projects with arrangements in place prior to 27 March 2018 will be eligible for the 15% MIT rate during the transition period where the rent is less than an arm's length amount and:

1. The cross staple rent is determined under a rent calculation methodology and that rent calculation methodology continues to be applied after that date. If the methodology changes, the 15% MIT rate will be capped based on the rent calculation methodology as at 27 March; or
2. For projects with no pre-existing rent methodology, but with an established fixed rent amount, an annual CPI increase to the fixed rent will be permissible noting the statutory cap.

A rent review process will not allow a project to increase the rental amount by changing the calculation methodology unless the methodology was already contemplated. It is unclear whether a market rent review process which forms part of an existing arrangement will constitute a rent methodology that may support a rental increase as a fixed rent amount, or a methodology subject to specified criteria.

If the components of distributable income includes rent that is taxed at both the 15% and 30% MIT rates, expenses will be first allocated to rent taxed at 15%.

Statutory cap

This methodology applies to projects eligible for transitional relief but without a lease or established rental methodology at 27 March 2018 and infrastructure is declared to be new economic infrastructure.

Broadly, the calculation is intended to result in the asset entity having no more than 80% of the project's current taxable income allocated to it (prior to applying any carry forward losses). If the cross-staple rent exceeds this amount, it will be treated as non-concessional MIT income and be subject to withholding at a rate of 30%.

Projects that are subject to the statutory cap will also remain subject to the NALIR.

Practically, for many new economic infrastructure projects in the early development stage, the amount of cross-staple rent will be limited by the NALIR while the project is in taxable losses, even though the statutory cap may permit a different level of rent in accordance with the statutory method statement.

Questions for further consideration

7 Year transition

1. Where third party comparables exist, are there sufficient publicly available transactions to benchmark?
2. Does comparable data availability vary between sectors?
3. When looking to benchmark transactions, what are the key indicia?

15 year transition

1. What is an objective methodology to set rent?
 - a. Will a rental calculation based on a formula always represent an 'objective methodology'?
 - b. If not, in what circumstances will it not represent an 'objective methodology'?
2. Where documentation used to set the rent does not form part of the lease:
 - a. Does there need to be evidence that this methodology was to be applied for the whole lease?
 - b. Can this assumption be made if there is a market rent review clause in the lease?
3. NALIR applies first and then the additional cap. In relation to the NALIR:
 - a. How does Treasury see NALIR working if there is insufficient available benchmarks?
 - b. In relation to the 7 year transition, the need to identify comparable Australian market pricing is highlighted. What is the position in relation to infrastructure assets?
 - c. Does the approach vary depending on the class of infrastructure assets?
4. What happens if there is a subsequent amendment to the taxable income? Presumably, that will amend the cap and so could result in consequential amendments?

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