Regulation Impact Statement

1. This Regulation Impact Statement covers the package of measures in Schedules 1 to 5 in Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018.

Background

2. Corporate income tax is currently levied at a rate of 30 per cent for companies with turnover of $25 million or more. Australia relies more heavily on corporate income tax than most other countries. In 2013, Australia's corporate taxation was 4.9 per cent of gross domestic product (GDP), while the Organisation for Economic Co-operation and Development (OECD) average was 2.9 per cent. A relatively heavy reliance on corporate tax has been a consistent feature of our tax system over several decades.

3. Where a foreign investor carries on a business in Australia itself or invests in an Australian business, that activity will typically be run through a company structure with the company subject to corporate income tax on its profits (regardless of whether the business is run directly by the foreign company or through an Australian subsidiary company). Dividends paid by an Australian company to foreign shareholders will not be subject to dividend withholding tax to the extent that the dividends are paid out of the company's taxed profits (i.e. fully franked dividends). Overall, foreign equity investment is typically subject to tax in Australia at a headline rate of 30 per cent.

4. Unlike companies, Australian trusts are generally taxed on a 'flow-through' basis. This means that there is no tax payable at the level of the trust. Rather, the beneficiaries of the trust are taxed on the trust income. For example, if a foreign investor is a beneficiary of a trust which earns Australian business income, the trust itself is not subject to tax but the trustee will generally be required to withhold tax at a rate of 30 per cent on behalf of the foreign investor (assuming the foreign investor is a company).[1]

5. While generally foreigners are subject to tax at 30 per cent on business profits, not all returns on foreign investment in Australia are taxed at the corporate income tax rate.

   5.1. Where a foreign investor invests through a managed investment trust (MIT), a lower 15 per cent withholding tax rate is available provided certain conditions are

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1. An exception to this is where the trust is a 'public trading trust'. These rules seek to prevent large, widely held businesses running trading businesses through a trust. In this case, if the trust carries on a trading business and is 'public' (that is, widely held), the trust is taxed like a company.

met. This rate applies to rental income and some financial services income. This concessional tax regime was announced in 2008 and was aimed at making the Australian funds management industry more internationally competitive.

5.2. Where a foreign investor loans money to an Australian business, the returns on that investment – the interest payments – can be claimed by the Australian company as a deductible expense. The foreign investor is typically subject to interest withholding tax of 10 per cent, unless reduced under a bilateral tax treaty or domestic exemption. For example, many foreign pension funds enjoy an exemption from interest withholding tax.

5.3. Where a foreign investor derives royalty income, (.that is, which are fees paid for the use of intellectual property), Australia generally charges 30 per cent royalty withholding tax. However, many of Australia's bilateral tax treaties reduce this rate.

6. In addition, foreign government investors enjoy a general exemption from tax where the investor is not acting in a commercial capacity. In practice, this can mean a sovereign wealth fund with an ownership interest of up to 20 per cent (or possibly more) can in some cases be exempt from interest and dividend withholding taxes, capital gains tax and tax on trust distributions (there is no exemption from company tax). While there is currently no legislative basis for this exemption, the Australian Taxation Office (ATO) administers this exemption on the basis of the international law doctrine of sovereign immunity.

7. This multiplicity of different tax rates, together with Australia's relatively high corporate tax rate, has seen a rise in tax structuring focused on converting active trading income (that would normally be taxed at 30 per cent) into interest, rent and other concessionally taxed forms of 'passive' income. The 'stapled structure' is one such arrangement.

1. The problem

Stapled structures that create integrity concerns

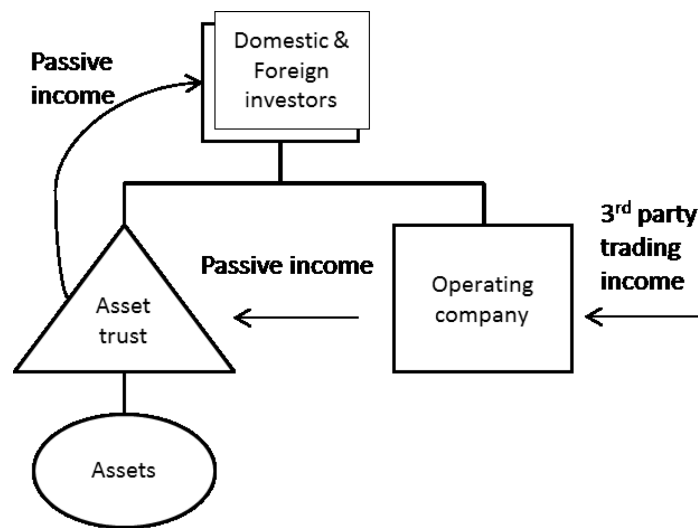
8. A stapled structure is a specific type of arrangement where two or more entities that are commonly owned (one of which is usually a trust) are legally bound together, such that they cannot be bought or sold separately. Stapled structures create integrity concerns where they are used to fragment an integrated trading business so that a portion of the business profits can access concessional tax rates. If the entire business was held in a single entity, all of the profits would generally be taxed at 30 per cent.

9. A typical stapled structure, as shown in Figure 1, that converts active trading income to concessionally taxed passive income, is set up as follows.

   – Investors own interests in a trading business (a company) and units in a trust (usually a MIT).

   – The trust holds property assets needed to carry on the trading business (generally land and buildings).

Figure 1: A stapled structure



10. The company carries on a business which derives trading income from customers. It pays rent for leasing the land assets from the trust. It may also pay interest on borrowings from the trust.

11. Commercially the trust and company are viewed as a single integrated business (for example, by investors and bank lenders). However, because the trust is legally separate and does not control the company, it is not considered to be carrying on a business (that is, it is considered to be passive).

12. As a result, the staple is able to effectively convert a portion of the trading income (in the hands of the company) into passive income (in the trust).

13. The trust is not subject to corporate tax. Rather, domestic investors are taxed on their share of the trust's income at their marginal tax rates and foreign investors are subject to lower withholding tax rates (0 to 15 per cent) on their share of the income.

14. The tax advantages for non—resident investors are significant. In the above example, trading income that is converted to rent can access the 15 per cent MIT withholding tax rate (rather than being subject to the 30 per cent corporate tax rate). In the case of a sovereign fund investor the rate can be as low as 0 per cent on the converted income.

Growth and proliferation

15. Stapled structures emerged in Australia in the 1980s in the property sector. In most traditional property staples, the trust invests in assets (for example, shopping centres, office buildings) and earns passive rental income from third parties while the operating company carries on a separate but complementary trading business (for example, property development). These stapled structures do not convert active trading income into passive income — passive income is earned from third parties.

16. Stapled structures have also existed since the late 1990s in some areas of infrastructure (notably, toll roads) but their use was initially limited. This structure involves the road being held by the trust and then being leased to the stapled company to run the toll road business. The use of trusts overcame corporate law constraints on distributing returns when projects in their early years are cash positive but make accounting losses.

17. Prior to 2008, the main tax advantage for investors (both domestic and foreign) from using stapled structures was generally limited to a timing benefit. While the trust was not subject to company tax, the profits from the trust were ultimately taxed in the hands of investors, at their marginal rates. For foreign investors, this typically meant they paid 30 per cent withholding tax on the profits of the trust (for example, on rental income). This was the case for stapled structures in the property sector as well as the limited number of rental staples in infrastructure.

18. Since the global financial crisis (GFC), a series of factors (both tax and non-tax) have combined to drive significant changes in the use of staples in Australia – with the result that staples are now being used in new ways and in new industries to generate significant tax advantages for foreign investors that are not available to domestic investors.

19. The key change was the introduction of a concessional MIT withholding tax rate on passive income (including rents) in 2008. This MIT concession was intended to make the property and funds management industries attractive by reducing the 30 per cent tax on foreigners on rental income and some financial services income earned through a MIT (a widely held, passive investment trust). The concessional MIT withholding tax rate is now 15 per cent.

20. Existing infrastructure staples became unanticipated beneficiaries of the MIT concession. As the MIT concession applied broadly to rental income from land, it had the inadvertent effect of providing a 15 per cent tax rate to foreign investors in those infrastructure businesses using stapled structures. This opened up the possibility for other land rich infrastructure businesses to argue that it was legitimate for them to also use stapled structures to split their business between a land-holding trust and operating company, and for a portion of their active business income to be converted into rent which was subject to the concessional MIT tax rate.

21. Other factors that have helped drive the recent growth in rental staples include:

    21.1. an increasingly uncompetitive corporate tax rate (of 30 per cent) by global standards;

    21.2. the substantial increase in the value of sovereign wealth funds and foreign pension funds associated with an ageing population in a number of developed and developing countries across the world; and

    21.3. the shift in investor focus away from mining in the aftermath of the recent mining boom along with the desire for stable, high yields in a post GFC, low interest rate environment.

Current and future use

22. In the infrastructure sector, almost $50 billion of pre-existing, state owned assets have been privatised using stapled structures in the last six years, purchased by a mix of foreign and domestic investors.

23. The use of stapled structures has also expanded into land based industries outside of the property and infrastructure sectors, with potential for significant future growth.

24. The value of assets in rental staples known to the ATO outside of traditional property and infrastructure is estimated to be approximately $5 billion. These staples hold assets like student accommodation, hotels, aged care facilities, renewable energy facilities (wind and solar farms) and agricultural land.

25. In addition to the large stock of current stapled structures, there is significant potential for growth that exacerbates the revenue risks into the future. Assets worth hundreds of billions of dollars remain on States' balance sheets and could potentially be privatised into stapled structures in the future.

Other tax concessions

26. Of additional concern to the proliferation of staples is how other tax concessions are used in conjunction with stapled structures to further lower effective tax rates. These include double gearing loopholes, the sovereign immunity exemption and the foreign pension fund exemption, which are explored further below. In addition, MITs have started to be used in new ways to reduce the amount of tax foreign investors pay on Australian trading income, including vertical structures (described below).

27. Finally, while the concessional MIT withholding tax rate was intended for use by the funds management industry (with the use of MITs commonplace in the commercial and industrial property sectors), the use of these concessions has more recently started to spread to the agricultural land and residential property sectors.

28. Policies designed to address the revenue risk presented by stapled structures must have regard to these additional tax concessions and emerging structures.

Double gearing loopholes through the thin capitalisation rules

29. An entity may be funded by debt or equity. Under Australian tax law, an Australian entity can claim a deduction for expenses incurred in connection with debt, for example interest payments. To prevent excessive debt loading in Australia to reduce tax liabilities, Australia has thin capitalisation rules which prescribe limits on debt that Australian and foreign owned multinational entities can use to fund the Australian operations.

30. Generally, entities may claim interest deductions on debt up to the higher of these three limits:

    30.1. Statutory safe harbour debt limit: a set rate of debt that an entity can use to fund its Australian operations (for general entities, currently 60 per cent debt to total Australian assets).

    30.2. Arm's length debt limit: this limit seeks to benchmark commercial or truly independent debt outcomes for the Australian operations.

    30.3. Worldwide gearing debt limit: allows gearing of the Australian operations to be geared up to the level of the worldwide group.

31. Despite these limits, some foreign investors may enter into 'double gearing' structures to obtain lower effective tax rates.

32. Double gearing structures involve multiple layers of flow—through holding entities (that is, trusts and partnerships) each issuing debt against the same underlying asset. This effectively allows an investor to gear higher than what is permitted under Australia's thin capitalisation limits, and obtain greater interest deductions. This means that more of the underlying profits from the Australian business (as business or trading profits are typically taxed at 30 per cent) can be extracted as concessionally taxed interest income (which would be potentially taxed at 0 or 10 per cent).

33. Provisions in the thin capitalisations rules exist to prevent double gearing. These are known as 'associate entity' provisions. Associate entity provisions are intended to prevent double gearing by requiring 'grouping' of 'associate' entities. Under the current rules, entities are grouped where there is an ownership interest of 50 per cent or more. Broadly, these rules look to the underlying assets of the associate entity and allow gearing of up to 60 per cent of those underlying assets, effectively preventing re-gearing of the same underlying assets using layers of entities.

34. In practice, the associate entity provisions do not currently apply to a wide range of investments because each individual investor will have an ownership interest of less than 50 per cent. For example, an investor bidding on an infrastructure asset as part of a consortium may have an ownership interest of 20 to 40 per cent — meaning they are not subject to grouping under the thin capitalisation rules.

35. Example 5.1 shows an example of a double gearing structure.

Example 5.1: Outcome under current 50 per cent or more associate entity test

- As Trust holds $300 million of assets, the statutory safe harbour debt limit in this structure should be $180 million (60 per cent of $300 million). SPV Trust 1 and SPV Trust 2 have equity interest levels in Trust of 33.33 per cent each.

- As the proportion of the entities' interest levels are below the current 50 per cent or more threshold, they are not required to group under the thin capitalisation rules.

- Through the insertion of the SPV Trusts, the foreign pension funds are able to inject an additional $48 million of debt (despite the level of assets remaining the same) within the structure and still be compliant with the thin capitalisation safe harbour limits. The result is that no debt deductions are denied.

Sovereign Immunity

36. Australia provides a unilateral exemption from tax to foreign government ('sovereign') investors. No exemption exists in legislation — it is based on longstanding ATO practice.

37. The principle guiding this exemption is that foreign governments should not be taxed on income from activities that form part of a government function rather than commercial activities. As such, the ATO generally grants immunity where a sovereign investor cannot influence the decision making of the entity in which it is investing. In practice, investors with ownership interests of up to 20 per cent (or even more) have accessed the exemption.

38. The exemption applies to a broad range of income types (for example, interest and dividends, as well as capital gains, distributions from MITs and trading trusts). However, it does not override company tax.

39. In the context of stapled structures, the exemption means no withholding tax is collected on income distributed from a MIT to a sovereign investor.

40. Most countries do not provide unilateral tax concessions for sovereign investors, with the exception of the US and the UK. A substantial amount of foreign investment in the infrastructure sector has come from jurisdictions without equivalent unilateral concessions.

41. Some countries provide tax concessions for sovereign investors on a reciprocal basis (for example, through tax treaties) but such concessions are generally only for interest. For example, most of the tax treaties Australia has with other countries provide sovereign investors, including sovereign wealth funds, with an exemption from withholding tax on interest. Only two of Australia's tax treaties, with New Zealand and Switzerland, extend this exemption to both interest and portfolio dividends.

42. Importantly, even with these bilateral concessions, sovereign investors from these countries still receive a much greater benefit when they invest into Australia due to our domestic sovereign immunity practice, compared to what Australia's sovereign wealth funds receive when investing into these countries.

Foreign pension funds

43. Australia currently provides a broad unilateral exemption from dividend and interest withholding tax for both government and private sector foreign pension funds that are exempt from tax in their home country. The exemption applies to both portfolio and non-portfolio investments; however, it does not extend to MIT distributions.

44. The exemption for interest withholding tax provides an incentive for foreign pension funds to gear their Australian investments as much as possible to lower their Australian tax. Combined with a stapled structure, this exemption can result in foreign pension funds paying little Australian tax on Australian business activities.

45. A foreign corporate receiving interest income typically pays 10 per cent interest withholding tax. By comparison, domestic investors would ordinarily pay tax on interest income at their marginal tax rates.

46. Most other countries do not provide exemptions for foreign pension funds, other than bilaterally through tax treaties.

Combined effect

47. Figure 2 shows how a stapled structure, combined with the double gearing loophole and sovereign wealth fund and foreign pension fund exemptions, result in very low rates of tax for foreign investors.

48. Figure 3 shows the effective tax rates that can be achieved by foreign investors using this structure.

Figure 2: A stapled structure combined with additional concessions

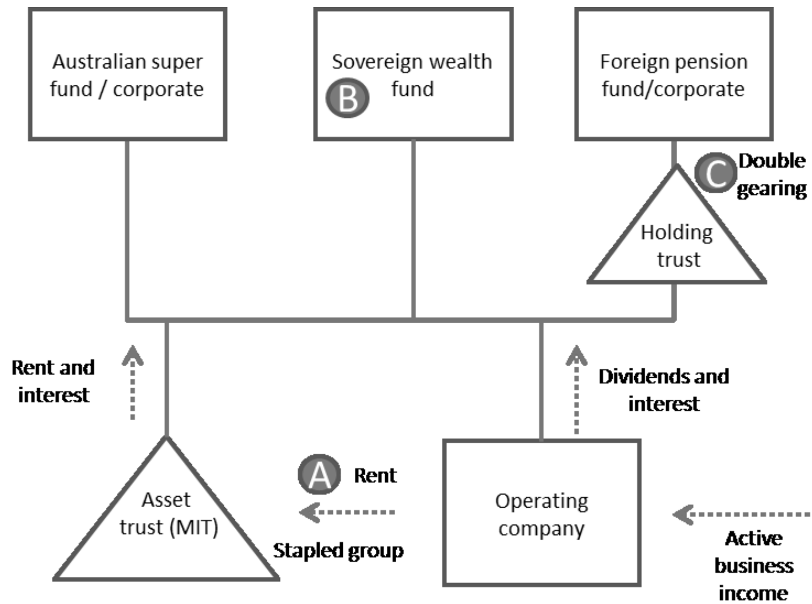
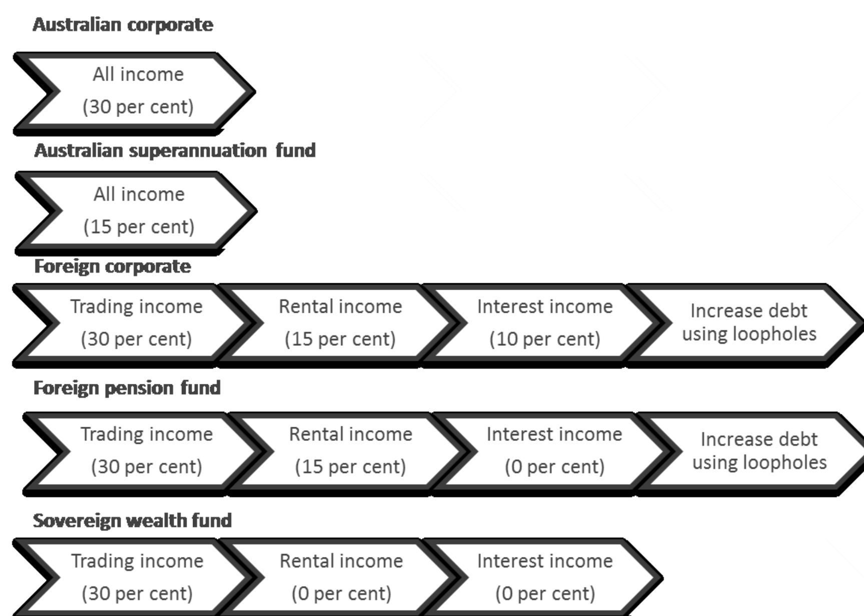


Figure 3: Conversion of income to access lower rates — illustrative effective tax rates achieved by converting trading income to rent and interest through a staple



Agricultural and residential MITs

49. As discussed above, income derived through a MIT is eligible for the concessional 15 per cent withholding tax rate. In the context of the agriculture sector, foreign investors can use a MIT (and foreign institutional investors can set up their own MIT) to invest in agricultural land and agribusiness to access lower tax rates on income from the land. This is compared with domestic investors who would pay tax at their marginal rates. The concessional tax rate enables foreign investors to pay more for Australian agricultural land, effectively at the expense of Australian revenue. Similarly, in the context of the residential property sector, foreign investors can use a MIT to access lower tax rates on income from residential housing held through a MIT than domestic investors who would pay tax at their marginal rates. The ability for foreign investors to access preferential tax outcomes may also lead to domestic investors being disadvantaged.

Emerging structures

50. While the most commonly used way to split up trading businesses has to date been through rental staples in industries with significant land-based assets (such as property, infrastructure and agriculture), new structures are now emerging that seek to convert trading income to passive income.

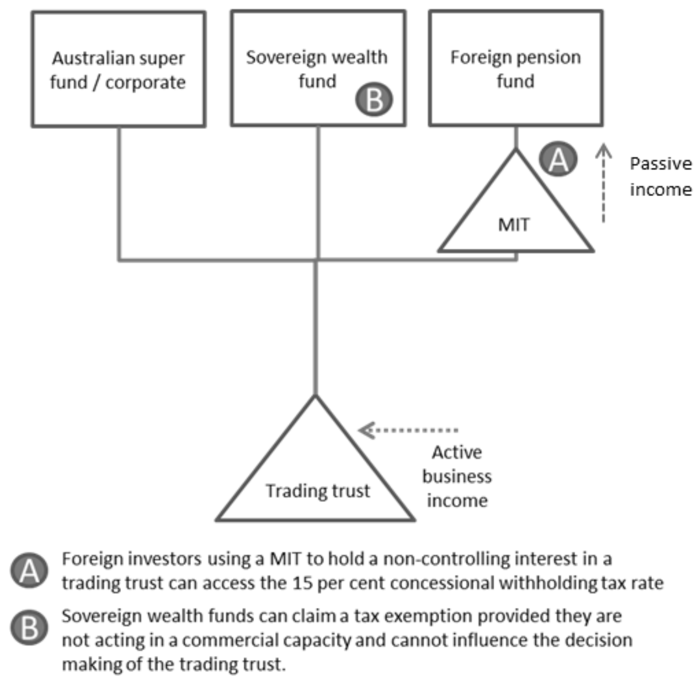
A vertical MIT structure

51. Under Australian tax law, widely held trading businesses operated through trusts are generally taxed as companies. If, however, a trading trust is not widely held, it is taxed on a flow-through basis but cannot obtain the MIT concession (because it carries on a trading business). In these circumstances, there will generally be a 30 per cent withholding tax on distributions made to foreign investors (other than interest, dividends and royalties).

52. Some foreign investors interpose a MIT on top of the trading trust in order to access the MIT concession for trading income. Even though the MIT concession was intended to apply to passive investment income, the untaxed income from the trading trust can be funnelled through the MIT to access the 15 per cent tax rate provided the MIT does not control the trading trust. These vertical MIT structures are being used by some foreign investors to hold interests in Australian trading businesses.

53. Vertical MIT structures can be used even where the business is not land rich.

Figure 4: A vertical MIT structure

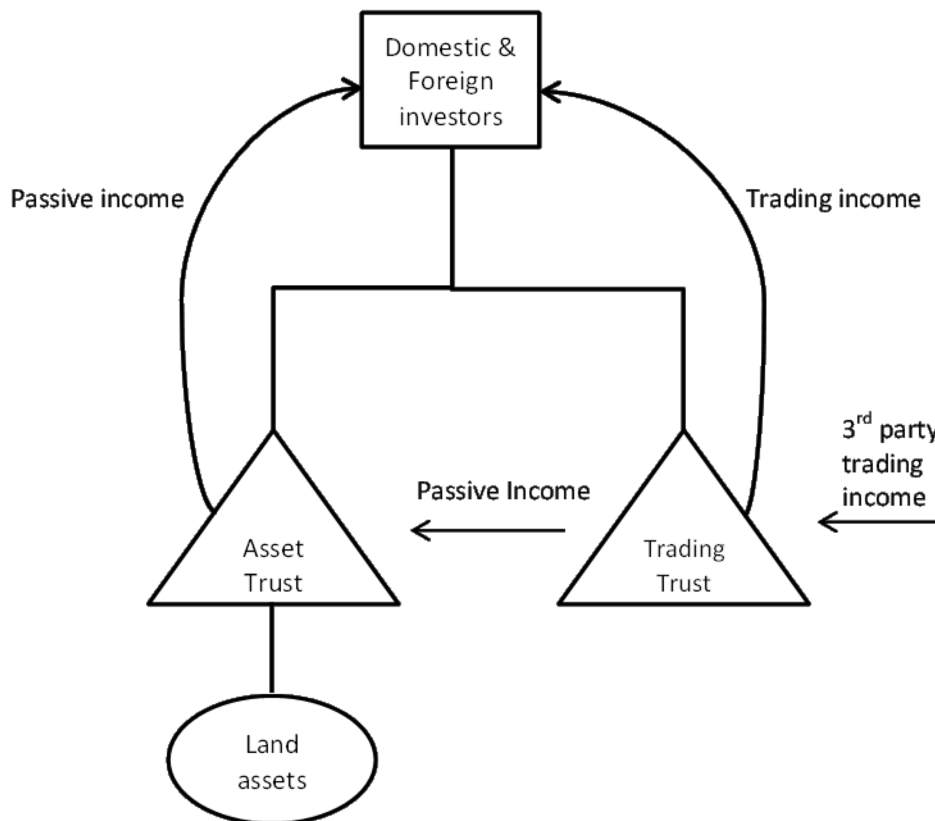


The double trust structure

54. Instead of an operating company being stapled to a flow-through trust, two trusts are stapled together. The asset trust works in the same way, that is, it holds the land-based assets. The difference now is that certain non-resident investors are able to achieve flow-through taxation on the operating entity's income too with the benefit of accessing tax treaty benefits or sovereign immunity.

55. The ownership of this structure is designed to ensure that the stapled trading trust does not attract the operation of tax rules which treat widely held trading trusts like companies for tax purposes. Rather, withholding tax, at the rate of 30 per cent must, prima facie, be withheld from any distributions to non-residents. A key tax benefit in this example is that sovereign immune investors pay zero withholding tax on both distributions by the asset trust as well as the trading trust.

Figure 5: A double trust structure



2. Objectives of government action

56. If unaddressed, the use of stapled structures and associated tax concessions for passive income could have significant implications for Australia's corporate tax system. It is also likely that stapled structures can evolve into further areas that cannot currently be foreseen. Government action to address this issue seeks to balance the following objectives:

- to protect revenue and improve the integrity of the corporate income tax base;
- to ensure Australia retains globally competitive tax settings;
- to provide a more level playing field between domestic and foreign investors; and
- to increase certainty for businesses, investors, ATO and the Foreign Investment Review Board, such that they can make informed decisions and invest with confidence.

3. Policy options

57. The following options were considered to address conversion of trading income using stapled structures.

    Option 1: Status Quo

    Option 2: Prevent trading income from accessing 15 per cent MIT rate

    Option 3: Close double gearing loopholes in the thin capitalisation rules

    Option 4: Limit the sovereign immunity tax exemption

    Option 5: Limit the foreign pension fund tax exemption

    Option 6: Prevent income from agricultural land from accessing 15 per cent MIT rate

    Option 7: Prevent income from residential housing accessing 15 per cent MIT rate

    Option 8: Package options 2, 3, 4, 5, 6 and 7 together

Option 1: Status quo

58. Under this option, no law changes would be made to address stapled structures. Instead, the ATO would continue to administer the existing law with respect to these structures.

59. In January 2017, the ATO released Taxpayer Alert TA 2017/1 *Re-characterisation of Income from Trading Businesses*, which outlined its concerns with stapled structures and warned that the general anti-avoidance provisions (Part IVA of the *Income Tax Assessment Act 1936*) might apply.

60. The general anti-avoidance provisions in Part IVA are designed to protect the integrity of Australia's income tax system by giving the Commissioner of Taxation power to take action against schemes that have been entered into for the sole or dominant purpose of obtaining a tax benefit.

Option 2: Prevent trading income from accessing 15 per cent MIT rate

61. This option involves applying a final MIT withholding tax at the corporate tax rate on 'fund payment' distributions from a MIT to a foreign investor, to the extent the

distribution is sourced from a cross staple payment (to prevent rental staples) or distribution from a trading trust (to prevent vertical MIT structures).

62. The 30 per cent MIT withholding tax rate would not apply to cross staple dividends, interest or royalties (if any). Dividends, interest and royalties are not within the scope of the MIT rules and are, by default, subject to withholding tax at the rates of 30 per cent, 10 per cent and 30 per cent respectively, but are significantly reduced under Australia's tax treaty network.

63. This option would neutralise the tax benefits obtained by foreign investors using rental staples, by subjecting cross staple payments to the company tax rate. Domestic investors continue to pay marginal rates and would not be impacted by the change.

64. It would not impact any third party income derived by the MIT as it is purely targeted at conversion of trading income through cross staple payments.

65. There are circumstances when cross staple payments do not convert trading income. For example, there may be commercial arrangements where the operating entity receives rent from third parties and this is merely 'passed through' to the trust. This is most common in the traditional property sector. Requiring these staples to restructure in order for the trust to receive these third party rents would create compliance costs, without raising revenue. For this reason, an exemption would be made for cross staple payments that involve a mere 'pass-through' of third party rent.

66. This option would also not apply where 5 per cent or less of the gross income of the trust relates to cross staple payments. This would lower compliance costs for entities that have some cross staple payments but where trading income conversion is not central to the structure.

67. Arrangements in existence on the date of announcement would be given a seven-year transition period. This is aimed at managing the impact on existing investments. Given the long life of infrastructure assets, a 15 year transition period for existing infrastructure staples would be given. However, in order to access transitional relief, entities would need to comply with stricter rules around the pricing of cross staple payments.

68. Treasury consulted stakeholders on other mechanisms to neutralise the tax benefits of rental staples. These included:

    68.1. denying the company a deduction for the cross staple payment; or

    68.2. imposing a trustee tax on the cross staple payment at the corporate tax rate.

69. The trustee level tax would be refundable to domestic investors (in the same manner as company tax is refundable to domestic shareholders through the dividend imputation system) but would act as a final tax for foreign residents. By comparison only foreign investors are subject to MIT withholding tax. The key advantage of the trustee level tax

compared to Option 2 is that it would apply in respect of sovereign wealth funds. Option 2 would not apply to sovereign investors who benefit from the sovereign immunity tax exemption in respect of withholding taxes. As the trustee tax is an entity level tax, sovereign investors would not be exempt.

70. Denying a deduction for cross staple payments would entail double taxation. That is, once at the company level (because the company is denied the deduction) and once in the hands of the investors (who are still taxable on distributions derived from the cross staple payment). Compared to Option 2, denying the deduction would significantly impact domestic investors.

71. These alternative mechanisms are discussed further in the next section.

Option 3: Close double gearing loopholes in the thin capitalisation rules

72. To address the issue of foreign investors entering into double gearing structures, this option involves lowering the associate entity test from 50 per cent or more to 10 per cent or more for the purposes of determining associate entity debt, associate entity equity and the associate entity excess amount. The lowering of the test would be limited to interests in flow-through entities.

73. The thin capitalisation arm's length debt test would also be clarified to require consideration of gearing against the underlying assets (where an entity has interests in another entity).

74. No transitional period would be provided for Option 3 as it closes a clear technical loophole in the law.

Option 4: Limit the sovereign immunity tax exemption

75. To prevent sovereign investors from accessing 0 per cent tax rates on trading income, the sovereign immunity tax exemption could be legislated and tightened.

76. Under this option, a sovereign investor would not be exempt from tax where:

– it holds an ownership interest of 10 per cent or more in the entity making the distribution or has influence over the entity's key decision-making; or

– it receives a distribution of active business income (such as where the income was derived in the course of carrying on a trading business or where income is a fund payment from a MIT derived from a cross staple payment).

77. To manage the impact on existing investment, a general seven-year transition period would apply to existing arrangements with a positive ruling from the ATO. The ATO's tax rulings on sovereign immunity are limited to 10 years, so a seven-year period will cover existing sovereign investments for most if not all of the life of existing approvals. For any sovereign investors that have been issued a private binding ruling by the ATO on sovereign immunity that expires beyond the seven-year period, the transitional period would extend to cover the duration of the ruling.

Option 5: Limit the foreign pension fund exemption

78. Under this option, the domestic exemption for foreign pension funds would be limited to interest and dividend income derived from an entity in which the foreign pension fund has a portfolio-like interest, that is, holding an ownership interest of less than 10 per cent and does not have influence over the entity's key decision-making.

79. To manage the impact on existing investments, a seven-year transition period would apply to existing arrangements.

Option 6: Prevent income from agricultural land from accessing 15 per cent MIT rate

80. Under this option, the tax law would be amended so that agricultural land can still be held in MITs, but would be subject to a MIT withholding tax rate at a rate equal to the top corporate tax rate on income from these investments (including rental income and capital gains).

81. To manage the impact on existing investments, a seven-year transition period would apply to existing arrangements.

Option 7: Prevent income from residential housing accessing 15 per cent MIT rate

82. Under this option, MITs will be able to hold investments in residential housing that is held primarily for rental purposes, however distributions derived from investments in residential housing that are not used to provide affordable housing would be subject to a MIT withholding tax rate at a rate equal to the top corporate tax rate.

83. To manage the impact on existing investments, a ten-year transition period (to 1 October 2027) would apply to existing arrangements.

Option 8: Packaging options 2, 3, 4, 5, 6 and 7 together

84. Because staples combine a number of different tax settings to deliver low tax rates to foreign investors, this option involves targeting the use of stapled structures through Option 2 but also adopting the options that address broader incentives for converting trading income into passive income (Options 3, 4, 5, 6 and 7).

4. Impact analysis and regulatory costing analysis

Option 1: Status Quo

Investment impact

85. Stakeholders have reported that the current level of uncertainty about the application of Part IVA to stapled structures may be having an adverse impact on investment, with investors seeking greater certainty before making decisions in the current environment.

Revenue impact

86. While Part IVA may apply to stapled structures, this result is not certain. In the meantime, staples remain widely in use with more being established on a regular basis.

87. If unchecked, the use of stapled structures will continue to grow rapidly, expanding in existing areas and evolving to new, land-based sectors.

88. This could have significant implications for Australia's tax revenue base. Currently, hundreds of millions of dollars in revenue are being forgone due to staples and associated tax concessions for passive income. If unaddressed, this could rise to be in the order of billions of dollars.

89. The use of rental staples could result in the unintended emergence of a dual corporate tax system that taxes foreign investors in land rich industries at rates anywhere between 0 and 15 per cent. Meanwhile, investors in other industries remain subject to the 30 per cent corporate tax rate, and domestic investors face their marginal tax rates of up to 47 per cent (including the Medicare Levy). This creates a tax bias in investment decisions, potentially drawing capital away from more productive industries, including, for example, businesses that are knowledge based and/or research and development intensive, rather than land rich.

Compliance costs

90. The ATO has yet to test in court whether Part IVA would apply to a stapled structure.

91. While Part IVA is determined on a case by case basis, a decision by a court that Part IVA applies to a particular staple would likely cast doubt over a wide range of stapled structures. If this were to happen, it would cause considerable uncertainty and likely force entities to restructure with little forward notice.

92. Even in the absence of a court decision, the uncertainty about the application of Part IVA to these structures gives rise to compliance costs as investors engage closely with the ATO to confirm the details of their structuring.

Option 2: Prevent trading income from accessing 15 per cent MIT rate

Impact on existing staples

93. This option would affect the value of assets held in staples. If foreign investors face a higher tax rate on returns from these investments, the net present value of the investment will be lower.

94. This would not be the case for traditional property staples, such as those investing in shopping centres, commercial office buildings and industrial buildings, to the extent they benefit from the exemption for 'pass-through' rent. In these staples, the trust owns the land and buildings and rents the property to third party tenants – therefore, this third party rental income would retain the 15 per cent tax rate as originally intended in the MIT rules.

95. The option includes a seven-year transition period for investments made before the date of announcement (15 years for infrastructure) in order to mitigate the impact on asset prices for those staples that are affected.

Investment impact

96. As a result of Option 2, foreign investors will pay appropriate tax on land rich investments because they are prevented from accessing the concessional tax rates for passive income on cross staple payments (which is actually trading income).

    96.1. It will not impact the level of tax paid by domestic investors on land rich investments. Domestic investors will continue to pay tax at their marginal rates.

97. This will mean lower returns for foreign investors in the sectors that currently use stapled structures – infrastructure, property, agriculture and renewable energy. This could potentially affect some marginal projects.

98. A key concern raised during consultation was that the proposed changes may negatively affect the viability of new nationally significant infrastructure projects. An exception for approved economic infrastructure facilities would mitigate this potential impact for approved projects. Such an exception would focus on new – not existing – facilities. That is, it would only be available if the infrastructure facility has not yet been constructed or for significant upgrades that are not yet committed to. This would ensure that the exception facilitates the construction of infrastructure to improve the productive capacity of the economy and support economic growth.

Revenue impact

99. As discussed above, hundreds of millions of dollars in revenue are being forgone currently due to staples and associated tax concessions for passive income. If unaddressed, this could create even further risks to revenue, potentially rising to be in the order of billions of dollars. As such, this option would provide significant revenue protection.

100. Vertical MIT structures pose a broader risk to the corporate tax base than rental staples because the tax benefits are not constrained to the conversion of rental income from land. This means they can be used in a much broader range of circumstances.

Compliance cost impact

Average annual regulatory costs (from business as usual)				
Change in costs ($m)	Business	Community organisations	Individuals	Total
Total, by sector	3.23	N/A	N/A	3.23

101. This option would involve compliance costs for trusts associated with implementing the changes. Trusts that receive cross staple payments will need to identify and separately report these payments to their investors. Trusts that do not receive cross

staple income directly may also need to make system changes because there is a chance they may receive this income from other trusts and will need to report it separately to their investors. That said, the implementation costs for this broader population will be lower than those trusts that receive the payments directly, as they will only need to on-report information received from other trusts, rather than identify and separate cross staple payments.

102. There is also likely to be a low increase in ongoing costs for trusts receiving cross staple payments associated with identifying and reporting these payments separately. MITs who receive this income indirectly via other trusts are not likely to face an increase in ongoing compliance costs, as the onward reporting of this information should be relatively automatic once systems are in place.

Other mechanisms

103. As discussed above, Treasury consulted stakeholders on other mechanisms to neutralise the tax benefits of rental staples, including:

- denying the company a deduction for the cross staple payment; or
- imposing a trustee tax on the cross staple payment at the corporate tax rate.

104. These mechanisms would both have far greater impacts on investors than Option 2 (in particular, they impact on domestic investors that do not benefit from the tax concessions being accessed through staples).

105. Under the trustee tax, the tax would be creditable and refundable to domestic investors, akin to domestic investors receiving franking credits under Australia's dividend imputation system.

106. This may give rise to a timing difference between the two taxing points; when the trustee is taxed and when the investor receives the credit. The time-value of money means this lag would put domestic investors in a worse financial position than under Option 2.

107. The trustee tax mechanism would also have adverse implications for third party bank financing and asset valuations.

107.1. In deciding the quantum and pricing of any debt finance, banks compare a project's cash flows with its interest payments. Imposing a trustee tax would reduce the project's cash flows, making the project higher risk from a financing perspective. This would in turn result in projects being subject to higher interest payments and potentially reduce the amount of external finance available. This does not occur under Option 2 as banks generally only look at tax paid at the project level, not the investor level. Withholding taxes are considered to be an investor level tax.

108. As discussed above, denying a deduction for cross staple payments would create double taxation in the company and trust, and would impact both domestic and

non-resident investors. This would likely force existing staples to restructure after the transition period ends. This may mean the trust needs to sell its assets into a new entity, triggering stamp duty, capital gains tax and refinancing costs.

Option 3: Close loopholes in the thin capitalisation rules

109. This option closes a clear loophole in the thin capitalisation rules that allows foreign investors to claim excessive debt deductions to lower their effective tax rates.

110. While the ATO is aware of these structures being used, there is a lack of data available on the number of double gearing structures in existence.

111. The option would not impact on other areas of the thin capitalisation rules or the tax law that use the concept of associate entity.

Investment impacts

112. As the option is designed to only target interests in flow-through entities, the lowering of the associate entity test to 10 per cent or more is expected to have a minor impact on investment. The proposal would not be extended to interests in companies or entities taxed like companies as the same double gearing concerns do not practically arise as they are taxed on their profits rather than receiving flow-through treatment.

113. The proposal would also not affect commercial portfolio investment. These investors are not thought to have sufficient influence over the capital structures of their investments to exploit the double gearing loophole.

114. A behavioural response to any changes to the associate entity provisions may be double gearing using the thin capitalisation arm's length debt amount (also called arm's length debt test). Legislative and practical uncertainty around the arm's length debt test has meant it is unclear whether the test is being applied as intended, which may leave open the potential for double gearing and claiming of higher interest deductions.

115. Whilst the test currently implicitly addresses double gearing, it is not an explicit requirement. In practice, this may mean that the gearing of the underlying assets is not necessarily inquired into.

116. Clarification of the thin capitalisation arm's length debt test is expected to have a minor impact as a very small proportion of entities rely on the arm's length debt test.

Revenue impact

117. As discussed above, hundreds of millions of dollars in revenue are being forgone currently due to staples and associated tax concessions for passive income. If unaddressed, this could create even further risks to revenue, potentially rising to be in the order of billions of dollars. As such, this option would provide significant revenue protection.

Compliance costs

Average annual regulatory costs (from business as usual)				
Change in costs ($m)	Business	Community organisations	Individuals	Total
Total, by sector	0.64	N/A	N/A	0.64

118. The proposal is expected to result in a low overall compliance cost impact, comprising a low implementation impact and a low increase in ongoing compliance costs.

119. The associate entity rules operate mechanically to prevent double gearing by adjusting the asset levels of the investor by the value of the investee. Where the investee (and the underlying assets) has not been fully geared up to the 60 per cent debt to assets safe harbour, the investor can gear against their proportion of the unused debt capacity. In these circumstances, the investor would need to rely on information from the investee to determine this amount.

120. With the lowering of the associate entity test to 10 per cent or more, it is expected that more entities will need to seek information from the flow-through entities they invest in to justify their debt levels. It is expected that this would result in a minor upfront compliance cost and would become part of normal practice over time given that entities with equity interests of 10 per cent or more would be able to obtain information.

121. In addition, where entities have diversified assets, the debt would only need to be justified and information sought where the entity is close to their safe harbour debt limit.

122. The clarification of the arm's length debt test is expected to result in minimal compliance costs given it is consistent with the original intent of the arm's length debt test and helps to clarify what is currently implicit.

123. This option also has the benefit of building on the existing thin capitalisation rules and methodologies for calculating the thin capitalisation limits, reducing its administrative and compliance burden.

Option 4: Limit the sovereign immunity tax exemption

Investment impacts

124. If this option was to apply to existing investments straight away, it could affect asset prices in markets where sovereign investors are a relatively significant source of investment (for example, infrastructure). This is because some sovereign investors will face a higher tax rate on investment returns, reducing the net present value of the investment, meaning they are willing to pay less for an asset.

125. The option includes a seven-year transition period for investments made before the date of announcement. This would mitigate the impact on asset prices.

126. In future, the higher levels of Australian tax paid by sovereign investors may reduce the prices they are willing to pay for Australian assets. In the infrastructure sector, this could reduce the price state and territory governments receive for privatised infrastructure assets as foreign government investors are key participants in the market for long-lived stable assets. In other markets, such as the property market, it is possible that lower returns for sovereign investors may mean some marginal projects will need to look to alternative sources of funding.

Revenue impacts

127. As discussed above, hundreds of millions of dollars in revenue are being forgone currently due to staples and associated tax concessions for passive income. If unaddressed, this could create even further risks to revenue, potentially rising to be in the order of billions of dollars. As such, this option would provide significant revenue protection.

Compliance costs

Average annual regulatory costs (from business as usual)				
Change in costs ($m)	Business	Community organisations	Individuals	Total
Total, by sector	0.32	N/A	N/A	0.32

128. Custodians are likely to be making distributions rather than the underlying investment entities. Generally, a sovereign investor qualifying for the exemption would notify the distributing entity, or its agent, of its qualification for the exemption and provide evidence to this effect. This is because it is the distributing entity that is responsible for collecting the withholding tax. Entities that are affected by this option would be those that make distributions that would no longer be exempt.

129. Sovereign investors who previously qualified for the exemption but no longer would under this option would need to update any distributing entities of their change in tax status once the seven-year transition period has expired. This will result in a minor one-off compliance cost associated with updating records.

130. Sovereign investors are also likely to engage the services of tax consultants to assist them to assess whether their existing investments qualify for an exemption under the new rules. This is likely to result in one-off purchase costs for sovereign investors with investments in Australia.

131. That said, this option should reduce ongoing compliance costs for sovereign investors. Previously, sovereign investors could only benefit from the exemption if they sought and received a ruling from the ATO. By clarifying the operation and scope of the

exemption in law, this option would allow sovereign investors to self-assess their tax position instead.

Option 5: Limit the foreign pension fund tax exemption

Investment impacts

132. The application of this change to existing investments straight away could affect asset prices in markets where foreign pension funds are a relatively significant source of investment. The seven-year transition period would mitigate this impact. In future, the higher levels of Australian tax paid by foreign pension funds are likely to reduce their desire to invest in some marginal projects, which may need to look to alternative sources of funding.

Revenue impacts

133. As discussed above, hundreds of millions of dollars in revenue are being forgone currently due to staples and associated tax concessions for passive income. If unaddressed, this could create even further risks to revenue, potentially rising to be in the order of billions of dollars. As such, this option would provide significant revenue protection.

134. Restricting the exemption to interest and dividends paid on portfolio investments will mean that foreign pension funds with significant ownership interests in Australian businesses must pay interest and dividend withholding taxes. This would also help to ensure Australia collects a fair share of tax on economic activity that occurs in Australia.

Compliance costs

Average annual regulatory costs (from business as usual)				
Change in costs ($m)	Business	Community organisations	Individuals	Total
Total, by sector	0.49	N/A	N/A	0.49

135. The compliance impact would be similar to that described for Option 4 above. Custodians rather than the underlying investment entities are likely to be making distributions to foreign pension funds. For foreign pension funds and these distributing entities there would be a minor one-off compliance cost associated with updating records. For foreign pension funds, there would also likely be one-off purchase costs associated with engaging the services of tax consultants to assess how their existing investments are affected by the changes.

136. Some foreign pension funds may be able to access other withholding tax exemptions. For example, those available under tax treaties or the domestic exemption for syndicated loans.

Option 6: Prevent income from agricultural land from accessing 15 per cent MIT rate

137. As a result of Option 6, trusts holding agricultural land will no longer get the benefit of the concessional MIT withholding tax rate, instead they would be subject to MIT withholding at the top corporate tax rate on fund payments relating to agricultural land made to foreign investors.

138. Practically this would mean that foreign investors holding agricultural land through MITs would face a withholding tax at a rate of 30 per cent rather than 15 per cent on income (rent and capital gains) from agricultural land. For domestic investors, this means they continue to be taxed on income from MITs at their marginal rates and continue to enjoy the commercial benefits associated with flow-through treatment of MITs.

139. Agricultural land that is held in smaller family trusts will continue to have the flexibility to access the benefits of flow-through treatment from MITs.

Investment impacts

140. Some foreign investors will pay a higher rate of tax on agricultural investments (including investment into agribusiness) because they are subject to a 30 per cent withholding tax on income available through a MIT rather than the concessional 15 per cent rate. This proposal will not affect foreign investors who hold agricultural land directly or through a company.

141. This option would mean that foreign investors could no longer obtain the concessional MIT rate on rent from agricultural land – whether or not it is leased to third parties. The key impact on the agricultural sector could be expected to be a potential adjustment to the inflated prices that foreign investors would bid for agricultural land. This would mean domestic farmers seeking to acquire new land would not be disadvantaged.

142. Although greater investment into agricultural land may be positive, a subsidy for these investments in the form of concessional withholding tax rates leaves revenue increasingly at risk and distorts investment. As land is a relatively immobile asset, it is desirable for tax to be extracted on investments in Australian land.

Revenue impacts

143. This option would mean that foreign investors pay tax on returns from agricultural land held in a MIT at a 30 per cent withholding tax rate, rather than at a lower 15 per cent withholding tax rate.

144. As such, adopting this option would help protect revenue, particularly in the future.

Compliance costs

Average annual regulatory costs (from business as usual)				
Change in costs ($m)	Business	Community organisations	Individuals	Total
Total, by sector	0.03	N/A	N/A	0.03

145. After the end of the transition period, MITs that hold agricultural land will be subject to a 30 per cent withholding tax rate. This will involve some one-off compliance costs associated with understanding the change in the withholding rate and re-evaluating operations as a result of the higher withholding rate. As the change involves only an adjustment to the withholding rate, the additional compliance costs would be minor.

Option 7: Prevent income from residential housing accessing 15 per cent MIT rate

146. Under Option 7, trusts investing in residential housing (except for affordable housing) will not get the benefit of the concessional MIT withholding tax rate, but would be subject to MIT withholding at the top corporate tax rate.

147. Practically this would mean that foreign investors in a MIT that invests in residential housing (other than affordable housing) will be subject to withholding tax at a rate of 30 per cent rather than 15 per cent on distributions (from rent and capital gains) derived from investments in residential housing. Domestic investors continue to be taxed on distributions through MITs with these investments at their marginal rates and continue to enjoy the commercial benefits associated with flow-through treatment of MITs.

Investment impacts

148. Some foreign investors will pay a higher rate of tax on investments in residential housing because they are subject to a 30 per cent withholding tax rate on income received through a MIT rather than the concessional 15 per cent rate. This proposal will not affect foreign investors who hold residential property directly or through a company.

149. As foreign investors would be subject to a higher tax rate, the key impact is expected to be a potential adjustment to the prices that foreign investors are willing to pay in this sector.

150. As all MITs investing in residential housing will continue to enjoy the commercial benefits associated with having MIT status, it is not expected that significant investment barriers would arise between different types of residential housing, as long as the purpose of the investment is to derive rent, such as build-to-rent. Investment in affordable housing will continue to be incentivised by a concessional 15 per cent MIT withholding tax rate.

Revenue impacts

151. The revenue impacts for this option are estimated to be unquantifiable.

Compliance costs

Average annual regulatory costs (from business as usual)				
Change in costs ($m)	Business	Community organisations	Individuals	Total
Total, by sector	0.05	N/A	N/A	0.05

152. After the end of the transition period, MITs that hold residential property (other than affordable housing) will be subject to a 30 per cent withholding tax rate. This is expected to result in a low one-off implementation impact associated with understanding the change and re-evaluating operations in light of the change, as well as a low ongoing compliance cost impact. As the change involves only an adjustment to the withholding rate, the compliance cost will be minor.

Option 8: Packaging options 2, 3, 4, 5, 6 and 7 together

153. This option has the advantage of targeting the use of stapled structures, emerging structures and the broader incentives for converting trading income into passive income.

Investment impacts

154. In the packaging of these options, the investment impacts of Options 2, 3, 4, 5, 6 and 7 (as discussed earlier) remain applicable.

155. This option will ensure that domestic investors are not disadvantaged when competing for investment under the current tax settings. As mentioned above, the current settings allow foreign investors to access tax rates of 0 to 15 per cent on income from investments in land rich industries — a concession not available to domestic investors who ordinarily would be taxed at their marginal rates.

156. The option could potentially affect some marginal projects due to the higher withholding tax rate faced by foreign investors. Although tax can have a significant impact on investment decisions, tax is only one of many factors that investors consider in their investment decisions. There are a multitude of other factors that investors consider, such as the regulatory, political and social environment of their investment. Any impact of this option on the viability of new nationally significant infrastructure projects is mitigated through the 15 year exception being provided for new and approved economic infrastructure facilities.

Revenue impacts

	2017-18	2018-19	2019-20	2020-21	2021-22
Revenue ($m)	–	$30.0m	$80.0m	$125.0m	$165.0m

157. This option is estimated to have a gain to revenue of $400.0 million over 2018-19 to 2021-22.

158. Moreover, the package protects the revenue base going forward. It was mentioned above that hundreds of millions of dollars in revenue are being forgone currently due to staples and associated tax concessions for passive income and if left unaddressed, further risks to revenue, potentially rising to be in the order of billions of dollars, could result. Consequently, the comprehensive nature of this option would address these current and future revenue risks in a more far-reaching manner, thereby providing the greatest opportunity for revenue protection.

159. As most of the options comprising Option 8 include transitional periods, it is anticipated that this option would provide significant revenue protection going forward following conclusion of the transitional periods.

160. The option to prevent residential housing MITs accessing the 15 per cent concessional tax rate is estimated to have an unquantifiable impact.

Compliance costs

Average annual regulatory costs (from business as usual)				
Change in costs ($m)	Business	Community organisations	Individuals	Total
Total, by sector	4.76	N/A	N/A	4.76

161. The compliance costs of the package encompass the compliance costs of Options 2, 3, 4, 5, 6 and 7. The package overall involves a low compliance cost impact, comprising a medium implementation impact and a low increase in ongoing compliance costs.

162. A regulatory offset has not been identified. However, Treasury is seeking to pursue net reductions in compliance costs and will work with affected stakeholders and across Government to identify regulatory burden reductions where appropriate.

163. The net benefits derived from the significant revenue protection and removal of distortions provided by the package would outweigh concerns about increased complexity and compliance costs, as well as the potential impact on investment.

5. Consultation plan

164. Treasury has undertaken significant consultation, including several rounds of public and targeted consultation.

165. A consultation paper examining the conversion of trading income derived through the use of stapled structures was released on 24 March 2017. This paper sought stakeholder views on potential policy options in relation to stapled structures, the taxation of real property investments and the re-characterisation of trading income. The consultation period ran for four weeks and closed on 20 April 2017.

166. There was strong engagement from the community; roundtables were held across Sydney and Melbourne, and submissions were received from over 50 stakeholders.

167. Treasury met with a range of stakeholders including industry groups, stapled entities, investor groups (pension funds and sovereign wealth funds), and their advisers.

168. On 2 May 2017, the Treasurer issued a media release noting that the timeline for the review was extended to allow more time for consultation and to formulate relevant options that minimise unintended consequences.

169. Treasury undertook a second round of targeted consultation with stakeholders in July 2017.

170. On 27 March 2018, the Government announced it would address the tax integrity risks posed by stapled structures and similar arrangements through a package of measures, that is, adoption of Options 2, 3, 4, 5 and 6.

171. On 17 May 2018, the Government released for public consultation a first tranche of exposure draft legislation and draft explanatory material that would give effect to Options 2, 3, 4 and 5. The consultation period closed on 31 May 2018. The consultation provided an opportunity for stakeholders to make submissions on implementation issues related to the draft legislation and to help limit any unintended consequences.

172. On 28 June 2018, the Government released a paper outlining the conditions stapled entities must comply with to access the infrastructure exception and the transitional arrangements. The consultation period closed on 12 July 2018. The consultation allowed feedback to be sought from interested parties on the proposed rules to inform the development of the legislation to give effect to the conditions. Exposure draft legislation and draft explanatory material to give effect to the conditions was released for public consultation from 7 August 2018 to 14 August 2018. This consultation enabled interested parties to provide feedback on the detail of the legislation and ensure it aligned with the intent of the policy.

173. On 26 July 2018, the Government released for public consultation the second stage of exposure draft legislation and draft explanatory material that would give effect to Option 8. The consultation period closed on 10 August 2018. The consultation provided an opportunity for interested parties to consider draft legislation that had been revised to reflect the feedback received in the public consultation on the first tranche of draft legislation.

174. The Government undertook public consultation on exposure draft legislation from 14 September 2017 to 28 September 2017 on changes relating to residential housing MITs, which included clarification that MITs could not acquire investments in residential housing, except affordable housing. The purpose of the consultation was to seek feedback to ensure the draft legislation achieved the policy aims.

175. Following consultation on this draft legislation as well as the feedback received following announcement (as part of the package announced on 27 March 2018) of the measure to prevent investments in agricultural land from accessing the 15 per cent concessional MIT withholding tax rate, the policies were refined to neutralise the tax benefits while retaining access to the commercial benefits of MITs. This led to inclusion of the refined policies as part of the release of the second stage exposure draft legislation and explanatory material, which clarified that MITs could hold investments in agricultural land and residential housing (that is held primarily for rental purposes), but income derived from these investments would be subject to a 30 per cent MIT withholding tax rate. The public consultation enabled feedback to be provided on the refined policies and the detail of the legislation.

176. Throughout the process, Treasury worked closely with the ATO to identify any implementation issues, integrity concerns and unintended consequences.

177. Over the course of the release of the consultation paper in 2017 through to announcement of the package of measures and release of the different stages of exposure draft legislation, Treasury has been engaging with a broad range of stakeholders on the various elements of the package.

178. Issues that have been raised during consultations can be broadly categorised as the following, which included:

– the importance of the length of any transition periods;

– exclusion of infrastructure and real estate investment from the scope of any changes;

– the commercial benefits of staples;

– the potential effect on foreign investment; and

– technical issues with the draft legislation, which may lead to unintended outcomes.

179. Careful consideration was undertaken on the issues raised during consultation, and a number of refinements were made to the measures in the package whilst balancing the desire to protect the revenue base, in particular:

- the stapled structures review was extended and a number of stages of public consultation were held to allow stakeholders an opportunity to provide feedback on the initial draft legislation as well as revised draft legislation;
- as the package focuses on neutralising the tax advantages available through a stapled structure, investors can continue to have access to the commercial benefits of staples and are not required to restructure;
- transitional arrangements have been included for the majority of the elements in the package to minimise the impact on existing investments, with a longer transitional period provided for infrastructure staples (which typically are longer lived investments). Transitional arrangements have not been provided where the change addresses a clear technical loophole in the law;
- the package allows third party rent passed through a staple to retain access to the 15 per cent concessional MIT rate;
- the package provides for an exception for Government approved, new nationally significant infrastructure; and
- a number of technical refinements were made to the legislation to ensure that it achieved the appropriate policy outcome and was publicly released for another round of consultation.

6. Option selection / Conclusion

180. The preferred option is to implement Option 8, that is, package options 2, 3, 4, 5, 6 and 7 together.

181. Option 8 is preferred over Option 1 as Option 1 does not provide certainty to investors on the tax treatment of stapled structures given the potential for application of Part IVA (the general anti-avoidance rule). Option 1 may also leave the corporate tax base at significant risk.

182. In contrast, Option 8 comprehensively tackles the various tax settings that are combined with staples to deliver low tax rates to foreign investors. Consequently, this option would be the most effective in providing significant revenue protection.

183. Moreover, if some of the options are implemented without the others, the reforms will be only partially effective in protecting the corporate tax base.

184. For example, adopting Option 2 alone would mean stapled structures are still very attractive for sovereign investors that are currently exempt from withholding taxes under the ATO’s administrative practice. It would also mean sovereign investors could still achieve very low tax rates using double gearing structures and leveraging the interest withholding tax exemption.

185. On the other hand, if no action was taken on the conversion of trading income to passive income (Option 2) and only Options 3, 4 and 5 were adopted (the options to address broader incentives for conversion), this would in effect embed a 15 per cent tax rate for foreign investors in certain sectors, effectively creating alternate corporate tax regimes of 15 and 30 per cent.

186. In addition, not adopting Options 6 and 7 would leave the sectors around agricultural land and residential housing exposed to the preferential tax outcomes that foreign investors are increasingly accessing in these sectors.

187. Option 8 also mitigates the potential impact on investment since it incorporates the transition periods relevant to the options.

188. For these reasons, only Option 8 would address the problems identified comprehensively.

7. Implementation and evaluation / review

189. Legislation is required to implement the preferred option, which the Government intends to enact as soon as practicable.

190. The majority of the elements of the package, that is Options 2, 4, 5, 6 and 7, will take effect from 1 July 2019.

191. Option 3 will take effect from income years commencing on or after 1 July 2018 as the option addresses a clear loophole in the current law which is being exploited. This means the majority of tax returns that are first affected would be lodged in 2020.

192. The ATO administers the existing rules that are relevant to the options. It is well placed to implement both the elements of the package and monitor their effects on the behaviour of corporate taxpayers.

193. Stapled entities that are under the transitional arrangements and/or are able to access the 15 year infrastructure exception will be subject to certain conditions that they must comply with to access the concessional MIT rate during the transitional period. This will provide safeguards to ensure that entities do not engage in aggressive cross staple pricing during the transitional period or during the 15 year infrastructure exception.

194. Those that wish to access the transitional arrangements will be required to make an election. This will enable the ATO to obtain information and monitor the staples that are accessing the transitional arrangements and that are not yet subject to the MIT withholding rate levied at the corporate tax rate. The ATO will also continue to have oversight of the staples that have elected into the transitional arrangements following the conclusion of the transitional arrangements.

195. The mechanisms built into the infrastructure exception that will be available for 15 years to new and substantially improved economic infrastructure facilities also

provide Treasury and the ATO with a greater ability to monitor the implementation of the exception. As granting of the exception will require approval from the Government, Treasury and the ATO will have full information and clear oversight of facilities that have access to the concessional 15 per cent MIT withholding rate. Assessments of applications for the 15 year infrastructure exception will also be informed by expertise from a range of public bodies involved with infrastructure and will be subject to legislative criteria.