A Bill introduced by Australia's Assistant Treasurer into Parliament on 20 September 2018 will impact a broad range of sectors that rely on foreign investment, including in infrastructure, funds management and real estate. The Bill, Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill, follows earlier Treasury discussion papers, two rounds of exposure draft (ED) law and lengthy consultation with Treasury in which EY and industry participated. Other Bills were introduced on the same day but are not discussed in this Tax Alert.1

The package of measures:

- Introduces a new 30% non-concessional category of income for the Australian managed investment trusts (MITs) foreign resident withholding tax, replacing the concessional 15% or 10% clean buildings rate in relation to certain:
  - Cross-staple income (with exemptions for certain third-party rent) other than interest income
  - Trading trust income
  - Residential housing income other than from affordable housing (now precluding income from student accommodation)
  - Agricultural land income

NEW! EY Tax News Update: Global Edition

EY’s new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration [here](#).

Also available is our [EY Global Tax Alert Library](#) on ey.com.
Global Tax Alert

• Limits foreign pension fund withholding tax exemptions for interest and dividends to income from portfolio investments in Australia.

• Codifies rules for applying tax exemptions for certain income of foreign government investors, with new restrictions.

• Makes thin capitalization changes to prevent double gearing arrangements.

The Bill requires detailed analysis by:

• Infrastructure project entities and sponsors
• Real-estate investment entities
• Managed funds and their administrators and custodian service providers
• Superannuation funds and other financial institutions
• Foreign investors including foreign super funds and sovereign wealth entities

Actions for consideration include:

• Planning for the implementation of these measures now, which may require new policies and procedures as well as changes to software
• Reviewing investments and financing structures for potential changes required
• Adjusting investor information and statutory disclosure documents, if need
• Assessing the application of the transitional rules: infrastructure entities may need to consider applying for private rulings to confirm access to transitional relief
• Making submissions to the Senate Economics Legislation Committee for its consideration of the Bill

Detailed discussion
Summary of proposed measures

The proposed changes will:

• Deny concessional withholding tax treatment for payments from certain arrangements in stapled structures and certain other payments to foreign investors by Australian MITs from 1 July 2019

• Modify Australia’s thin capitalization debt deduction denial rules (from 1 July 2018)

• Limit other foreign investor concessions

The Bill goes beyond the original 2017 Treasury paper and Government announcements which focused on proposed changes to address issues with stapled company-trust structures that were considered to re-characterize active income as passive income in order to access lower tax rates through MITs. The measures in the final package are much broader and include a modified approach to the investment restrictions for Australian MITs in residential property, as originally proposed in the Government’s 2017 affordable housing package. The Bill includes further changes to EDs issued for consultation, notably new restrictions for investments in student housing by MITs and modifications as well as redrafting of the provisions which appeared in the ED.

The integrity rules and transitional relief measures which apply from various dates (other than for the thin capitalization changes) as well as certain infrastructure carve outs contribute to this being a complex package of changes.

Also introduced in various Bills into Parliament on 20 September were previously announced measures (not discussed in this Tax Alert) including notably:

• Changes to the MIT and attribution MIT rules, from the 2017-18 income year
• Expansion of the significant global entity definition to groups headed by proprietary companies, trusts, partnerships and investment entities and modifications to the Country-by-Country Reporting rules, broadly from 1 July 2018
• Further changes to Australia’s thin capitalization rules to remove tax only valuations for the safe harbor calculation and certain tax consolidation changes, from 1 July 2019

Non-concessional MIT income

A range of fund payments made by a MIT to a foreign investor will be subject to MIT withholding tax at 30% to the extent that they are attributable to non-concessional MIT income, from 1 July 2019. The 30% rate is now specified, replacing the ED drafting which referred to the top corporate tax rate.

An amount of a fund payment will be non-concessional MIT income if it is attributable to any of the following:

• An amount derived from certain cross staple MIT arrangements
• A distribution from an entity that carries on or controls a trading business
• MIT residential housing income
• MIT agricultural income
Infrastructure impact

MIT cross-staple arrangement income subject to 30% withholding is broadly assessable income derived by a MIT asset entity from an operating entity in a cross-staple arrangement, which is not excluded from being a fund payment of a MIT (e.g., dividends and interest). This aspect of the Bill is broadly in line with the previous ED.

Amounts attributable to a cross-staple arrangement which are attributable to third-party rent (i.e., not from a stapled entity in the arrangement) are excluded. Capital gains made from the transfer of an asset by the asset trust to the operator trust should also not be cross-staple arrangement income.

There are two other exceptions for cross-staple payments:

- 15 year approved economic infrastructure facility exception
- De minimis exception of 5% of assessable income

A new definition of “industrial, commercial or scientific equipment” now clarifies that payments for the use of or right to use such equipment will not be considered a royalty to the extent that it constitutes rent from land.

Approved economic infrastructure facility exception

Eligibility requirements for the approved economic infrastructure facility exception include:

- Application must be made to the Treasurer by an Australian government agency
- The Treasurer may approve the facility if satisfied that:
  - The facility is an economic infrastructure facility
  - The estimated capital expenditure on the facility is AUD$500 million or more
  - The facility is yet to be constructed, or the facility is an existing facility that will be substantially improved
  - The facility will significantly enhance the long-term productive capacity of the economy
  - Approving the facility is in the national interest

An economic infrastructure facility is a facility which is any of:

- Transport infrastructure
- Energy infrastructure
- Communications infrastructure
- Water infrastructure

The economic infrastructure exception has been extended to expressly include improvements to a facility.

The limitation that only Australian government agencies may apply to the Treasurer for the concession raises issues for privately procured projects which satisfy all the other requirements. For example, in large scale renewables projects typically undertaken among wholly private sector parties, the parties would need to ask a government agency to make the application on their behalf.

The 15-year concession period commences when the asset is first put to use, which is preferable to commencing the concession period from financial close. However, as most Greenfield projects will be in tax losses for many years into their operations, this limits the practical benefit.

The Bill confirms availability of a deduction for cross-staple rent during the concession period. The explanatory memorandum now includes comments intended to support that the Australia’s Part IVA general anti-avoidance rules should not apply where a choice to take this deduction is made, however this drafting could be clearer.

Transitional rules – 27 March 2018

Transitional arrangements apply to infrastructure facilities in stapled structures approved before or under a contract entered into before 27 March 2018. The new measures do not commence:

- For economic infrastructure facilities – until the later of 1 July 2034 or 15 years from when the asset is first used to generate assessable income, but not after 30 June 2039
- For other infrastructure facilities – until the later of 1 July 2026 or 7 years from the day in which the asset is first used to generate assessable income, but not after 30 June 2031

The transitional rules are complex and include multiple conditions and cover various arrangements, which require careful analysis to determine how they may apply for each project.

What constitutes a “facility” for these purposes will be critical to determining whether enhancements, refurbishments and/or expansions of the asset are covered by the transitional regime. The Bill confirms the availability of a deduction for cross-staple rent during the transition period and the Explanatory Memorandum (EM) again seeks to support that the Part IVA general anti-avoidance rules should not apply.

Cross-staple rent integrity measures

Integrity measures require cross-staple rental arrangements to satisfy the current MIT non-arm’s length income rule to access the transitional provisions. If the Commissioner
Global Tax Alert

of Taxation makes a determination to apply the non-arm’s length income rule then the trustee of the MIT will be liable to pay tax on the amount at 30%.

In addition to satisfying the non-arm’s length income rule, economic infrastructure facilities seeking access to extended transitional relief will also need to satisfy a cross-staple rent cap. Any breach of the cross-staple rent cap will result in withholding at 30% to the extent that the rent cap was exceeded.

A concessional cross-staple rent cap or statutory cross-staple rent cap might apply to the economic infrastructure facility staple, depending on whether an established method of determining rent was in place at 27 March 2018. Despite extended consultation between industry and Treasury, there remains considerable uncertainty as to whether cross-staple rental methodologies which contain market rent review clauses will be able to access to concessional cross-staple rent cap in practice.

MIT trading trust income

Fund payments that are attributable to distributions made from a trading trust to a MIT (directly or indirectly through a chain of flow through entities) will be non-concessional MIT income, with foreign resident withholding tax applied at the 30% rate.

A transitional rule delays the start: an amount will not be non-concessional MIT income from trading income if:

- Immediately before 27 March 2018, the MIT held a total participation interest in the second entity of an amount greater than nil
- The amount was derived, received or made by the MIT before 1 July 2026

Apportionment is required to determine the non-concessional MIT income if new participation interests are acquired after 27 March 2018.

MIT residential housing income, including student accommodation

The original Government proposal to restrict residential real estate investments by MITs to only commercial residential premises or “affordable housing” has been replaced: it now includes residential housing property income from sources other than affordable housing as non-concessional MIT income subject to 30% foreign resident withholding tax treatment.

Transitional relief applies for residential investments held at 14 September 2017 until 1 October 2027.

Income attributable to a “residential dwelling asset” which is not otherwise used to provide affordable housing is caught as well as capital gains on membership interests in certain entities that hold residential dwelling assets.

A residential dwelling asset is an asset that is:

- A dwelling
- Taxable Australian real property
- Any of the following:
  - Residential premises but not commercial residential premises
  - Premises used primarily to provide accommodation for students (with a limited exception for certain schools)

Changes made in the Bill mean that student accommodation will now be subject to the 30% withholding for foreign investors. Student accommodation held as at 20 September 2018 (which includes a contract for the acquisition or creation of a facility that contains a dwelling, but not the mere ownership of land) will benefit from transitional relief until 1 October 2027.

The exclusion of off campus student accommodation providers from the MIT concessional rate is disappointing and will have a significant negative impact on the student housing market. In our view:

- Excluding off campus student accommodation will place greater pressure on affordable residential accommodation.
- The change will act as a significant disincentive for future investment into the student sector by foreign investors given the tax impost has doubled from 15% to 30%. Consequently, there is likely to be a shortfall in special purpose student accommodation and students will be forced to seek alternative accommodation in the broader residential housing market thereby increasing rental price pressure in this sector.
- Off campus student accommodation has long been considered to be accommodation of a kind not suitable for long term residential accommodation and therefore should not be excluded from the 15% withholding rate. The exclusion may potentially have the opposite effect from what the Government has intended as it is likely to lead to increased pressure on housing prices and housing affordability in general.
MIT agricultural income

MIT agricultural income subject to the 30% non-concessional MIT withholding tax broadly encompasses income attributable to Australian agricultural land assets (held directly or indirectly) that are used or could be reasonably used for carrying on a primary production business and are held primarily for the purpose of deriving or receiving rent. This includes capital gains on certain membership interests in entities that hold Australian agricultural land. Transitional relief applies for assets acquired on or before 27 March 2018 until 1 July 2026.

Other foreign investor changes

Foreign super funds withholding tax exemption

A superannuation fund for foreign residents will only be eligible for an exemption from Australian withholding tax on distributions of dividends and interest, where the following two conditions are met:

- It has a portfolio-like interest (less than 10%) in the “paying entity,” at the time the payment is made and throughout any 12-month period in the previous 24 months
- It does not exert relevant influence over the entity

The percentage held is calculated on a total participation interest basis i.e., direct and indirect interests in the relevant Australian paying entity.

The changes apply to income derived on or after 1 July 2019. However to the extent the income relates to an investment asset that was acquired on or before 27 March 2018, a transitional rule extends the application date to 1 July 2026.

Sovereign wealth funds exemption

Australia’s sovereign immunity tax exemption will be legislated and will apply if:

- A covered sovereign entity (extensively defined) has a portfolio-like interest in an Australian resident company or Australian MIT making the payment, at the time the payment is made and throughout any 12-month period in the previous 24 months.
- The payment is covered - including dividends, interest, fund payments from a MIT but not non-concessional MIT income (including MIT cross-staple income disregarded by the approved economic infrastructure facility exemption or disregarded by any of the transitional rules) or a gain on the disposal of those interests or is consular income.

- The sovereign entity does not exert relevant influence over the entity.

Aggregation of interests in applying the non-portfolio interest test is done on the basis of a “sovereign entity group.”

The changes apply from 1 July 2019. However transitional rules apply to amounts in respect of an investment asset held by a sovereign entity and certain capital gains and losses in respect of that asset if the sovereign entity acquired the asset on or before 27 March 2018 and:

- On or before that date, the sovereign entity applied for a private ruling to the effect that the investment asset qualifies for sovereign immunity and the ruling was granted before 1 July 2026.
- The private ruling applied during at least part of the period starting on 27 March 2018 and ending before 1 July 2026.

In this case, the amendments will not apply in relation to that investment asset until the later of:

- The 2025-26 income year (i.e., until 1 July 2026)
- If the private ruling still applies in a later income year, that later income year

Thin capitalization

Two proposed measures are intended to address the use of so called “double gearing” structures, which involve multiple layers of flow through entities (i.e., trusts or partnerships) that each issue debt against the same underlying asset.

The ownership percentage in categorizing an entity as an associate entity is reduced from 50% to 10%. In addition, in determining the arm's-length debt amount, an entity must consider the debt to equity ratios of any entities which the entity has a direct or indirect interest in, that are relevant to the considerations of an independent lender or borrower.

The measures apply from 1 July 2018, with no transitional relief.

Senate Review as part of the process

The Bills have been referred to the Senate Economics Legislation Committee (SELC) for inquiry and report by 9 November 2018 as part of the normal Senate process.
Implications

Entities affected by the various measures should:

- Consider whether to make a submission to the SELC in its consideration of the Bill and other related Bills.
- Review investments, projects and structures to determine whether transitional arrangements might apply.
- Prepare for the impact of the changes including for policies, procedures and systems.

Endnote

For additional information with respect to this Alert, please contact the following:

**Ernst & Young (Australia), Energy and Infrastructure, Sydney**
- Richard Lambkin, richard.lambkin@au.ey.com

**Ernst & Young (Australia), Energy and Infrastructure, Melbourne**
- Bruno Dimasi, bruno.dimasi@au.ey.com
- Richard Buchanan, richard.buchanan@au.ey.com

**Ernst & Young (Australia), Energy and Infrastructure, Brisbane**
- Reid Zulpo, reid.zulpo@au.ey.com

**Ernst & Young (Australia), Energy and Infrastructure, Perth**
- Katrina Piva, katrina.piva@au.ey.com

**Ernst & Young (Australia), Energy and Infrastructure, Adelaide**
- Sean van der Linden, sean.van.der.Linden@au.ey.com

**Ernst & Young (Australia), Real Estate, Sydney**
- George Stamoulos, george.stamoulos@au.ey.com
- Daryl M Choo, daryl.choo@au.ey.com
- Stephen J Chubb, stephen.chubb@au.ey.com

**Ernst & Young (Australia), Financial Services, Sydney**
- Antoinette Elias, antoinette.elias@au.ey.com

**Ernst & Young LLP, Australian Tax Desk, New York**
- David Burns, david.burns1@ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2018 EYGM Limited.
All Rights Reserved.

EYG no. 011161-18Gbl
1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com