THE TAX INSTITUTE

22 August 2017

Mr Jeremy Hirschhorn
Deputy Commissioner
Public Groups and International
Australian Taxation Office
GPO Box 9977
SYDNEY NSW 2001

By email: jeremy.hirschhorn@ato.gov.au

Dear Mr Hirschhorn,

Taxpayer Alert TA 2017/1 – Re-characterisation of income from trading businesses

1. Introduction

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the *Taxpayer Alert TA 2017/1 – Re-characterisation of income from trading businesses* (**TA**).

The release of the TA on 31 January 2017 has caused great confusion and uncertainty in the marketplace in relation to the current law that applies to stapled structures, particularly as:

- The TA does not provide any detailed reasoning regarding the ATO's concerns; and
- The TA ostensibly targets arrangements that attempt to fragment an integrated trading business by re-characterising trading income to more favourably taxed passive income. However, the TA appears to have a much broader application to stapled structures generally as it discusses all stapled structures which can give rise to a separation between trading and passive income.

Subsequent to the release of the TA, the ATO has made informal comments in discussions with stakeholders that stapled structures in certain industries (e.g. property and land rich infrastructure projects) may be acceptable while stapled structures in other industries (e.g. renewables, agriculture) are not.

2. The Tax Institute's Specific Concerns

The Tax Institute has a number of concerns with TA 2017/1 which we set out below and which we believe should be clarified by the ATO.

a) **Acceptable v unacceptable industries** – The distinction between acceptable and unacceptable industries as outlined above is not captured in the TA. If that is to be the foundation of the TA, it should be clearly spelled out.

b) **Clarification of the policy** – There needs to be a clear policy statement of the precise concerns the ATO has in relation to the arrangements the subject of the TA and what aspects or outcomes of these arrangements are unacceptable to the ATO and why and how the acceptable / unacceptable industries' dichotomy fits within that policy framework.

c) **Clarification of structures acceptable to the ATO: stapled structures v other non-stapled structures** – It is unclear from the TA which structures involving the fragmentation of a trading business are acceptable arrangements to the ATO and which are not. Based on the information in the TA, it appears that stapled structures are broadly not acceptable. Structures that purport to fragment a trading business for the purpose of re-characterising trading income as passive income that do not involve a stapled structure are not dealt with in the TA. Therefore, it is unclear which of these types of structures are acceptable to the ATO and which are not.

If the ATO is primarily focused on circumstances where an integrated business is fragmented, and regards stapled structures as just one of many arrangements where trading income could be re-characterised as passive income, this needs to be made very clear by the ATO. Further, the ATO should give examples of other structures which they are concerned about.

d) **Clarification of structures acceptable to the ATO: industry v industry** - We were advised in our meeting with ATO officers on 20 June 2017 that stapled structures involving renewables and agricultural assets are high risk and should not be set up as they fall directly within the ambit of the TA. We were further advised that the only acceptable stapled structures are property entities and privatisations that involve land rich entities that are currently on foot and have been discussed with the ATO. The ATO also indicated that some structures involving student accommodation, hotels and retirement homes are still under consideration. Our concern is that this approach of permitting stapled structures within certain industries while disallowing the use of these structures in other industries is not based on any principle and causes uncertainty and confusion.

We were also advised in that meeting that the ATO has formed the view of what are acceptable structures and that this would remain unchanged until the time Treasury's review of the taxation of stapled structures concludes and anything emanating from that review would be prospective only.

Given the state of flux that industry has been in since the release of the TA, it is useful that some light has been shed on the ATO's view of these arrangements. However, the ATO's position and the rationale for the position should be made clear in a published form. We note the ATO's intention to issue further guidance[1] and urge this be done as quickly as possible.

e) Legal analysis - There is a list of provisions under the heading "Legislative References" in the TA. Provisions relevant to each example are mentioned in each example in the TA. However, they are accompanied by little or no analysis regarding how they apply to the structures of concern to the ATO. Therefore, it is unclear to what extent the ATO considers that these provisions, and the tax law more broadly, is not being complied with.

3. The Tax Institute's General Position

Arms' length payments within stapled structures

The Tax Institute is of the view that a basic principle should apply so that stapled structures should be permitted where a stapled structure involves a payment set on clear arms' length terms and there is a relevant market from which to source comparable pricing for the payment. In this regard, an inappropriate tax outcome is not achieved simply because a stapled structure has been adopted. Further, we do not see why the view the ATO takes with respect to cross-staple dealings where income is derived from unrelated third party tenants[2] could not also apply to rent derived from related parties provided the rent is paid on an arms' length basis.

For example, in the hotel industry, it is not uncommon for one entity to hold the bare real estate and charge arm's length rent to another entity carrying on the hotel business. We do not see a policy justification for a different tax outcome arising in a staple scenario simply because the real estate and the hotel business are owned by the same investors. The investors in the staple are in the exact same position vis a vis their investment in the real estate as the investors in the real estate in the third party scenario – deriving rent from the utilisation of a real estate asset. In fact, imposing a differential tax outcome on a stapled structure in this scenario would be distortive, as it would incentivise hotel businesses to sell down their interest in the real estate to other investors, instead of remaining as the owner of the real estate, even if the original owner would have been best placed to hold the real estate.

This demonstrates that the stapled structure itself should not be viewed as abusive or high risk *per se*. Rather, concerns should only arise if such structures are being used to artificially inflate the amount of profit that is derived by the land trust, ie that payment terms are not arm's length.

[1] P7 of the TA

[2] See p2 "Cross-staple dealings tend to be immaterial compared to the core business operations of each entity and most significantly, Asset Trust receive all or most of its income, such as rent, from unrelated third party tenants in respect of its discrete passive investment activities."

In our view, if the taxpayer can demonstrate that the cross-staple payment is based on arm's length pricing, the ATO should be comfortable that no mischief is being achieved, and there is no "re-characterisation". Rather, there is an appropriate amount of rent being derived for the contribution of a real estate asset to a business, and that that rent is subject to the tax treatment appropriate for that type of income and that type of taxpayer.

The same should apply to any industry where a relevant market exists for the real estate alone, which may include student accommodation, retirement villages, storage facilities and others. The ATO should therefore state as a general principle that the TA does not apply if the cross-staple payment is set at arm's length.

Obviously, appropriate qualifications would be needed and accepted to deal with situations where there is no genuine market against which to determine arms' length pricing eg where there is no genuine market for the real estate alone.

4. Examples

Whatever the outcome from all the above, the TA would benefit from inclusion of more specific 'real-life' examples of what the ATO regards as high risk arrangements and arrangements that are low risk as well as examples that do not just involve stapled structures.

For example:

- Are there any examples in the renewables or agricultural industry where the ATO considers that the TA would not apply? For example:
  - if land is held in a trust for asset protection purposes;
  - if land is held in a trust to preserve the ability to use the land for a different purpose; or
  - if the operating business could be run by an independent third party.
- What are the ATO's views on the extent to which the anti-avoidance rules can apply to a stapled structure where the relevant trust is not a "public unit trust"?

These examples should be addressed in any further guidance the ATO issues on this matter.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Matthew Pawson
President