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Fragmenting the Part IVA Lore Applying to Stapled Structures

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CONTENTS

1 Overview

The title of this paper leaves little doubt as to my opinion on the lack of depth of the Australian Taxation Office's **(ATO)** recent views regarding stapled security structures and the purported application of Part IVA.[1] More lore than law.

My basic proposition is that hyperbole, including the use of (in this context) emotive terms such as "fragment", "contrived", "concern", "re-characterise" and "artificially diverted",[2] has distracted attention from the fact that there is a lack of analysis as to how it is that the Commissioner of Taxation **(the Commissioner)** might actually try apply Part IVA to stapled structures. Instead, there is conjecture about how far-reaching the Commissioner's view might be (e.g., asset types, privatisation vs. non-privatisation, etc.) rather than a sensible discussion about how the ATO believes Part IVA might actually be applied in the first place.

This paper seeks to address what I see as the shortcomings in the ATO's apparent views, although it should be said that in the absence of any clear public statement of reasoning, the exercise is a little like boxing at shadows.

It is against this backdrop of ATO activity (and the resultant commotion among industry players and advisors alike) that the Government has commissioned Treasury to consult on the "integrity risks" regarding the use of stapled structures.[3] That being so, and for the avoidance of any doubt, I make no arguments for or against what an appropriate Government policy on this matter may be – far be it from me to do so. However, I do think it is reasonably clear what the current policy is and has been.

Furthermore, it should be noted that Treasury's consultation paper canvassed no proposals which would seek to clarify the scope and application of Part IVA to stapled structures – arguably, this belies the credibility of the ATO's position. What is being considered appears to rely on more of a policy focussed approach, driven not by perceived integrity risks, but by potential revenue risks into the future if the current policy remains in place. Hopefully, at the conclusion of its consultation process, Treasury is transparent in its recommendations.[4]

1.1 Clarifying the Scope

The ATO's apparent concern is with structures that *"…attempt to fragment an integrated trading business in order to re-characterise trading income into more favourably taxed passive income."*[5]

In this context, the ATO identifies four different types of stapled structures: financing, rentals, royalties, and synthetics.

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[1] Of the *Income Tax Assessment Act 1936* **(the 1936 Act)**.

[2] Terms that are all used in the first paragraph alone of ATO Taxpayer Alert 2017/1: Recharacterisation of income from trading businesses **(Taxpayer Alert)**.

[3] Department of Treasury Consultation Paper dated March 2017.

[4] Refer to Pitcher Partners' submission to Treasury dated 20 April 2017.

[5] Taxpayer Alert.

The first of these, financing stapled structures, has been labelled by the ATO as the "third wave" of stapled structures,[6] arriving in the mid-2000s (waves one and two being A-REITs and privatisations respectively). I do not discuss financing stapled structures in any detail this paper. There has already been so much said and written about the potential reach of section 974-80[7], and with the introduction of the Non-Arm's Length Income **(NALI)** rule in Subdivision 275-L and proposed changes to debt/equity rules in the wind[8] it seems to me that there is little scope to claim that there are financing stapled structures to which Part IVA might be applied. This is not say that the ATO will not attempt to apply Part IVA – financing via staples is clearly on its radar, and the ATO has highlighted "dual trust" structures as being of interest.

Nor do I discuss royalty or synthetic stapled structures in any detail in this paper. These, together with rentals, are described by the ATO as the "fourth wave".[9] They are not relevant to the infrastructure sector. However, in my view, including these in the same category as rental stapled structures in its Taxpayer Alert, and related forum discussions that have followed, is undoubtedly designed to enhance the ATO's prospects of achieving the outcome it is hoping for (i.e. skewering all staples outside of REITs and privatisation). Synthetics, by their very nature, have a high degree of artificiality. Royalty stapled structures are, in the absence of Part IVA being applied, only relevant where Division 6C is not in play (i.e., due to ownership of a relevant trust not meeting the definition of a "public unit trust").[10]

The ATO has stated that there are $9.1 billion of fourth wave structures in existence and another 39 that have proposed worth of $10.2 billion.[11] To better understand the ATO's viewpoint on their purported proliferation it would be helpful to see the breakdown (and source) of these statistics between each of the rentals, royalties and synthetics stapled types.

In any event, the scope of this paper is to address Part IVA issues in connection with rental stapled structures. Put simply, it is my view that Part IVA could rarely, if ever, apply.

[6] Page 9 of presentation delivered by the ATO at ATO Infrastructure Event in Sydney on 22 March 2017 **(ATO Infrastructure Event presentation)**.

[7] Of the *Income Tax Assessment Act 1997* **(the 1997 Act)**

[8] Exposure Draft legislation released 10 October 2016.

[9] Page 10 of ATO Infrastructure Event presentation.

[10] This is not an indication by me that Part IVA could (or would) apply one way or another. It is simply that I think they will have different Part IVA considerations.

[11] Page 10 of ATO Infrastructure Event presentation.

2 Types of Rental Stapled Structures

The types of stapled structures causing the ATO concerns as structures designed to fragment integrated trading business to re-characterise trading income include the following:

- restructures of existing infrastructure businesses from corporate form into stapled structures **(“Rental Restructure Case”)**;
- greenfield infrastructure businesses being established in stapled structure form; and
- acquisitions of existing infrastructure business into stapled structure form.[12]

Land-rich privatisations staples, such as ports and electricity, have been identified by the ATO as a special case, where it *“reserves the right to apply Part IVA for those swimming outside the flags”*.[13] There is no reason at all provided for why they are a special case. In my view, there is something oddly disconcerting when the Tax Administrator is not prepared (or able) to rationalise the exercise of its power of discretion to apply Part IVA[14] - so much for transparency.

Some people at the ATO may well retort *“well, would you like us to apply Part IVA to everything we can?”* Truthfully, I would not mind. But only where it actually does apply. In this context it is worth noting that, to my knowledge, there have been no proposals canvassed as part of Treasury’s consultation for a legislative carve-out to explicitly shield privatisations, and other stapled structures deemed to be acceptable to the Government, from the purported application of Part IVA. Why not? It would certainly expose the extent of the ATO’s conviction in its views on Part IVA to apply to other stapled structures. I would be surprised if the Commissioner was to ever fully litigate a Part IVA matter, let alone obtain an affirmative court decision, involving the denial of a rental deduction in a straightforward infrastructure staple.

In the analysis set out in this paper I provide my views and comments on the application of Part IVA to these types of rental stapled structures.

Before doing so, it is worth briefly addressing the objectives and outcomes of rental stapled security structures.

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[12] Refer Taxpayer Alert which also notes that there are also structures that do not involve legal-form stapling that are on the ATO’s radar.

[13] Page 15 of ATO Infrastructure Event presentation.

[14] Pursuant to section 177F of the 1936 Act the Commissioner “may” make a Part IVA determination but he is not obliged to do so.

2.1 What is a rental staple?

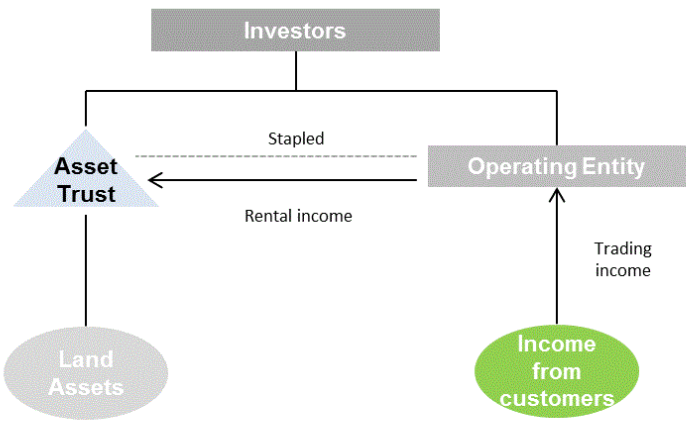
As defined by the ATO in the Taxpayer Alert:

"A rental staple typically displays all or most of the following features:

- "*Asset Trust owns selected assets, being assets which are usually purportedly land or a fixture on land*
- *Operating Entity* [for the purpose of this paper I have assumed that Operating Entity is a company] *enters into one or more agreements with Asset Trust to lease or otherwise access the selected assets to enable Operating Entity to operate its business*
- ***the nature of the business is such that the transactions to divide the business in this manner are not transactions that third parties acting at arm's length would usually enter into, and it is often also the case that the business is not one capable of division in any commercially meaningful way***
- *Operating Entity claims a tax deduction for the payments made to Asset Trust under the agreement(s), and*
- *Asset Trust and Investors may also purportedly be a MIT under section 275-10 of the ITAA 1997."* **[Emphasis added]**

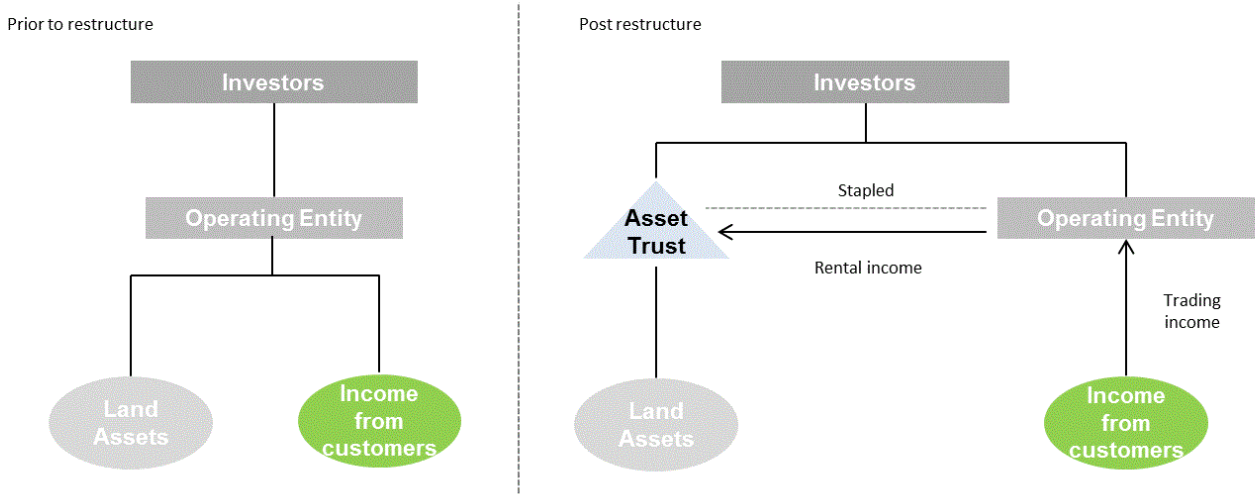
I will come back to the third bullet point later in this paper, other than to note for now, that the ATO clearly assumes (as a matter of fact) that there is dissonance between the form and substance of the transaction.

Diagrammatically, the structure this is represented as follows:[15]



[15] Diagram from the Taxpayer Alert.

In a Rental Restructure Case, this is depicted as follows:[16]



Crucially, both descriptions and depictions by the ATO ignore any funding associated with the assets, thereby allowing the layperson to assume that the structures are entirely funded by equity. That is simply unrealistic, particularly in the infrastructure sector. Debt financing is invariably crucial to any infrastructure investment, and for the purposes of defining rental staples (cf. financing staples) it may be assumed that all debt resides with the holder of the assets, Asset Trust.

2.2 What are the outcomes?

Rental stapled structures allow capital intensive assets of an enterprise to be held separately (in a trust) from the operational assets and activities held by the same economic owners (often in a company).

In an infrastructure context, the assets involved are those that comprise land including assets that are fixtures on the land. This could include, for example, wind farms, storage facilities and electricity related infrastructure. Including privatisation assets, the scope is obviously wider.

2.2.1 Tax aspects

Amongst those in the tax community (not just the ATO) there is a large emphasis placed on tax features and outcomes of the rental stapled structure. So I will address those first, although doing so is not at all meant to imply that they are fundamentally tax driven schemes. Leaving aside the application of specific tax integrity rules (discussed further below), broadly:

- the Operating Entity includes income from customers in its assessable income, and obtains deductions for the rent that it pays to Asset Trust and its ordinary operating expenses;
- Asset Trust includes rental income in its assessable income, and obtains deductions for capital allowances on depreciable assets residing on the land and interest on debt funding;

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[16] Ibid.

- Asset Trust is treated as 'flow through' pursuant to Division 6 of the 1936 Act, with its net income taxed in the hands of investors; and
- investors will be taxed on distributions of taxable income by Asset Trust at the rates of Australian tax that apply to them.

So, the taxable income of the structure, which equates to the economic totality of the arrangements, is fully subject to Australian tax at applicable rates of tax. No asymmetric tax outcomes across the structure, no deferrals, no non-equity return provided to offshore parties.

In the Rental Restructure Case, the tax outcomes are the same, except that there are some steps that occur before the rental agreement is put in place. These steps would typically involve:

- the acquisition of shares in Operating Entity (because there would be no need to restructure if shares in a company were not acquired in the first place);
- the establishment of Asset Trust as a subsidiary of Operating Entity;
- the transfer of land assets to Asset Trust; and
- the *in specie* distribution of units in Asset Trust to Investors.

From a tax perspective:

- any gain on the transfer of assets from Operating Entity is subject to Capital Gains Tax **(CGT)** (upon a direct transfer of assets to Asset Trust, or upon its deconsolidation from Operating Entity); and
- the *in specie* distribution will be treated as a return of capital (reducing cost base in Operating Entity) or a distribution of profits, as the case may be.

Again, no amount escaping the Australian tax net.

If the restructure is performed soon after Investors acquire an interest in Operating Entity, then any CGT for Operating Entity on the transfer of assets to Asset Trust may be minimal, assuming that tax consolidation rules have been applied (e.g., because there has been a 'step-up' in the tax value of the assets). But in that case the sale of shares in Operating Entity by its previous owners will presumably have been dealt with under the CGT regime.[17]

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[17] Whether CGT applies respect of the previous owners may depend on whether or not the interests in Operating Entity are, in the case of a foreign vendor, Taxable Australian Property under Division 855 of the 1997 Act. In any event that is not a Part IVA consideration with respect to the new Investors.

In describing the tax outcomes, the ATO is less expansive:[18]

> *"[t]he re-characterised income is diverted to a flow-through trust with the result that:*
>
> - *Asset Trust is assessed on a flow-through basis (that is, usually not taxed);*
> - *distributions from Asset Trust may be ultimately subject to taxation at a rate of commonly between 0 to 30%; and*
> - *although Operating Entity would be taxed at the corporate rate of tax, it is unlikely to have significant taxable income, largely because of deductions in respect of the payments to Asset Trust.*
>
> *But for these structures, it would be reasonable to expect the trading income to form part of the taxable income of a corporately taxed entity."*

Although less expansive, it is no less insightful – taxable income has not changed; it is the same.

Furthermore, reference in the second bullet point to *"distributions…ultimately [being] subject to taxation at a rate of commonly between 0 to 30%"* is misleading to the extent that it implies, in the case of a rental stapled structure, that there is taxable income that is recharacterised to have a 0% tax rate. The inference is misconceived.

2.2.2 Specific tax integrity rules

I do not propose to discuss in depth the scope of specific integrity rules that overlay what is set out above, except to note that they are extensive. Moreover, they are contemporary and do not sit in some part of the 1936 Act that has been left untouched and gathering dust whilst developments in stapled structures have overtaken the rules. In summary:

- Broadly, Division 6C of the 1936 Act ensures that Asset Trust will only remain flow through (and not subject to tax as a corporate entity) where it is a public unit trust provided that:
    - its assets comprise interests in land, including fixtures;
    - Operating Entity does not control Asset Trust;
    - Asset Trust rents out its assets for the purpose of deriving rental income.

  The most recent amendments to Division 6C took effect from 5 May 2016.

- The NALI rule in Subdivision 275-L of the 1997 Act ensures that the rentals charged by a trust qualifying as Managed Investment Trusts **(MITs)** cannot be more than an arm's length rental amount.

  The NALI rule was introduced with effect from 5 May 2016.

- Potential access to the MIT withholding tax concessional rate of 15%, in particular for the distribution of net rental income and capital gains to eligible foreign investors.

[18] From the Taxpayer Alert.

The most recent amendments to MIT eligibility requirements took effect from 1 July 2016.

2.2.3 Non-tax outcomes

The ATO is yet to publicly acknowledge the non-tax outcomes of rental stapled structures in a Part IVA context, other than its unexplained (and until otherwise explained, perhaps artificial) delineation for privatisations and REITs.

The non-tax effects of rental staples are extensive, and I have outlined some of these below:

A trust owns the assets and a company runs the operations

The implementation of a rental staple necessarily requires that legal title of the relevant assets resides with different entities. There are real legal (and taxable) transactions required to ensure that this occurs. It does not involve the mere booking of accounting entries. Nor are the transactions temporary in nature (i.e., they are not temporary transactions waiting to be unwound).

To the tax community the non-tax differences between a trust and a company might be trivialised, but so long as there are differences I am not sure that it is wise to do so, otherwise, why would they exist as separate vehicles in the first place? To this end:

- companies enjoy perpetual succession, whereas trusts do not;
- companies have limited liability so that liability for a company's debts are generally limited to assets of the company;
- companies are subject to stricter legal requirements (*Corporations Law* and general law) regarding payment of distributions and returns of capital;
- directors of companies owe a fiduciary duty to the company. Trustees owe a fiduciary duty to the trust's beneficiaries.[19] As The Hon Justice K M Hayne AC states[20]:

> *"…Dixon J said in* Mills v Mills *(Mills), '[d]irectors of a company are fiduciary agents'. Hence they owe fiduciary duties. But….it is important to recall what Romer J said in* City Equitable*:*
>
> > *It has sometimes been said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship to the company, that statement is true enough. But if the statement is meant to be an indication by way of analogy of what those duties are, it appears to me to be wholly misleading."*

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[19] It should be noted that this is another key reason why investors will have greater certainty regarding their entitlement to distributions, which is discussed at paragraphs 54 to 60 of this Response.

[20] Hayne, K M, *Directors' Duties and a Company's Creditors* [2014] MelbULawRw 28

Ability to distribute cash returns to investors

The typical profile of investors in infrastructure is that they require a regular and stable cash return. As such, it is important that an investment structure be arranged in a way that is capable of providing cash returns to its investors, both from profits and through the return of invested capital.

Adoption of a rental stapled structure enables cash to be distributed to investors via an Asset Trust without the legal impediments that would otherwise exist for payments of dividends and returns of capital if all assets were instead held by a single holding company structure. These are explained as follows:

<u>Dividends</u>

With respect to the payment of dividends, reforms to the *Corporations Act 2001 (Cth)* ***(Corporations Act)*** in 2010 removed the statutory requirement that dividends must be paid "out of profits".[21] However, judicial decisions since then have indicated *"that there remains a general law principle that dividends may only be paid out of profits"*.[22] Although there have been repeated calls for the position to be clarified, section 254T of the *Corporations Act* has not been amended since 2010. The Government has twice proposed amendments, once to reinstate the profits test (in 2012), and another time to abolish it definitively (in 2014). Neither amendment has proceeded.

For infrastructure assets, the financial profile is typically that there are often accounting losses for some period of time due to the amortisation of the upfront capital ongoing investment, interest payments on debt and ongoing capital expenditure. Accordingly, the absence of profits, even though there may be available cash, means that the payment of dividends is not an option.

<u>Returns of capital</u>

Returns of capital out of a company are permitted only in circumstances where all of the following requirements of section 256B of the *Corporations Act* are satisfied:

- it is fair and reasonable to the company's shareholders as a whole;
- does not materially prejudice the company's ability to pay its creditors; and
- is approved by shareholders under section 256C (i.e., by a resolution passed at a general meeting of the company).

It is not reasonable to expect that a company's directors would effectively subject themselves to a perpetual requirement to consider section 256B and to convene general meetings of its shareholders to approve the payment of returns of capital on every occasion that there is cash to be distributed.

Unlike corporate entities, trusts are not subject to the *Corporations Act* requirements for returning capital. As such, there is flexibility in its ability to pay returns of capital (tax deferred distributions) to investors free from impediment.

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[21] Introducing instead a "solvency test": section 254T of the *Corporations Act*

[22] See *Wambo Coal Pty Ltd v Sumiseki Materials Co Ltd* [2014] NSWCA 326 at [57].

Lower cost of debt

Borrowing by a trust that is flow through for tax purposes improves the cost of (and access to) debt funding. To explain this:

- Debt funding agreements for infrastructure investments will typically contain financial covenants whereby lenders will require that a minimum Debt Service Coverage Ratio **(DSCR)** is maintained by the borrower.
- Broadly, DSCR is defined as the ratio of cash flow available for debt service **(CFADS)** to service debt requirements for a given period.
- Broadly, CFADS is defined as Earnings Before Interest, Tax, Depreciation and Amortisation **(EBITDA)**, less (among other things) cash tax paid during the relevant period.
- Accordingly, to the extent that tax is paid at the investor level (because of the flow through nature of Asset Trust), rather than the borrower level, then the DSCR will be lower.

I discuss further below why the mere payment of less tax (at the borrower level) as an explanation of this commercial benefit is not something to which Part IVA will apply.

Evidence for the fact that DSCR is a genuine concept cannot only be found embedded in the covenants of actual debt funding agreements, but it is also referred to in APRA Prudential Standard *APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk* as a credit risk criterion used by APRA regulated financial institutions. Specifically, a higher DSCR reflects a lower credit risk. A lower credit risk naturally means lower interest.

3 Part IVA

For the purposes of this paper I do not provide an overview of the legislative framework for Part IVA, of which much has already been written elsewhere. Broadly, it applies where the Commissioner makes a determination to assess a taxpayer as if a scheme had not been entered into. The basis for the determination must be that it is objectively reasonable to conclude that, having regard to eight factors, the sole or dominant purpose of a party to the actual scheme was to obtain a tax benefit for the relevant taxpayer.

As I stated earlier, the ATO is yet to publicly provide any technical insight into how it would apply Part IVA to rental stapled structures. However, based on my practical experience, I understand that its Part IVA argument, at least to date, has been along the lines of the following:

- a narrow scheme can be identified, which involves the acquisition of land assets by Asset Trust and the renting of those assets to Operating Entity; and
- an annihilation approach can be applied to "delete the scheme" as it exposes a coherent taxable situation, being the *status quo* prior to the restructure. There is no need to engage in any kind of reconstruction or speculation.

On this basis, it is argued that the tax benefit exposed is the rental deduction claimed by the Operating Entity.

It is noteworthy that the tax benefit identified for Part IVA purposes is the rental deduction, when the ATO has publicly stated that its concern is that *"[t]hese structures are used to reduce the tax rates applicable to trading income"*. That is, the ATO's concern is not with reductions in taxable income *per se*, but reductions in the applicable tax rate. However, for the purposes of a Part IVA analysis the reduction of a tax rate is not capable of being a tax benefit.

3.1 Narrow scheme

The adoption of a narrow scheme eliminates the surrounding facts of a wider scheme which might explain other circumstances, such as how and when the Investors came to acquire the assets. For example, that could explain the appetite and basis on which the investment was made – in a Rental Restructure Case an infrastructure asset might be acquired from a former investor for whom a single holding company structure was adequate. They choose to sell the shares in the company but for the new Investors, who desire a periodic and stable cash return, the structure is not suitable (for reasons explained above).

Under the narrow scheme approach it also means that the *status quo* before the restructure is not able to be viewed in context – that is, to explain what brought about the imperative for a change in the single holding company structure to a staple (i.e., new ownership with differing investment return objectives).

Regardless, the narrow scheme still does not lend itself to a finding that Part IVA applies, let alone a Part IVA style annihilation of the rental deductions.

3.2 Annihilation

As noted at Paragraph 1.81 of the Explanatory Memorandum **(EM)** to the relevant amending Act to Part IVA in 2013:[23]

> *"this annihilation approach is a simple and effective way to identify tax benefit in a case where the mere deletion of a scheme exposes a coherent taxable situation – without the need to engage in any kind of reconstruction or speculation."*

Real non-tax consequences, the EM says, will typically prevent annihilation applying. Once annihilated, it is *a fait accompli* that there will be found to be a sole of dominant purpose of obtaining a tax benefit. Presumably, the ATO places weight on the fact that there is common (i.e. identical) ownership of the entities that are stapled together as a basis to argue that, in an economic sense, the underlying owners have not changed following the transfer of assets – it is merely transferring assets from the left hand to the right hand.

However, in the present case, there is little required to defuse the annihilation, having regard to the non-tax outcomes of holding certain assets in a trust instead of a company. In the scheme defined:

- there is a transfer of title of assets from one taxpayer to another taxpayer (for market value consideration);
- the taxpayers are not special purpose entity types created under tax law. They are conventional and well known in Australia from a legal and commercial perspective, and each has its differences from the other; and
- the acquiring trust (i.e., Asset Trust) is required to have funding support (in the form of equity and debt) for its acquisition of the relevant assets and ongoing capital expenditure. Conversely, the equity and debt position of the transferring company is relieved.

Furthermore, and in any event, although there is common underlying economic ownership, there is court authority which explicitly rejects the notion that entities within the same economic group cannot be attributed independent status for tax purposes.[24]

Put simply, the scheme cannot be merely deleted to expose a coherent taxable situation. Annihilation does not work.

Despite my views on the annihilation, following the 2013 amendments to Part IVA, I am less inclined to resist the possibility of there being a tax benefit identified in the scheme. As such, it is prudent to consider the scheme's purpose under s177D.

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[23] Explanatory Memorandum to the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

[24] See *Commissioner of Taxation v BHP Billiton Finance Ltd (2010) 182 FCR 526; Ashwick (Qld) No 127 v Commissioner of Taxation (2007) FCA 1388*

3.3 Purpose

3.3.1 What recharacterisation?

In commencing an analysis of Part IVA purpose on this matter, it is worth re-emphasising at the outset that the ATO's philosophical concern (which is all we have to go on from what it has said publicly at this stage) is the purported recharacterisation of trading income into rental income.

Having regard to the substance of the transaction, in my view the term "recharacterisation" is incorrect. When the transactions are completed at arm's length there can be no argument that the result of the staple is to in fact *properly* characterise the active and passive aspects of the enterprise which generate an income yield. Without being divided into its components, the income is in fact mischaracterised as being entirely attributable to active trading income rather than taking account of the economic value of availability of the use of underlying assets.

3.3.2 Simplicity of the narrow scheme

The problem for the ATO with its narrow scheme, and apparent Part IVA approach to rental staples generally, is the simplicity of the transaction steps giving rise the purported tax benefit. Conversely, to "go wide" would require the ATO to concede that rental stapled structures are fundamentally acceptable.

Regardless, in essence, the simplicity of the narrow scheme self-addresses the two most important factors in section 177D of the 1936 Act, "the <u>manner</u> in which the scheme was entered into or carried out" and the "<u>form and substance</u> of the scheme".

In *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216 ***(Hart)***, Gummow and Hayne JJ cautioned both the Commissioner, against applying Part IVA on the basis that less tax was paid than would have been if the scheme had not been entered into, and taxpayers, against reading it in a way that inoculated it against ordinary transactions:[25]

> *"The bare fact that a taxpayer pays less tax, if one form of a transaction rather than another is made, does not demonstrate that Part IVA applies. Simply to show that a taxpayer has obtained a tax benefit does not show that Part IVA applies. With these considerations in mind, it is sometimes said that it is necessary to read Part IVA in a way that will not bring "ordinary" transactions to tax. It is obvious that the content of such a proposition turns entirely upon what is meant by "ordinary"."*

Gleeson CJ and McHugh J in *Hart* further elaborated:[26]

> *"As Hely J correctly observed in the Full Court, the fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of tax benefits associated with its adoption does not of itself mean that there must be an affirmative answer to the question posed by s 177D. Taxation is part of the cost of doing business, and business transactions are normally influenced by cost considerations. Furthermore, even if a particular form of transaction carries a tax benefit, it does not follow that obtaining the tax benefit is the*

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[25] *Hart* at paragraph 53.

[26] *Hart* at paragraph 15.

> *dominant purpose of the taxpayer in entering into the transaction. A taxpayer wishing to obtain the right to occupy premises for the purpose of carrying on a business enterprise might decide to lease real estate rather than to buy it. Depending upon a variety of circumstances, the potential deductibility of the rent may be an important factor in the decision. Yet, if there were nothing more to it than that, it would ordinarily be impossible to conclude, having regard to the factors listed in s 177D, that the dominant purpose of the lessee in leasing the land was to obtain a tax benefit. The dominant purpose would be to gain the right to occupy the premises, not to obtain a tax deduction for the rent, even if the availability of the tax deduction meant that leasing the premises was more cost-effective than buying them."*

Having regard to the above, it is difficult to comprehend how the transfer of assets from one type of entity to another, all done within the Australian tax net and at arm's length values with supporting levels of equity and debt funding, could be seen as anything other than the transfer of legal and substantive risks and benefits of ownership from one taxpayer to another.

3.3.3 A "manner" evidenced by selection of assets

I understand that the thrust of the ATO's concern arises from the so-called "fragmentation" caused by only certain assets being held by Asset Trust - or more specifically, a selection of only those assets to which Division 6C will not apply because there is an eligible investment business of Asset Trust.

In response to this, I find it peculiar that Part IVA can have residual application when there is a specific integrity rule, namely the NALI rule, which in fact appears to contemplate that an enterprise will not be contained within a single entity. More curious is that fact that the ATO has itself recognised in its Law Companion Guide LCG 2015/15[27] that a single integrated businesses may be "fragmented" among stapled entities, and that is permissible, such to application of the NALI rule.[28]

In any event, I suspect, but do not know, that the ATO considers rental stapled structures to be "unordinary" because identical Investors have economic ownership of both stapled entities. If so, then it appears that the non-application of Division 6C (and therefore obtaining flow through tax treatment) is viewed as the mischief – but that is not a tax benefit. Nor is it determinative in applying a Part IVA analysis to the manner and form and substance of the purported scheme.

To this end, the selection of assets to be held by a certain entity *is* fundamentally ordinary. The Commissioner has himself acknowledged this in Tax Determination TD 95/*4 Income tax: does the simple disposition of an income producing asset by a natural person to a wholly owned private company constitute the carrying out of a scheme to which Part IVA of the* Income Tax Assessment Act 1936 *will be applied?* **(TD 95/4)**

In TD 95/4 the Commissioner has ruled that the answer is "no" where there is a simple transfer of assets from an individual to a company. There is no suggestion that an individual must divest all or his or her assets to the company (it would be absurd to suggest so). There, an individual is "fragmenting" his or her asset portfolio. Moreover, TD 95/4 addresses the situation where a CGT rollover is being obtained on the transfer. In the case of a Rental Staple Restructure there is in fact no transfer of assets to Asset

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[27] LCG 2015/15 - *Managed Investment Trusts: the non-arm's length income rule in sections 275-605, 275-610 and 275-615 of the Income Tax Assessment Act 1997*

[28] Paragraphs 51 to 61A of LCG 2015/15.

Trust that is not dealt with as a taxable transaction (directly upon the transfer of assets, or otherwise upon deconsolidation). It is difficult to reconcile the Commissioner's approach in TD 95/4 with its current approach to stapled structures.

In the context of integrated businesses being fragmented, the use of stapled structures to hold assets in different legal entities is essentially no different than a factory premises being held by one entity and the related employees and sales and distribution business being held by another related company. Would the ATO really have us believe that the entire operations of a single enterprise must be held in a single entity lest Part IVA apply to the inter-entity transactions? The fact is that the commercial world is riddled with economic groups organising themselves in a way where there are multiple separate legal entities.

Notwithstanding the ordinariness of a particular transaction, I am conscious that mere decisions or selections do still have the potential of being pejorative in considering the "manner" in which the scheme is entered into or carried out.

That is what happened in *Hart*. Gleeson CJ and McHugh J approved Hill J's finding (but not his ultimate conclusion on Part IVA) that:[29]

> *"While the scheme did permit the borrowing of moneys for the two purposes indicated, one private and the other income producing, the manner in which the scheme was formulated and thus entered into or carried out is certainly explicable only by the taxation consequences. By 'manner' here I refer to splitting what might commercially be seen as one advance into the two separate advances with interest on the income producing advance being permitted to remain unpaid, to be capitalised and the capitalised amount then attracting the compound interest with the amount which would otherwise have gone towards payment of that interest being directed towards the repayment of the capital outstanding on the private advance."*

In my view, the selection of assets transferred from one entity to another is clearly distinguishable from, what was in *Hart*, a narrow scheme whereby the "splitting" selection was found to be the scheme itself. That is, the splitting of deductible and non-deductible interest under the same borrowing was the scheme. There is no suggestion post-*Hart* that a taxpayer cannot obtain certain loans for private purposes and other loans for business purposes. The reason that will not fall foul of Part IVA is because each loan arrangement will have a manner that is ordinary, and a form and substance that has no dissonance. This is no different to a decision to hold certain assets in one entity but not in another to implement as rental stapled structure.

3.3.4 Sale and leaseback cases

The sale and leaseback cases on Part IVA[30] are relevant in a Rental Restructure Case in that they take the above analysis regarding form and substance further by directly addressing the leaseback by the transferring Operating Entity, albeit with a third party financier.

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[29] *Hart* at paragraph 13.
[30] *See Eastern Nitrogen Ltd v FCT* (2001) ATC 4163 **(Eastern Nitrogen)***; FCT v Metal Manufactures Ltd* (2001) ATC 4152.

The respective courts found that Part IVA did not apply notwithstanding that issues of "elements of artificiality" were raised. Lee J considered this in *Eastern Nitrogen*, examining the key issues identified at first instance that gave rise to questions of form and substance, being "elements of artificiality":

- market value
- retention of control by the taxpayer of the assets sold; and
- the high degree of certainty of reacquisition at the end of the lease.

Lee J noted that where a scheme involves a transaction that creates legally enforceable rights and obligations, an objective assessment of the purpose of the transaction must have regard to them. The presence of "elements of artificiality" may be relevant for the purpose of the transaction but is not determinative and does not remove the requirement to consider the effect of the transaction and its rights and obligations.

In the Full Federal Court decision in *Hart*, Hill J was more circumspect, noting the following with respect to the sale and leaseback cases:[31]

> *"There were, of course, different legal consequences between a loan and the so-called lease. On the other hand it is hard to imagine that the transaction would have been structured in the way it was (where the right of the lender was really a right in equity to enter the premises and remove the plant at the end of the co-called "lease") but for tax. Yet it was held that the scheme was not one to which Part IVA applied".*

As Carr J stated in *Eastern Nitrogen*:[32]

> *"Advice was taken on legal, accounting, taxation and financial implications. That, in summary, was the manner in which the scheme was entered into.*
>
> *The scheme was carried out by compliance with the terms of those two agreements. The agreements were not shams. They reflected real transactions which the parties had agreed upon. The parties carried out the scheme by honouring the respective obligations which the agreements imposed.*
>
> *In my view, the manner in which the scheme was entered into and carried out were neutral in terms of indicating objectively an objective purpose on the appellant's part of obtaining a tax benefit. A merchant bank had a financial service to sell and it did so successfully. There were negotiations about the terms and conditions of the transaction, but there was nothing unusual, uncommercial or unexpected about either the manner in which the scheme was entered into or in which it was carried out. A large amount of money was involved. Thus it was to be expected that there would be important formal issues to be resolved and that the agreements would be prepared by lawyers. But the basic transactions were simple and straight forward."*

The substantial effects of rental stapled structures have none of the elements of the artificiality of the type referred to by Lee J in *Eastern Nitrogen*: the assets are transferred permanently to Asset Trust,

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[31] *Hart v Commissioner of Taxation* [2002] FCAFC 222 at [60].
[32] *Eastern Nitrogen* at 4179.

they are transferred for market value; and an arm's length rental is paid by Operating Entity to Asset Trust for their ongoing use under lease.

The Commissioner's public ruling on sale and leaseback transactions (TR 2006/13)[33] provides clarity that these are facts which will be influential:[34]

> *"In most situations, sale and leasebacks will be explicable on the basis of a dominant purpose of obtaining a benefit other than a tax benefit, for both lessees and lessors. However, some transactions may have particular steps which may raise a real concern that the transaction, or part of it, has a dominant purpose of securing a tax benefit such that Part IVA of the ITAA 1936 may apply. See Law Administration Practice Statement PS LA 2005/24 Application of General Anti-Avoidance Rules. Aspects of sale and leaseback transactions which are likely to raise concerns include:*

- *an appropriate balancing adjustment and/or capital gain is not included in the assessable income of the lessee and lessor as applicable;*
- *at the time the sale and leaseback is entered into there is an intention to assign the right to income arising from ownership of the asset during the period of the lease;*
- *appropriate values are not used (both in relation to the sale of the … and for the purpose of setting the residual value for the asset (see Taxation Ruling IT 28));*
- *the overall sale and leaseback arrangement itself was not designed to provide a positive cash result to the lessor before taking into account the tax benefits (other than the effect of investment and/or development allowance): see Taxation Rulings IT 2220 and IT 2051; or*
- *the sale and leaseback arrangement does not effectively provide the full value of the purchase price of the asset to the vendor lessee when the asset is sold for leaseback."*

3.3.5 Lower cost of debt

As mentioned above as a matter on which I would elaborate further, the mere payment of less tax (at the borrower level) as an explanation of a commercial benefit (being a lower cost of debt) is not something to which Part IVA will apply.

It is accepted that Part IVA will not apply if all that has happened is that the taxpayer has rearranged its business so as to pay less tax. Hill J referred to this in *Macquarie Finance*:[35]

> *"91. McHugh J in his separate judgment was careful to distinguish the scheme employed in Spotless from a mere rearrangement by a taxpayer of its business so as to pay less tax. Spotless involved much more than the mere switching of investments from one attracting tax*

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[33] Taxation Ruling *TR 2006/13: Income Tax: sale and leasebacks*.
[34] Paragraph 37 of TR 2006/13.
[35] *Macquarie Finance Ltd v FC of T* 2004 ATC 4866 at 4887.

> *to another investment having a tax advantage. So to describe the scheme in Spotless would be simplistic."*

These comments go beyond observations on the identification of the scheme. They are the conclusion drawn as to the dominant purpose of the schemes entered into. Part IVA will not apply if all that has happened is that the taxpayer has rearranged its business so as to pay less tax. *Spotless* concerned an elaborate tax scheme and its attendant circumstances; *Hart*, a scheme where the form of the loan itself revealed that it had an embedded tax avoidance purpose. Having regard to the eight factors, the conclusion was drawn that each was a tax avoidance scheme.

It is certainly difficult to comprehend any perception that the establishment of a rental stapled structure would have any of the hallmarks of scheme of the kind in *Spotless*. The High Court set out the origins of the scheme entered into by the taxpayer in *Spotless* and described the implementation of the scheme employed as follows:[36]

> *"In mid-1986, in anticipation of the receipt of a significant amount upon the proposed flotation of shares of Spotless Services, Mr Williams invited proposals from a number of financial institutions for the short-term investment of those moneys. These proposals were considered in consultation with the legal advisers of Spotless Services and eventually led to the Joint Venture Agreement between the two taxpayers. A number of possible avenues of 'off-shore' investment were considered, including the EPBCL proposal which was adopted…..".*

Under the narrow scheme, assets are acquired by Asset Trust and it enters into a lease. There is no elaborate tax scheme.

More recently, Part IVA was found to apply in *Orica*[37], which involved a round-robin of financing instruments, with no effect other than monetisation of a tax benefit. The findings are equally not applicable to rental staples:

- In *Orica*, the relevant Australian company, Orica Finance Limited, entered into a transaction that was not commercial because it was not intended to produce anything but a loss.[38] As a result of implementing a rental stapled structure, there is no reduction of taxable income within Australia. In fact, application of the NALI rule will ensure that taxable income is generated by Operating Entity (income from customers less rent paid to Asset Trust) compared to a single holding company where this may not be the case in the short term.

- In *Orica*, the scheme lacked permanency and brought no lasting advantage to the group. That is, the financing instruments were unwound as soon as the US tax losses were utilised.[39] In a rental staple, acquisition of assets by Asset Trust is for full market value consideration, and is permanent with no intention (subjective nor objective) for the structure to be unwound at any time.

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[36] *Spotless* at 5207.
[37] *Orica Limited v Commissioner of Taxation* [2015] FCA 1399.
[38] Orica at [22].
[39] Ibid.

In my view, the decision in *Orica* does no more than follow the principles laid down by the High Court in *Spotless*: Part IVA will apply to elaborate tax schemes and their attendant circumstances. The narrow scheme identified in connection with rental staple restructures is not such a scheme.

4 What Next?

In the absence of the Government quickly resolving what its policy is with respect to stapled structures[40] (which, in my view, had been clear until consultation commenced in March 2017) we are left with the unsatisfactory position of the ATO's posturing on Part IVA through the Taxpayer Alert. Prior to the initial announcement of Treasury's consultation, I understand that the ATO had planned to provide public guidance on its views in the Taxpayer Alert. Regardless of the progress of consultation, I would encourage the ATO to provide its further guidance sooner rather than later – it would be illuminating for everyone, not just those in the infrastructure sector.

[40] The consultation process having now been deferred.