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6 September 2007

Tax Changes for Australian Property Trusts and Stapled Entities

1. Background

On 16 August 2007, the Government introduced into Parliament the Tax Laws Amendment (2007 Measures No. 5) Bill 2007 (“**the Bill**”). The Bill contains two sets of measures that affect stapled entities and trusts – one that helps stapled groups to restructure without triggering adverse tax outcomes, and a second designed to permit Australian trusts to expand offshore. Both measures have been introduced principally to facilitate the offshore expansion of Australian Listed Property Trusts (“**LPT**”) and have been driven by the recognition that Australian tax law needs to be flexible and accommodate the effects of tax rules in other countries.

2. Overview

The first measure in the Bill is based on the hypothesis that an Australian LPT adopting a stapled structure is likely to be at a competitive disadvantage when bidding for an offshore entity, such as a US real estate investment trust (“**REIT**”). Owners of interests in the REIT would likely be able to exchange their interests in the REIT for interests in an (unstapled) bidder and receive a full roll-over of any tax liability; owners who exchanged their interests in the REIT for stapled interests in an Australian LPT would likely receive only a partial roll-over, making the offer from the unstapled bidder more attractive.

The Bill proposes allowing the reorganisation of a stapled Australian LPT to interpose a head trust (the “**interposed trust**”) to hold the interests in the stapled entities without triggering Australian capital gains tax (“**CGT**”). This new structure will then permit the Australian LPT to offer interests in the new single interposed trust as consideration for the acquisition of interests in a REIT.

A related measure in the Bill then adjusts some of the other tax consequences in Australia where an LPT undertakes a re-organisation to establish this new structure. One of the consequences that would otherwise arise is that the new structure potentially exposes the interposed trust and its investors to the provisions which tax some trusts as if they are companies and their unitholders as if they are shareholders (Division 6C of the *Income Tax Assessment Act, 1936* (Cth)). The exposure would arise because the interposed trust would now own shares in companies which might be carrying on active trading businesses. The Bill reduces this exposure.

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The second measure is designed to permit the offshore expansion of Australian LPTs. The Bill amends Division 6C where an Australian LPT acquires ownership or control of an offshore company or group that is principally involved in investing in land. While the target entity might enjoy flow-through treatment in its own country, Australia's laws are more tightly drawn – the offshore expansion could expose the LPT to Division 6C because it owns shares in companies which might be carrying on very modest active businesses in a foreign country. The Bill qualifies this exposure where the LPT is investing offshore.

We have issued a separate Brief on the new Division 250 which is also contained in the Bill (see http://www.gf.com.au/477_573.htm).

3. Facilitating the restructure of stapled entities

3.1 CGT roll-over

The proposed changes will provide CGT roll-over relief for stapled security holders upon the reorganisation of stapled groups, where the stapled security holders exchange their units and shares for units in an interposed trust. The interposed trust can be a newly established trust or a trust that is currently part of the stapled group.

Just after the restructure is completed (“**completion time**”) each stapled security holder must own a percentage of the ownership interests in the interposed trust that reasonably equates to the percentage of the ownership interests the stapled security holder held in the stapled entities prior to the restructure.

In addition, each stapled security holder must have the same, or as nearly as practicable the same, proportionate market value of ownership interests in the interposed trust as they had in the stapled entities before the completion time – this will be relevant, for example, where the group has ordinary and preferred interests on issue. This means that changes in the relative proportions of different kinds of ownership interests before and after completion time must be the same.

Further conditions also apply specifically for foreign resident members.

Broadly, the consequences of the roll-over for the holder of the stapled securities are:

- any capital gain or loss on the disposal of the stapled securities will be disregarded – revenue gains and losses are not addressed (unlike the analogous roll-over for interposing a new head company between an existing company and its shareholders); and
- the cost base of the units in the interposed trust should effectively be the same as the holder's previous aggregate cost base in the stapled entities.

The interposed trust is taken to have a cost base in the ownership interests in the stapled entities which is determined by reference to the cost base of

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the assets held by the stapled entities, reduced by the amount of any liabilities in respect of those assets. (This differs significantly from the existing scrip-for-scrip roll-over rules where an LPT's cost in the ownership interests it acquires in exchange for issuing its own units will usually be increased to the market value of the interests it acquires. Rather, it follows the rules in the roll-over for interposing a new head company between a company and its shareholders.) Adjustments may be required if some of the stapled entities' assets at completion time were acquired pre-CGT (i.e., before 20 September 1985). The determination of the assets' cost bases and the allocation of liabilities among assets may be a significant compliance exercise for some stapled groups.

The CGT roll-over amendments apply to CGT events that happen on or after 1 July 2006 – some 14 months ago.

3.2 Division 6C

The Bill includes two changes to Division 6C.

One change is designed to reduce its potential applicability after the restructure of a stapled group. It provides that a public unit trust that is an interposed trust will not be subject to Division 6C if:

- the trust is an interposed trust in relation to the restructure of the stapled entities (see above);
- a roll-over was obtained; and
- the trustee of the trust does not carry on a trading business, other than controlling a trading business through its ownership of the company, the shares in which were one of the stapled securities, and its subsidiaries.

In other words, the interposed trust will be able to own shares in any company which was previously one of the stapled entities and carries on a trading business, without triggering Division 6C. Further, the interposed trust's immunity from Division 6C also applies where a subsidiary of the formerly stapled company carries on a trading business. As currently drafted, it appears the immunity is not limited to subsidiaries that were owned by the stapled company prior to the roll-over; that is, the protection for the interposed trust expands to accommodate new subsidiaries of the company acquired after the roll-over occurred. If the protection did not extend to new subsidiaries, the group structure would effectively be frozen at its state after the restructure, even though, had the restructure not occurred, new subsidiaries could have been added under the stapled company without affecting the exposure of the stapled trust to Division 6C.

However, it is clear that this regime only assists where the appropriate stapled structure was in place and then a restructure is undertaken; the rules do not apply to protect a head trust if the same ownership structure is put in place from scratch – a trust is established to hold units in a trust and shares in a company that are then stapled. The head trust of such a

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structure would enjoy no protection from Division 6C because the structure does not arise from the restructuring of (already) stapled entities.

The amendments will apply from the 2006/07 year of income.

4. Facilitating offshore expansion

The second change to Division 6C is directed to offshore expansion by trusts and stapled groups, but is not tied to the restructure amendments. It amends Division 6C to provide that a public unit trust will not be subject to Division 6C only because it has acquired an ownership interest or control of a foreign entity whose business, when considered together with the businesses of entities that the foreign entity controls, consists primarily of investing in land outside of Australia for the purpose of deriving rent. Unfortunately, the Bill does not provide any further guidance on what is meant by “primarily.”

This means that if an Australian LPT acquires a US REIT whose business consists of investing in land primarily for the purpose of deriving rent, and the US REIT has a subsidiary that carries on a trading business (eg, a taxable REIT subsidiary), then even though the LPT may be taken to control the subsidiary indirectly, Division 6C will not apply.

Again, it is important to note the limited scope of this measure. The Bill offers no similar protection from Division 6C if a trust acquires an *onshore* entity which invests primarily in land, even land offshore; if a trust acquires an offshore entity that invests in land *in Australia*; or if the trust acquires an offshore entity that invests primarily in *non-land* passive investments which would not trigger Division 6C, but also has a subsidiary with modest trading activity.

The amendments will apply from the 2006/07 year of income.

For further information, please contact:

Andrew White

andrew.white@gf.com.au

61 2 9225 5984

Simon Clark

simon.clark@gf.com.au

61 2 9225 5957

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www.gf.com.au

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Greenwoods & Freehills Pty Limited

ABN 60 003 146 852

Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Facsimile (02) 9221 6516 Telephone (02) 9225 5955

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