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INFRASTRUCTURE PARTNERSHIPS AUSTRALIA
BUILDING AUSTRALIA TOGETHER

01 April 2015

Committee Secretary
Senate Economics Reference Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Submitted by email to economics.sen@aph.gov.au

RE: INFRASTRUCTURE PARTNERSHIPS AUSTRALIA SUBMISSION TO THE SENATE INQUIRY INTO CORPORATE TAX AVOIDANCE AND MINIMISATION

Dear Secretary,

Infrastructure Partnerships Australia welcomes the opportunity to provide this submission to the Senate Economics References Committee in respect of the Inquiry into tax avoidance and aggressive tax minimisation by corporates (the Inquiry). This submission addresses the following terms of reference of the Inquiry:

- The adequacy of Australia's current tax laws;
- Any need for greater transparency to deter tax avoidance and provide assurance that all companies are complying fully with Australia's tax laws; and
- The performance and capability of the Australian Taxation Office (ATO) to investigate and launch litigation in the wake of drastic budget cuts to staffing numbers.

We understand that a number of companies from the infrastructure sector are making submissions which will specifically address their circumstances. By comparison, this submission makes some observations which are of general relevance to participants who build, own, operate, invest in and fund infrastructure in this country, recognising that efficient and well-functioning infrastructure is critical to the Australian economy and to the quality of life enjoyed by Australians.

The following areas are discussed:

- Background information in relation to Infrastructure Partnerships Australia;
- The use of trusts and stapled entities by infrastructure investors;
- Some key errors with the Tax Justice Network Report, principally the failure to recognise that tax is paid by the investors in a trust rather than by the trust itself, and the flawed calculation of companies' Effective Tax Rate; and
- Budget cuts to the staffing of the ATO and Treasury.

ABOUT INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

Infrastructure Partnerships Australia is the nation's peak infrastructure body – formed in 2005 as a genuine and enduring policy partnership between Australia's governments and industry.

IPA's formation recognises that through innovation and reform, Australia can extract more from the infrastructure it's got, and invest more in the infrastructure we need.

Through our research and deep engagement with policymakers and industry, IPA seeks to capture best practice and advance complex reform options to drive up national economic prosperity and competitiveness.

Infrastructure is about more than balance sheets and building sites. Infrastructure is the key to how Australia does business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policy reforms and priority projects that will build Australia for the challenges ahead.

Infrastructure Partnerships Australia supports the maintenance of a robust, fair, efficient, stable and certain tax system and recognises the importance of tax payments to the Australian economy.

THE USE OF TRUSTS AND STAPLED ENTITIES BY INFRASTRUCTURE INVESTORS

On 25 March 2014, the Board of Taxation released its Discussion Paper on the Review of the Debt and Equity Tax Rules. The background to the work being undertaken by the Board of Taxation was a concern by the government that the debt/equity rules, which have been in place for a decade, were not being interpreted as intended by Parliament (and in fact were being interpreted in ways which were adverse to taxpayers). A key part of that discussion paper considered the application of the debt equity rules to stapled structures.

In considering stapled structures, at paragraph 5.46 of the Discussion Paper, the Board of Taxation states that:

> *Stapled structures are a commercial reality and are a significant subset of the investment population. The current uncertainties about the potential application of section 974-80 to stapled structure arrangements should be removed. If there are any specific integrity concerns, any response should be proportionate and carefully targeted at genuine cases of mischief.*

IPA endorses these comments, and makes the following observations:

- Stapled structures have been a part of the Australian investment landscape since the late 1980s and have been used extensively to support investment in infrastructure and property assets. The operation of these structures is well-known; however, their taxation treatment remains the subject of debate, causing uncertainty.

- Despite having been aware of stapled structures for some time, for example through industry participation in National Tax Liaison Group (NTLG) meetings, the ATO has only relatively recently begun its review of such structures.

Observations and assumptions in relation to infrastructure projects

In considering tax paid by infrastructure projects and stapled structures, it is first important to understand some key characteristics of:

- the relevant infrastructure projects where stapled structures are used;
- the typical investors; and
- the legal structures used and why those structures are preferred or required.

Characteristics of infrastructure projects

Infrastructure investment exhibits the following characteristics:

- High up front capital costs – regularly the capital cost of an infrastructure project is in the hundreds of millions, if not billions of dollars. There may often be further significant lumpy capital costs for asset overhauls and upgrades at key points in the life of the investment.
- A long-term investment horizon – often the investment will have a finite project life, with the asset being handed back to the government or retendered at the conclusion of the investment term, which may be 20 years, but is commonly say 40 or 99 years.
- Ongoing, costly maintenance of the infrastructure asset throughout its life and before it is handed back to the government.
- The investment may generally have a number of phases – these include a construction phase; a "ramp up" phase; and a mature operations phase.
- The investment pay-back is in the form of regular cash flow yields over the operating life of the investment – there is typically no expectation of returns being derived from long-term appreciation in the value of the infrastructure asset.

These characteristics translate to the following cashflow, accounting and tax profiles throughout the investment life:

Perspective	***Construction e.g. years 1-2***	***Ramp up e.g. years 3-5***	***Mature operation e.g. year 6+***
Cashflow	Significant cash outflows. Minimal revenue inflows.	Cash inflows expected to exceed cash outflows.	Extent by which cash inflows exceed cash outflows is relatively stable and predictable.
Accounting	Costs are generally capitalised. Project may be in a small loss or a relatively neutral accounting position	Project has accounting profits; however, since revenues will generally be cash revenues but expenses will include significant non-cash expenses for depreciation/ capital allowances, cash will exceed accounting profits. Generally a negative Net Asset Position as Project cannot be revalued for accounting.	Accounting profit, but when timing differences reverse (i.e. depreciation), accounting profit will exceed tax profit. Cash continues to exceed accounting profit due to non-cash expenses.

Tax	Tax losses due to deductions for construction interest and various other statutory deductions e.g. for establishment costs for debt and equity.	Tax losses due to carry forward tax losses from construction – further, the use of diminishing value depreciation for tax compared with straight line for accounting means that accounting profit would be higher than tax profit position.	Tax profit, but when timing differences reverse (i.e. depreciation), accounting profit will exceed tax profit. In this phase the project will be tax paying.

Characteristics of infrastructure project investors

Because of the long project duration and the return profile of infrastructure assets, investors attracted to this investment class are commonly investors with a long-term investment horizon who are attracted to regular and (relatively) stable returns. Such investors include superannuation/pension funds, sovereign wealth funds and life insurance companies: domestic and foreign. The investment in infrastructure will commonly be part of an allocation to an "other investments" class in the investor's portfolio of investments. Such investors will generally be concessionally taxed, and are often tax exempt in their home jurisdictions.

It is common to consider the investors in infrastructure projects purely in the context of equity investors; in reality however, there will invariably be a significant portion of the cost of the project funded using debt in order to reduce the overall cost of the project and to reduce its required rate of return. Accordingly, a significant portion of the returns from an infrastructure project will be received as interest in the hands of the debt financiers. Further, given the size of the funding required for an infrastructure project, it is not uncommon for there to be different tranches of debt, with at least one tranche of debt being subordinated to the senior project debt.

The equity and debt investors for infrastructure assets are increasingly global in their outlook, irrespective of whether they have a local or foreign base. These investors are not constrained to investing in projects only in Australia. The competition for their funds is global and it is fierce.

Accordingly, in evaluating any given infrastructure investment, from a tax and regulatory perspective the following factors will be considered:

- Is the investment structure clear and easy to understand?
- What is the effective rate of tax payable on the project and at how many levels is tax extracted? In this respect, the interaction of income tax, withholding tax, and tax credit/rebate rules will be relevant. Ideally, tax should only be payable at a single level, so there is no double taxation.
- Is the tax treatment of the investment structure certain, and can the investor be confident that the treatment of the structure will be predictable/stable/consistent over the long-term project timeline?
- What are the compliance/regulatory obligations in respect of the structure and what are the costs and practicalities of compliance (e.g. residence of board members, locations of meetings, number, frequency and complexity of lodgement obligations, risks and consequences of non-compliance)?
- Will tax losses be preserved, and at least be able to be carried forward to offset future project income?

- Will interest be deductible?

Choice of appropriate legal structure for infrastructure investment

It is now appropriate to consider the choice of structure for investment in infrastructure, bearing in mind the characteristics of infrastructure projects and of infrastructure investors as set out above. The below discussion considers a stand-alone project in a special purpose vehicle. Due to the size of infrastructure projects, it is common for such projects to be financed and managed in a stand-alone special purpose vehicle.

To the extent there are structural impediments, risks, or inefficiencies created by a legal structure, this can have the ultimate consequence of reducing the price an investor would be willing to pay for their investment, or, where a change occurs that is unpredicted, this can affect the ongoing financial security or viability of the project and/or the quality of services provided to customers of the project. As such, structural problems, risks, and inefficiencies have real consequences in an environment where Australian governments are promoting the development of infrastructure projects and the recycling of major infrastructure assets.

Use of a simple corporate structure

At the simplest level, investors may invest using a company structure. Such a structure would have the following advantages from a tax and commercial perspective:

- The tax treatment of companies is relatively clear, certain and understandable, even to a foreign investor;
- For a domestic superannuation fund and resident individuals, Australia's imputation system should broadly mean that dividends are taxed at their tax rate;
- Tax losses generated during the early years of the project should generally be able to be carried forward to offset project income either by virtue of the continuity of ownership test or, failing that, the same business test. Further, the recently enacted infrastructure loss rules may preserve the real value of carry forward losses when the project is a designated project; and
- A company structure provides protection for investors in terms of limitation of liability.

However, a company also has some very significant structural deficiencies for infrastructure projects:

- Even after the amendments to section 254T of the *Corporations Act 2001*, there were difficulties in a company paying distributions in the absence of accounting profits (and the new section 254T has not completely resolved these difficulties due to the requirement for companies to be net asset positive). In the absence of profits, a capital return is required for a company seeking to distribute free cash flow to shareholders. This is not a viable on-going option in a listed environment.

- Lenders to infrastructure projects evaluate a project's debt service coverage ratios (DSCR) for the purposes of sizing and pricing the project debt. In calculating the DSCR for a company, the base calculation focuses on post-tax income. In the case of a flow through vehicle, with tax paid in the hands of the investor rather than by the vehicle, the DSCR is calculated by reference to pre-tax income. This enables greater leverage and better debt terms in the entity and thereby enables an overall lower cost of funds.

- During the ramp up phase of the project, should a company seek to distribute excess cash to investors, such distribution would be in the form of an unfranked dividend. Accordingly, notwithstanding that the project is in tax losses at this time, tax would be payable in the hands of the investor on this distribution. Therefore, the nature of company taxation brings forward the payment of tax to a time when the project is in tax losses.

- Even more importantly, in circumstances where excess cash is distributed as unfranked dividends in the early years of a project life, in the later years of a project, when timing differences reverse (for example, accounting straight line depreciation exceeds tax diminishing value depreciation), a company may have insufficient accounting profits to pay out imputation credits in the form of franking credits. The effect of this is that the infrastructure project can end up being subject to double tax: one impost of tax in the hands of the investor and a second impost of tax in the hands of the company. Whilst companies should pay their fair share of Australian tax, IPA submits that it is not the intention of a fair tax system that a project be subject to a double impost of income tax.

Equity investor members of IPA have advised that the combined effect of these last two bullet points: the bringing forward of taxation, and the imposition of double tax, would have a material effect on the cost of an infrastructure project and accordingly its pre-tax required rate of return.

It is our experience that this issue is not well understood outside the infrastructure community and that misunderstanding of this issue gets lost in irrational aspects of the tax debate.

Use of a trust structure

The above considerations leads to a trust structure being a preferable investment vehicle for an infrastructure project as compared to a company structure. Key advantages of a trust structure include:

- Referring back to the table outlining the cash, accounting and tax profiles of an infrastructure project, during the ramp up phase of the project, since the project is in a tax loss position, free cash can be readily distributed as a return of capital without the need for accounting profits. This mitigates the disadvantages of a company structure in terms of the bringing forward of tax and the double taxation of project income.
- For a trust structure, tax would be paid once – in the hands of the investor – and broadly at the investor's marginal tax rate. Where the investor is foreign, withholding taxes will apply. Withholding taxes will often be imposed as final taxes, thereby reducing the foreign investor's Australian tax compliance obligations. In some cases, the Managed Investment Trust regime may apply. This regime was implemented specifically to encourage foreign investment into Australia.

There are, however, also some disadvantages in using trust structures:

- Unless the trust is a widely held listed trust, the trust would not be able to rely on the same business test in the event there is a change in majority underlying ownership in the trust, which thus results in the loss of the benefit of any accumulated project tax losses. Whilst we have indicated that generally it is expected that infrastructure investors will have a long-term investment horizon, there are a variety of commercial reasons why an investor may divest its interest:

  - The infrastructure investment may have been part of a specific allocation for example to the “other investments class”, and with changes in market values, such as during the GFC, the investor may have been required to divest certain assets to maintain its portfolio distribution within its published proportions;
  - The investor may simply be acting in accordance with modified portfolio investment weightings;
  - An investor may have been a construction company or builder which, as part of its involvement in the consortium, was required to have some equity “skin in the game” during the construction ramp up phases of the project but which, now significantly de-risked, is seeking to recycle its capital into new ventures.

- The concept of a trust is generally less widely understood by investors, particularly foreign investors, than a company. This complexity is compounded where it becomes necessary to use a stapled structure.

Unfortunately, in the case of infrastructure projects, it is rarely possible just to use a simple structure involving a single trust. This is because of the application of Division 6C of the ITAA 1936. Division 6C (and its threshold requirement that the trust invests in eligible investment business which is relevantly defined to include an investment “in land for the purpose, or primarily for the purpose, of deriving rent”) effectively imposes complexity on the structuring of infrastructure projects. As examples, licence fees, tolls, port charges, gas transmission tariffs and generation income are generally not rentals. The discussion of section 974-80 in relation to stapled structures is only necessary because Division 6C effectively forces infrastructure projects to use stapled structures.

If it is accepted that double taxation of an infrastructure project is unfair and not consistent with the government’s intention of encouraging infrastructure investment; and it is understood that an equity investor may also be a debt investor in an infrastructure project, then IPA submits that Division 6C should be redrafted so as to include income derived from defined infrastructure activities as an eligible investment business. IPA further submits that abusive debt arrangements are currently appropriately and effectively managed through the application of the thin capitalisation regime, the transfer pricing rules and the general anti-avoidance provision.

THE TAX JUSTICE NETWORK REPORT INTO THE TAX PRACTICES OF THE ASX 200

IPA is disappointed with views expressed by the Tax Justice Network in its report *“Who Pays for our Common Wealth? Tax Practices of the ASX 200”*. Whilst we encourage discussion of Australia’s tax system, have read the recently released tax reform discussion paper with interest, and look forward to the Government’s release of its Green and White Papers on the reform of Australia’s tax system, we are concerned that misinformation such as that contained in the Tax Justice Network’s report damages the reputation of and trust in the government, the ATO, and corporate taxpayers. This in turn harms the credibility of the tax system. Australia has a very robust tax system and it is easy to lose sight of this.

There were some fundamentally inaccurate and misleading aspects of the Tax Justice Network’s report. Principal among these:

- ***Taxation of trusts –*** The report failed to recognise that income taxation is generally not paid by trusts as a matter of policy and design: instead, income tax on taxable income of a trust is

paid in the hand of the trust's investors. Where the investor in the trust is a foreign resident, robust legislative provisions, such as the withholding tax regime, prevent that investor's income escaping the Australian income tax net.

- ***Calculation of a company's effective tax rate*** – A key measure used by the Tax Justice Network in their report was a company's average cash tax paid divided by its accounting income. This measure was referred to as the company's "Effective Tax Rate".

  The concept of a company's Effective Tax Rate is a measure that is well understood in business, has developed over many years and is used in a number of jurisdictions. The cash tax ratio used by the Tax Justice Network does not meaningfully represent a company's Effective Tax Rate. A better starting point for such analysis would be the reconciliation to the statutory tax rate, which is normally included in the notes to a company's accounts.

Calculation of a company's Effective Tax Rate

The error in the Tax Justice Network's methodology is to mix actual tax paid with accounting profit. Companies don't pay tax on their accounting profit – they pay tax on their taxable income.

Tax and accounting often take account of income and expenses in different years, a concept referred to by accounting and tax professionals as timing differences. For example, a company may depreciate assets at rates set by the Commissioner of Taxation and, as permitted, will often use the diminishing value method of depreciation. These rates are often different from those used for accounting purposes; further, generally the straight line method of depreciation is used for accounting purposes.

Other common timing differences arise due to deductions being available for interest during a project's construction phase (for accounting purposes, such interest would generally be capitalised) and statutorily allowed deductions for borrowing costs and for equity raising costs. Because of timing differences, tax is often paid in an income years that is different to the year of the accounting profit to which the tax relates.

In addition, there will often be instances where tax and accounting will be essentially different, giving rise to what is referred to by accounting and tax professionals as permanent differences.

Common examples of permanent differences include the additional credits that are available to a taxpayer under the research and development tax concession or, in prior years, the investment allowance regime. Such concessions were deliberately implemented by the government to encourage companies to undertake investment and research and development activities in Australia.

Infrastructure projects, by their nature often have early year losses. Factors contributing to this include the deductibility of construction interest, and of equity raising and borrowing costs, and the availability of diminishing value method depreciation deductions. Further, many infrastructure projects will have some expenditure in relation to research and development activities. Accordingly, applying the Tax Justice Network ratio to an infrastructure project will often mean that in the early years of the project, the project will not be paying tax at a rate of 30 per cent of its accounting profit.

BUDGET CUTS TO THE STAFFING OF THE ATO AND TREASURY

Infrastructure Partnerships Australia recognises the importance of the ATO and Treasury to the functioning of the tax system. Also of importance are professional and respectful working relationships between the ATO and Treasury and taxpayers.

We acknowledge that the ATO is currently undergoing significant cultural change under Commissioner Chris Jordan and the broad experience of our members has been positive: there has been a noticeable focus on resolving matters, and working with taxpayers in a co-operative, professional and respectful way.

We note that the terms of reference include consideration of the effect of staffing cuts at the ATO. For the purposes of this submission, we also note the critical importance of Treasury in the design and implementation of good tax policy, and we recommend that the terms of reference also consider the effect on the tax system of budget staffing cuts within Treasury.

FURTHER CONTACT

We hope these comments are of assistance to you as the Inquiry progresses. Should we be able to provide additional information or assistance, please contact Ms Zoe Peters, IPA's National Manager, Social Markets, on (02) 9240 2064.

Yours sincerely,

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