

06 June 2014

General Manager
Law Design Practice, Revenue Group
The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxlawdesign@treasury.gov.au

Dear General Manager,

RE: SUBMISSION ON THE EXPOSURE DRAFT LEGISLATION FOR THE THIN CAPITALISATION REFORMS

Infrastructure Partnerships Australia (IPA) welcomes the opportunity to provide these comments on the exposure draft legislation for the thin capitalisation reforms, namely the *Tax and Superannuation Laws Amendment (2014 Measures No. 3) Bill 2014: Thin capitalisation and 23AJ*.

The need for the amendments has been attributed in the Explanatory Memorandum (EM) to the fact that the current legislated debt limits now exceed the normal gearing levels of most corporates with truly independent financing arrangements. However, despite the wider trend towards lower gearing levels, many social and some economic infrastructure projects have debt to equity ratios which significantly exceed the current safe harbour ratio of 3:1 (and would exceed the 1.5:1 ratio in the exposure draft by even more).¹ As such, ensuring the alternate tests within the rules operate effectively is important to the infrastructure sector, specifically the arm's length debt test (ALDT) and the worldwide gearing test.

While we recognise that the ALDT is not amended by the draft Bill, it is the subject of a current Board of Taxation review, with the Board to report to the Federal Government by December this year. As such, it would be logical to defer the measures in the Draft Bill until there is more clarity around the outcome of the ALDT review.

On the detail of the Draft Bill, IPA's comments focus on three key areas:

- the worldwide gearing test;
- the lack of transitional arrangements; and
- compliance costs.

¹ These entities are typically able to justify a higher level of debt as the cash flows from the project are relatively secure over the long-term, enduring beyond one or more economic cycles.

WORLDWIDE GEARING TEST FOR INBOUND ENTITIES

IPA welcomes the extension of the worldwide gearing test to inbound entities. However, it is concerning that the extension may not apply to vehicles that enter into major infrastructure projects. Due to their size, major infrastructure projects are often too big for one investor to carry out by itself; rather, they are carried out by a consortium of investors. This means that the Australian vehicle carrying out the project is not majority owned by any one investor.

One of the key requirements to be eligible for the worldwide gearing test for inbound entities is that the project vehicle must be included in a set of audited consolidated foreign financial statements [proposed section 820-933 (4)]. A consortium vehicle, which does not meet the accounting consolidation criteria for any one of the consortium investors, may not be able to achieve this (notwithstanding the fact that such a vehicle would be classified as an inward investor for thin capitalisation purposes).

IPA recommends that the new test for inbound entities be amended to encompass the above situation. This would also make the new test for inbound investors consistent with the worldwide gearing test for outward investors. Where a vehicle is classified as an outward investor due to a relationship it has with a shareholder, such a vehicle has access to the worldwide gearing test, notwithstanding the fact that it may only have Australian operations.

An additional difficulty we observe with the requirement for audited consolidated financial statements arises in situations where the foreign parent of a controlled Australian vehicle is exempted from preparing such consolidated financial statements under the applicable foreign accounting standard.

For example, paragraph 31 under the New Zealand IFRS 10 provides a NZ parent which qualifies as an investment entity with an exemption from the preparation of consolidated statements. Instead, it is required to record its investment in all subsidiaries at fair value. An Australian entity controlled by such a parent would be precluded from access to the worldwide gearing test, even though in a practical sense the reporting exemption does not change the worldwide gearing of the NZ parent and its controlled subsidiaries. We suggest amendments be included which provide an alternative avenue for information to be collated and applied under the test (e.g. from special purpose accounts).

TRANSITIONAL ARRANGEMENTS

The exposure draft legislation on thin capitalisation (and section 23 AJ) provides that the amendments apply to assessments for income years starting on or after 1 July 2014. In view of the Federal Government's announced reform agenda since coming to office in September 2013, there are considered merits in adopting some form of transitional measure to ease the adjustment particularly to the revised/reduced safe harbour ratios for a broad cross-section of taxpayers.

Accordingly, for example, the new debt-to-asset ratio for non-financial entities could be reduced in either a two-step or three-step process over two or three years from 75 per cent to 60 per cent of

assets. This would allow taxpayers more time to adjust to the new lower debt to asset restrictions thereby reducing the immediate need to re-negotiate existing financial facilities.

Similar staggered reductions in the safe harbour ratios could be adopted for non-bank financial entities and for banks.

IPA recommends some flexibility with a transitional approach rather than "grandfathering" existing loans from the new safe harbour ratios.

COMPLIANCE COSTS

There is a need to minimise the costs of complying with the ALDT (borne by the infrastructure projects which could need to rely on the ALDT). In this regard, we support the ICA's recommendations. That is, we recommend the removal of the requirement the ALDT be annually tested. Further, we recommend that the factor analysis be done on a prospective basis. For infrastructure projects this will shift the risk of compliance to the project participants, which they can assess as with other project risks.

Should we be able to provide additional information or assistance, please contact Ms Zoe Peters, IPA's Manager, Policy, on (02) 9240 2064.

Yours sincerely,



BRENDAN LYON
CHIEF EXECUTIVE OFFICER