INFRASTRUCTURE
PARTNERSHIPS
AUSTRALIA

30 August 2019

Jason Heng
Assistant Commissioner
Australian Taxation Office
GPO BOX 9990
SYDNEY NSW 2001

Sent via email to: Jason.Heng@ato.gov.au

Dear Mr Heng,

Re: Feedback on the Law Companion Ruling (LCR2019/D2) on Non-Concessional MIT Income

Infrastructure Partnerships Australia wishes to thank the ATO for the opportunity to comment on the Law Companion Ruling (LCR2019/D2) on Non-Concessional MIT Income.

1. General

The draft LCR provides the ATO's views on their interpretation of Schedules 1 and 5 of the recently enacted Treasury Laws Amendment (Making Sure Foreigners Pay Their Fair Share of Tax in Australia and Other Measures) Act 2019 (the Act). Aspects of the new law are complex in their application and having published guidance on these matters should assist taxpayers in applying the law to their circumstances.

1.1 Scope of the Draft LCR and Division 6C core concepts

As an overarching comment, the guidance provided in the Draft LCR covers a number of matters which, in our view, are not directly relevant to the Act.

The Draft LCR considers a number of concepts that we consider are core to Division 6C of the Income Tax Assessment Act 1936 (Cth), including:

- investing in land within the meaning of section 102M (at paragraphs 11-17)
- the meaning of 'rent' (at paragraphs 50-87), and
- Examples 11 and 13 raise the concept of 'trading trust'.

Although these concepts are important and relevant to the Act, Infrastructure Partnerships Australia considers that it would be preferable for the ATO to address these matters in a separate publication given they have application to the broader taxpaying community, not just to taxpayers impacted by the Act.

This would then allow the LCR to be consistent with Law Companion Ruling LCR 2015/1, "Law companion ruling: purpose, nature and role in ATO's public advice and guidance", which states that the purpose of a LCR is to provide an insight into the practical implications or detail of recently enacted law in ways that may go beyond mere questions of interpretation (at paragraph 8).

In addition, by only providing the ATO's views on certain aspects of Division 6C, several other issues potentially relevant to the infrastructure sector remain without ATO guidance, including:

- the meaning of 'primarily' for the purpose test
- consequences of the change of use for all/part of the property (e.g. rezoning)
- scope of 'incidental and relevant' and 'ancillary' activities, and
- the meaning of 'land' (particularly in the context of new asset classes e.g. wind farms).

Therefore, to the extent the ATO does not remove these sections from the Draft LCR, the ATO should also provide further guidance on its view on these topical Division 6C issues.

1.2 Consultation outcomes

As you are aware, Treasury undertook extensive consultation with taxpayers, industry bodies and tax advisers in relation to the drafting of the Act. There are aspects of the Draft LCR where the position adopted by the ATO appears to be inconsistent with these consultations and the outcome intended by Treasury.

Consequently, in our view, if the ATO's proposed administration of the Act (as expressed in the Draft LCR) gives rise to outcomes that are inconsistent with the intended outcomes that were expressed by Treasury during the consultation process, it may be necessary to seek a legislative amendment to clarify the position.

Given that any legislative process could take some time, and having regard to the adverse impact of uncertainty on taxpayers, we would strongly encourage the ATO to review the submissions made during the development of the Act, and to consult with Treasury to confirm that the proposed interpretation of the Act as set out in the draft LCR is consistent with the intended outcomes.

The specific inconsistencies we have identified are outlined in the following sections of this submission.

2. Transition – concept of a 'facility'

2.1 Concept of 'facility' and 'ultimate facility'

The Draft LCR attempts to provide guidance on the meaning of 'facility', and introduces a new concept of 'ultimate facility'. This concept is not used in the Act, was not previously used in the Explanatory Memorandum (EM) when the legislation was introduced and, to the best of our recollection, not contemplated in discussions with Treasury during the consultation period. In this regard, the Draft LCR suggests that notwithstanding that facilities are part of an integrated system or network which may be considered a broader facility, they may be considered discrete and separate facilities for the purposes of the new rules.

As noted above, the discussion of 'facility' in the Draft LCR is not consistent with the discussions that Infrastructure Partnerships Australia had with Treasury during the consultation period. At a policy level, there was a need to balance having a simple practical transition regime, against issues that might be created in the event that taxpayers might seek to introduce new activities into an existing stapled structure that had the benefit of the transition rules. As you are aware, the original exposure draft legislation used the narrower term 'asset'. Given the uncertainty this created in relation to augmentations and expansions of existing facilities and whether the transitional rules would apply to the expansions, the terminology was changed to 'facility' so as to make it clear the intention was to encompass a broad concept and capture the broader collection of assets that form part of the one facility including stay in business capital expenditure and organic growth capital expenditure.

Based on the commentary in the Draft LCR, where multiple ‘facilities’ make up an ‘ultimate facility’ then each of those facilities would need to be considered separately in assessing:

a) whether the facility meets the transitional rules, and
b) whether a facility is eligible to be an ‘economic infrastructure facility’ (notwithstanding it may form part of an integrated network or be subject to the same lease).

This could lead to (a) new expenditure being a new facility not having a transition period, or (b) for historic expenditure, two transition periods for the ‘ultimate facility’ (i.e. 15 years for the economic infrastructure facility component and seven years for other parts of the ultimate facility).

For new expenditure not classified as part of an existing facility, this would result in the relevant State Government being required to make an application to the Treasurer for a fresh 15 year transition period where the nationally significant economic infrastructure conditions are met.

If this interpretation were taken, this interpretation may not provide economic infrastructure facilities and capital improvements with the 15 year transitional relief that was clearly intended to be provided. It could also add to their cost of compliance.

2.2 Interpreting the term ‘facility’

The EM provides some guidance in relation to the definition of a ‘facility’ (refer paragraph 1.117 to 1.120). The EM states that a ‘facility’ is a collection of assets and sets out a number of features or characteristics to assist with interpreting the term facility. These can be seen in five categories – functional integration, separate revenue stream, legal rights, financial viability and other.

With respect to the third consideration, the legal rights of the parties in respect of the assets, the EM provides the following list:

- the scope of any existing and proposed lease agreement
- the applicable regulatory framework, and
- any applicable licence or concession arrangements.

Relevantly, Example 1.13 in the EM provides some guidance for electricity network service providers with respect to a specific example relating to expanding an existing electricity network to a new suburb, linking the specific example to the factors outlined in 1.117 of the EM.

The Draft LCR provides some examples (e.g. Examples 5, 6 and 9) of a ‘facility’ that are of relevance to our members. However, given how broad they are, we suggest that the examples provided in the Draft LCR will provide little certainty to taxpayers given the limited detail within the examples, and that, if anything, the examples may cause greater uncertainty or encourage outcomes that we believe were unintended by the legislators. We would suggest replicating Example 1.13 in the EM as this provides guidance on the legislators view on expansionary or enhancement capital expenditure.

If they would be of assistance, we also provide some examples in Appendix A (using a similar level of detail in terms of background facts and terminology to Example 1.13 of the EM), to illustrate how we consider the rules were intended to operate.

We expect our members in regulated industries would greatly benefit from obtaining clarity from the ATO as to how the law should apply to fact patterns similar to those in the examples set out in Example 1.13 or Appendix A.

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2.3 Investments in moveable property as part of a facility

The Draft LCR at paragraph 165 provides a view that, to be a 'qualifying' part of a facility, assets must have a connection to land on which they are situated, with the result that moveable property and items not characterised as fixtures cannot comprise part of a facility. In our view, the legislation is drafted in a way which specifically contemplates the inclusion of moveable property within the concept of a facility.

In order to access the concessional treatment afforded in relation to an approved economic infrastructure facility or a facility with access to the transitional provisions, the amount in question must be 'rent from land investment'. Rent from land investment is limited to rent from 'Division 6C land' which is specifically defined to include:

- land within the meaning of Division 6C (which includes an interest in land and fixtures on land), and
- 'other assets' if an investment in those other assets would be an investment in land under section 102MB(1) of the 1936 Tax Act. Section 102MB(1) deems investments in moveable property (being property that is incidental and relevant to the renting of land, customarily supplied or provided in connection with land, and ancillary to the ownership of land) to be investments in land.

Further, in considering the hallmarks of a facility as identified in the EM, we submit that moveable property may exhibit the following characteristics:

- they may be functionally interconnected
- they may not give rise to a separately identifiable revenue stream
- they may be subject to the same legal rights, regulatory regime, or licence or concession arrangements as other land and fixtures, and
- their financial viability, along with other assets, may be dependent on expansions or enhancements that will occur to the facility after the transition time.

For completeness, it is noted that the EM does not list a connection to the land as a relevant factor at 1.118.

Accordingly, we consider that moveable property may form a part of a facility where such items of moveable property appropriately display the characteristics of being a part of the facility as identified at paragraph 1.118 of the EM.

In our view, the comments in paragraph 165 of the Draft LCR should be clarified to reflect the above position.

2.4 Renewable Energy

Paragraphs 216 and 217 of the Draft LCR discuss energy infrastructure and what constitutes an economic infrastructure facility. Generation plants are included but only 'certain' renewable energy and storage assets are included. The inference is that certain (undefined) renewable assets may not meet the definition. We think, given the amount of investment made in renewable energy in Australia, it would be helpful to understand whether there are particular issues pertaining to those renewable energy assets that give rise to special consideration.

3. Transition – changes to existing cross-staple arrangements

The Draft LCR at paragraph 263 states:

> 'The following are some examples in which the relevant entities may cease to qualify for the MIT cross staple arrangement income transitional rules…**where the external entities are replaced, or their participation interests are varied. For example, there is a change in ultimate economic ownership of the asset entities and operating entities.**' [Emphasis added]

This is further reiterated at paragraph 267 of the Draft LCR.

We consider that the views expressed by the ATO in relation to a change in ownership in the Draft LCR is inconsistent with the approach that had been discussed with Treasury officials during the public consultation period. More importantly, it would also be a significant departure from the intended (and widely understood) operation of the scope of the transitional provisions for existing staples in relation to MIT cross-staple arrangement (MIT CSA) income.

In addition to the policy aspects, we consider that the drafting of the relevant provisions of the Act does not support the ATO's proposed interpretation. When considered in the context of how other aspects of the transitional provisions are drafted (e.g. the transitional provisions for the MIT residential housing and agricultural provisions, trading trust measures, etc, where the transitional provisions are specifically available only to the relevant investor), Parliament must have intended that the MIT CSA transitional measure to continue to apply at the asset entity/operating entity level regardless of changes in economic ownership of those entities.

We have set out some further comments below to support this position from both a policy and technical perspective. If the ATO does not agree with the comments below, we consider this an area that will require urgent attention from Treasury and/or the Government to rectify any uncertainty created by the drafting as it could have a material impact on investment values for a range of domestic and foreign investors. In respect of the latter category, this would further add to a perception of Australia that Australia's tax laws are 'fluid'.

3.1 Policy considerations

It was clear throughout the consultation process that the transitional provisions that applied to 'Element A' of the package of measures (i.e. in relation to MIT CSA income), attached to the 'stapled entities' (i.e. asset entity and operating entity) rather than to any particular investors in the staple - this was intended to ensure the 15 per cent MIT rate would continue to apply to qualifying cross-staple arrangement income, for a period of either seven or 15 years. This was put forward by stakeholders (and in our view, accepted by Treasury) as an important aspect in managing sovereign risk perceptions for investors that had effectively bid away the benefit of stapled structures (i.e. through the tax assumptions used in bid models) and to ensure that these changes did have an immediate and drastic impact on asset prices for investments held via stapled structures.

In particular, we are of the view that the ATO's interpretation is inconsistent with the policy intent of providing a long term transition for MIT CSA income for qualifying staples because:

- Investors who sell their investment in a staple would take an immediate (and potentially drastic) loss on the sale because the benefit of the intended transition would not pass onto the acquiring investors. The purpose of the long transition period (particularly for infrastructure staples) was, as

we understand, to effectively ensure that there was no immediate/significant impacts on investment values of existing staples.

- This loss of value would equally impact continuing investors. That is, if a change in economic ownership in the relevant staple causes the transition to be lost for the entire staple - this means an unrelated investor selling their interest in the staple could result in all investors (including continuing ones) no longer being eligible to access the transitional relief.
- The ATO's interpretation could create a drag on market activity - for example, because investors may be forced to hold onto the assets to prevent value destruction and/or it may reduce the number of bidders in the market for these assets.
- There would be significant practical difficulty in monitoring changes in ultimate economic ownership (for example, many large infrastructure staples will have wholesale funds/listed entities whose ownership may change on a regular basis). Furthermore, the ATO does not provide any views on the level of ownership change that would be required before the staple would no longer qualify for the transition.

3.2 Drafting considerations

Section 12-440 applies to provide transitional relief from the application of the MIT CSA income provisions for certain cross staple arrangement income that is (or is attributable to) 'rent from land investment' from a 'facility'. While the qualification conditions vary between sections 12-440(1) (which deals with Australian Government Agencies) and 12-440(2) (which deals with arrangements more broadly), the following are key requirements for the transitional provisions to apply:

- The cross-staple arrangement in relation to the facility must have been entered into by the transition date or it must have been reasonable to conclude the cross staple arrangement would have been entered into by the transition date
- The stapled entities in relation to the cross staple arrangement must have existed before the transition date
- Each entity that is a stapled entity in relation to the cross staple arrangement must have made a choice by the required date, and
- The income must be received during the transitional period (broadly, seven or 15 year, taking into account the sunset dates).

The structure of this transition rule requires consideration of the affairs that existed between the asset entity and operating entity in relation to the particular facility at the time of the transition. Nowhere does it require a consideration of who the external investors are in the staple. That is, this is effectively a transition that is intended to attach to the staple and its qualifying assets/income, rather than any particular investors.

In addition, we submit that when you contrast the drafting of this transitional provision to the other transitional provisions in the Act, it is clear that the above interpretation was intended. To this end, the transitional rules for the MIT trading trust income, MIT residential housing income and MIT agricultural income have specific rules that seek to limit access to the transitional rule (in cases where the assets are not held directly by a MIT) to the 'total participation interests' held by the particular investor in the asset holding (underlying) entity before 27 March 2018 (refer to section 12-447 as an example). These rules specifically ensure that where there are new investors who acquire an interest in the asset holding entity, or an existing investor that increases their total participation interest in the entity, transitional relief is only available to the existing investors and only on the portion of income attributable to the interest held before

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the transition date. Similarly, the transition rules for sovereign immunity and foreign pension funds, are drafted in a manner to specifically attach to a particular investor rather than the assets (i.e. for sovereign immunity – the transition is available where the investor has a ruling covering the investment, and for the foreign pension fund exemption – the transition applies where particular investors acquired their interest before the relevant transition time).

4. Concessional cross-staple rent cap

The concept of an 'objective method' is important to the application of the concessional cross staple rent cap for an economic infrastructure facility. Paragraph 1.152 of the EM states that:

> 'In order to establish that there is a method that is set out in the documents, the method must be objective and sufficiently prescriptive so that the calculation of the rental charge relies upon objectively discernible information, and produces a result that would be the same for any reasonable person applying it.'

Given the significance of this area of the Act, it was Infrastructure Partnerships Australia's expectation that the LCR would provide further guidance on what constitutes an objective method and what 'associated documents' will be sufficient evidence to document an objective method. However, the LCR does not provide any further details on what constitutes an objective method other than refer to sections of the EM.

Given the importance of what constitutes an 'objective method' in determining the cross staple rent cap, we would welcome further examples in the LCR setting out what is an objective method and in particular what is 'objectively discernible information' for the purpose of determining whether an objective method exists.

In addition, paragraph 286 of the LCR states that a method that requires the parties to agree on the rent, or a component of the rent formula, will not be an objective method as it is not a method wholly external to the parties. We acknowledge that an objective method would not exist where a lease agreement provides for the rent to be determined at the discretion of the Asset Trust or based on agreement between the Asset Trust and the Operating Entity (paragraph 1.154 of the EM). However, where a lease sets out that every 3/5 years the rent is reset to a market value rent (with the option of this being settled by arbitration if the parties do not agree) with the rent being increased by CPI in the intervening years, we would suggest that this would be an objective method.

Furthermore, the concept of agreeing a 'component of the rent formula' was not addressed in the EM or during the consultation process with Treasury. It would be helpful to understand what this comment is trying to address as a number of methods (that are sufficiently prescriptive in a lease document and/or associated documents) require both the Asset Trust and Operating Entity to agree on inputs that form part of the agreed method. We are of the view that the agreed components of a prescriptive method should be an objective method for the purposes of the new rules. We would welcome an example of this in the LCR.

4.1 Objectively Ascertainable

Paragraph 283 states the following:

> 'While 'objective method' is not defined, the Commissioner's view is that the method must be objective in that it must be capable of measurement wholly external to the parties who have entered into the lease. The method should produce results capable of independent reproduction

> and should also be objectively ascertainable without reference to discretion or judgment by the parties to the lease. While the method need not be evidenced in the lease agreement, it must be capable of reference to the lease.'

We suggest some examples should be provided to illustrate what would be a method that is readily ascertainable and that which is not. In arm's length situation, it would be reasonable to expect an expert to be engaged by the parties to assist with negotiation of a complex arrangement; such as a rental agreement, an offtake, a license, a business sale, etc. We would expect, therefore, that the test would be one that is reasonably ascertainable by an expert in the relevant area. We would welcome further guidance on this point.

4.2 Amount

Following on from the example above, a number of leases will have an initial predetermined rent during the years that the project is in the start up phrase. Once the project is fully operational the rent will be set at a market rent. However if this does not meet the requirements to be an objective method then it seems to us that the taxpayer will be forced to use an amount set for rent in the early years of the project adjusted for CPI. This seems unfair. In such circumstances the 80/20 method should be available. Could this be clarified in the LCR?

5. Conclusion

We trust that the above information will be of use to you in further developing the guidance to be provided to taxpayers. We value and appreciate the opportunity for engagement with you in this process and would welcome the opportunity for further discussions with you to clarify the matters raised herein.

Sincerely,

ADRIAN DWYER

Chief Executive Officer

Appendix A: LCR 2019/D2 Regulated transmission network examples

The purpose of the following examples is to illustrate how the transitional rules in relation to MIT cross staple arrangement income apply to a regulated transmission network. The two examples focus on expansion and enhancement of a network that is an existing economic infrastructure facility.

Example 1

Prior to 27 March 2018, Asset Trust acquired from a State Government a leasehold interest in the land and associated assets that comprise a regulated electricity transmission network (the **transmission network lease**), which meets the definition of an existing economic infrastructure facility that is eligible for the transitional concession in s12-440.

At the same time it entered into the transmission network lease, Asset Trust subleased the land and assets that comprise the electricity transmission network to the Operating Entity, who operates the network (the **sublease**). The sublease comprises a cross staple arrangement.

Pursuant to the terms of the transmission network lease, transmission services licence, the regulations and other relevant rules, the Operating Entity is required to deliver transmission services within a set geographic area and to maintain the safety and reliability of the transmission network for the duration of the lease period.

Asset Trust incurs costs after 1 July 2019 to expand the transmission network to connect new generation capacity to the existing transmission network. The expansion involves constructing a new transmission line and associated assets in a new part of the geographic area covered by the transmission network lease. The expansion will increase network capacity and upgrade the efficiency of the network to meet customer demand.

The expansion will be connected to the existing network and will form part of the regulated asset base, which will increase Operating Entity's regulated transmission services revenue.

Given the factors in paragraph 1.118 of the Explanatory Memorandum, the new transmission line and assets are considered to be enhancements to the existing transmission network facility.

This is on the basis that:

- The expansion is functionally and physically connected to the existing transmission network facility as it connects new generation capacity to the transmission network within the set geographic area
- As the expansion forms part of the regulated asset base and increases existing regulated transmissions services revenue, it does not result in a new separately identifiable revenue stream, and
- The expansion has been constructed to satisfy the Operating Entity's obligations arising under the transmission network lease, transmission services licence, the regulations and other relevant rules (i.e. the new assets are a consequence of, and will be subject to, the same regimes that apply to the existing facility).

Example 2

The facts are the same as Example 1, except that in July 2019, as part of its normal business, Operating Entity bids for the right to build a high voltage power line to connect a newly constructed windfarm to the existing electricity transmission network. The power line is a contestable asset pursuant to the National Electricity Rules, meaning that Operating Entity is not required under the regulations to build it, but rather must compete for the contract to build it. Operating Entity is successful in its bid and procures Asset Trust to invest in the new network connection.

Being a contestable asset, the costs incurred by Asset Trust to build the new network connection do not form part of the regulated asset base and therefore do not increase Operating Entity's regulated revenue. Operating Entity will receive income in relation to the new network connection under a separate contract with the windfarm.

As with Example 1, the new network connection is considered to be an enhancement to the existing transmission network facility given the factors in paragraph 1.118 of the Explanatory Memorandum.

This is on the basis that:

- As per Example 1, the new network connection is functionally and physically connected to the existing transmission network (i.e. to transmit high voltage electricity to customers across the network within the relevant geographic area)
- Whilst the new network connection is a contestable asset, it is nonetheless subject to the same transmission network lease, transmission services licence, the regulations and other relevant rules that apply to the existing transmission network facility, and
- Being a contestable asset, the new network connection will not increase the regulated transmission services revenue, but will generate unregulated revenue from the windfarm customer. Such unregulated revenue is part of the ordinary and usual course of a transmission network business, i.e. the network comprises both regulated and unregulated assets, so generates both regulated and unregulated revenue.