INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

31 May 2018

Mr Brendan McKenna
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: stapledstructures@treasury.gov.au

Dear Brendan,

RE: FEEDBACK ON THE TREASURY LAWS AMENDMENT (STAPLED STRUCTURES AND OTHER MEASURES) BILL 2018 EXPOSURE DRAFT AND EXPLANATORY MEMORANDUM

Thank you for allowing Infrastructure Partnerships Australia (IPA) to meet with Treasury regarding the first stage of the exposure draft (ED) and explanatory material (EM) on the package of measures relating to the tax treatment of stapled structures and other measures.

As discussed during our meeting on 22 May, we have a number of comments and observations in response to the exposure draft. We have kept these comments brief, however we are available to discuss the comments below in further detail, if needed.

1. Timing and staging of the package of measures

We understand it is proposed that the related integrity measures for accessing the infrastructure concession and the transitional arrangements will be introduced into Parliament as a separate draft legislation later this year. However, given the complexity of the issues, it is critical that the measures proposed across the package are considered by stakeholders in a holistic manner.

Given the start date of 1 July 2018 for the thin capitalisation measures, we suggest decoupling these measures and introducing them in Parliament as planned in June.

However, given the start date of 1 July 2019 for the cross-staple payments measures, we believe Treasury should take additional time to carefully and deliberately consider feedback it receives from industry, including the comments made below. This is important to ensure the intended policy objectives are met while reducing the risk of any unintended consequences which could have significant adverse implications for investors.

To this end, we strongly encourage Treasury, rather than drafting and introducing legislation in a piecemeal manner, to instead integrate this exposure draft with the additional draft legislation into one complete package.

2. Definition of 'asset'

The use of the term "asset" in Schedule 1 of the ED as well as the EM, in the context of this legislation and related policy objectives, should be clarified to mean an economic infrastructure asset in its entirety that operates in an integrated manner to serve or meet a public purpose. This clarification is required because the

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term "asset" is generally interpreted in other provisions of the *Income Tax Assessment Act* (ITAA) on an individual functional asset basis. Without this necessary clarification, it would be left to the ITAA interpretation, which in our view is a narrow interpretation and inconsistent with the intentions of this provision.

This clarification is particularly important because the ATO may take this narrow interpretation of the term "asset". For instance, in ATO's draft tax ruling 2017/D1 *Income tax: composite items and identifying the depreciating asset for the purposes of working out capital allowances* (TR 2017/D1), the ATO stated that "*a modification or alteration to an existing asset can itself be a separate depreciating asset*". Importantly, using a similar example to that contained in example 1.4 of the EM relating to enhancements to an existing electricity distribution network, the ATO stated that "*the new distribution line (or addition) is a separate asset from any existing distribution infrastructure*".

We welcome the inclusion of example 1.4 in the EM which indicates that transitional relief is intended to be available for subsequent expansions to an electricity network that was acquired by an entity under a contract entered into on or before 27 March 2018.

However, we are concerned that the current drafting in Part 3 sub-item 9(2) of the ED may not give effect to that intent. Specifically, the operation of the transitional provision envisaged in the EM example relies on considering the entire electricity network as a single asset acquired before 27 March 2018 and that the subsequent expansion of the network constitutes an enhancement of that asset.

Noting our comments above regarding the accepted meaning of an asset, without further legislative drafting, we are concerned that a court or ATO would not consider that the electricity network and the expansion would comprise a single asset for these purposes. We request that Treasury consider further legislative drafting that more clearly gives effect to the intent expressed in the EM example.

Specifically, given the intention of the provisions in the ED, we recommend providing a definition that clearly encompasses collectively the broader piece of the infrastructure asset, including any future modifications, alterations, enhancements and improvements in relation to it. This definition should also include subsequent capital expenditure which is permitted or required under relevant regulations, legislations, leases or licences.

This drafting should also confirm that both lifecycle capital expenditure and organic growth of the same economic asset in the same geographical area to provide related or ancillary services are enhancements to the existing economic asset and will qualify for the transitional rules.

From a policy perspective, there is no reason for the taxation of income associated with future capital expenditure (which is required to maintain, expand and organically grow a business existing as at 27 March 2018) to not be covered by the transition period. In particular, this cover is necessary given that original investment decisions to lease an asset were based on underlying assumptions related to the tax treatment of income derived over the period of the lease.

2.1 'Economic infrastructure asset'

Under proposed section 12-450(4) an economic infrastructure asset is an asset that is transport, energy, communications or water infrastructure for "public purposes". In paragraphs 1.53 and 1.54 of the EM, further context is provided around what is meant by the term "public purposes".

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We submit that both the ED and the EM should make clear that "public purposes" could be either direct or indirect. For example, a desalination plant may supply water to the State water authority who in turn supplies water to the public. While this could be extrapolated from the EM comments in paragraph 1.54, we consider that adding further clarification in the legislation would provide additional certainty across the different types of relevant infrastructure.

Similarly, the application of the "public purposes" test is unclear in situations where although the asset is used for or by the public, it is provided for such use through third party intermediaries rather than the actual infrastructure owner or operator.

In this regard, we submit that an infrastructure asset category where it is reasonable to expect direct or indirect use of the asset, supply or services, or transport of goods by public users, should satisfy the "public purposes" test.

3. Transitional provisions paragraph 9(2) – the requirement for investors to have entered a contract by 27 March 2018

The transitional relief afforded to affected investors under sub-item 9(2) of the transitional provisions only applies if an entity entered into a contract before 27 March 2018 in respect of the acquisition and creation of an asset. That is, the transitional relief under this section only applies to legal commitments in place at the time of the announcement.

In addition to asset acquisition, we recommend that the legislation also accommodate leases entered into on or before 27 March 2018 of an asset given that asset privatisations are often undertaken in the form of long-term leases of the relevant infrastructure.

We understand that Part 3 sub-item 9(2)(b) will be amended to ensure that it also covers a cross staple arrangement that "had been" entered into prior to 27 March 2018. This amendment should cover circumstances where it may be "reasonable to conclude" that a cross staple arrangement will be entered into; for example, where an operating entity had not been incorporated as at 27 March 2018, however the intention for a stapled arrangement was evident as the asset trust had been formed prior to 27 March 2018.

The transitional concessions should also apply to arrangements where investors had a commercial commitment to investments or capital expenditure as evidenced in constituent documents or other objective evidence that existed prior to 27 March 2018, and not be limited to a legal commitment.

To address any concerns that the Treasury may have on this point, we submit that there is legislative precedent available to Treasury in relation to this matter. Specifically, in enacting the *Tax Laws Amendment (2008 Measures No 6) Act 2009*, a broader concept was introduced as part of the Capital Gains Tax (CGT) measures for roll-overs for corporate restructures. Under these rules, where an arrangement did not involve a takeover bid or a scheme of arrangement, the measures will apply to an arrangement *"if a decision to enter into the arrangement was not made before 7.30 pm (legal time in the ACT) on 13 May 2008"* (underlined for emphasis). The EM for these measures provide that:

"1.81 It will be a question of fact as to whether a decision to enter into the arrangement was made before 7.30 pm, by legal time in the Australian Capital Territory, on 13 May 2008. However, it is expected that there would be some evidence of the decision in the records of the acquiring entity or the original entity. "

Under these provisions, a contract does not need to be entered into by the stated time, however a decision to enter into arrangement will need to be made.

We strongly suggest a similar approach is adopted for the transitional provisions in this ED. We also recommend that guidance is provided to assist with determining what evidence is sufficient to support that a decision is made by 27 March 2018.

4. Clarifying the definition of 'rent'

According to the ED, where a cross staple payment is attributable to an amount of rent derived by a stapled entity from a third party, that payment will not constitute 'non-concessional MIT income'. However, the term 'rent' is not defined in the ED. We suggest that the term should be specifically defined for these provisions.

At a minimum, 'rent' should be defined in accordance with Division 6C of the ITAA 1936 (including any charge for assets referred to in 102MB ITAA 1936). Additionally, for the purposes of these provisions, we suggest that the term 'rent' should be extended to include income from providing long-term use rights of property to third parties (i.e. licence fees).

As well, if the operator's system allows this, we consider that composite charges levied should be able to be unbundled to determine the rent component.

5. Clarifying the definition of 'attribution'

The ED does not provide clear guidance on net income as is attributable to non-concessional MIT income (section 12-435) or is attributable to an amount that is third party rent (section 12-440(3)).

Without guidance on this, we would be concerned about how these types of attribution is to be undertaken where different entities are involved, where there are cross staple payments between those entities, and where there are complex issues relating to expense allocation dealing with interest and other expenses.

6. Section 12-440(2) – Capital gains arising from cross staple transactions

According to the EM, the integrity measure is designed to address the inappropriate recharacterisation of active income to passive income. As it currently stands, capital gains made from transferring assets across a staple are captured in the definition of 'non-concessional MIT income'. However, a payment made for the sale of an asset is not a recharacterisation of active income into passive income.

Asset transfers can occur for various reasons. For instance, an infrastructure MIT may sell surplus land on the edge of a residential area to the operating side of the stapled group so that the stapled group could pursue development activities, such as a joint venture with a builder (i.e. turning industrial assets into a residential development). Clearly, such an asset sale would not relate to the conversion of active income to passive income.

If the draft legislation is not amended to exclude payments relating to asset transfers, the integrity measure would capture amounts that are not within the policy objective of the legislation. It would also have material adverse implications for stapled groups even though they are not engaged in recharacterisation activities.

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7. Section 12-450(2) – Approved economic infrastructure asset exception

Under the proposed measures in this section, only an Australian government agency (excluding the Commonwealth) may make an application for the approved economic infrastructure asset exception. We are concerned that this procedural requirement will preclude projects that otherwise qualify for the concession merely because they are procured and delivered wholly within the private sector. We submit that the ability to apply for the exception should be extended to private sector applicants.

We understand the basis for allowing only Australian government agencies to make the application is:

1. To prevent the Treasurer being inundated with applications for the concession; and
2. Based on a view that an Australian government agency would generally be a participant in economic infrastructure which has a public purpose. Otherwise, even where economic infrastructure with a public purpose is undertaken wholly by private sector participants, there is an expectation there would be an Australian government agency sufficiently motivated to make an application on their behalf.

We submit that accessing the exception requires satisfaction of significant substantive requirements that already tightly constrain the number of projects that could potentially access the measure. Aside from the $500 million estimated capital expenditure requirement, there is also a considerable administrative burden placed on the applicant to demonstrate that the project will significantly enhance the long term productive capacity of the economy.

We submit that it is highly unlikely that opening the measure to private sector applicants would result in the Treasurer being inundated with applications, noting that the now expired tax loss incentive for designated infrastructure projects was open to private sector applicants, and that there was no successful application made by a private sector or Australian government applicant for that measure.

We are also concerned that Australian government agencies may not be sufficiently motivated to apply for the exception even where they are a direct participant in the project. The likelihood that an Australian government agency would make an application on behalf of a project in which they had no direct interest would seem even more remote.

We believe that the exception is an important policy setting for encouraging critical investment in the development of nationally significant public infrastructure that will enhance the Australian economy. There are many examples, such as but not limited to renewables, bio-energy, gas fired generation and water treatment projects that are undertaken wholly between private sector proponents. If the policy objective encouraging the development of approved economic infrastructure assets is to be realised, it is essential that the private sector proponents of these projects are able to apply for the exception.

In addition to this, we also recommend that the requirement for approved economic infrastructure asset to have an estimated capital expenditure of $500 million or more should be amended to be a package of assets that have an estimated capital expenditure of $500 million or more. This would allow, for example, wind farms and similar energy generation assets, to be eligible for the approved economic infrastructure asset exception.

8. Application of Part IVA

The current provisions (section 9(4) of the transitional rules for existing assets and section 12-453 for approved economic infrastructure assets) only provide protection in relation to the deductibility of rent paid by the operating entities during the concession period, if the taxpayer is otherwise entitled to a deduction for the rent.

However, we are concerned that these provisions are too narrow since they do not deal with the position before or after the applicable transition period. Importantly, in our view, specifying that a deduction is available does not necessarily prevent the ATO from asserting the application of Part IVA.

We therefore believe that the ED should specifically and unambiguously address the application of Part IVA for stapled structures in the case where Part IVA could be applied to deny deductions to the operating entity.

SCHEDULE 3 – FOREIGN SUPERANNUATION FUNDS WITHHOLDING TAX EXMEPTION

Section 128B(3C) - Ordinary commercial rights of third party debtors should be excluded from the amendments to the foreign residents withholding tax exemption

We note that under the proposed reforms a relevant foreign superannuation fund holding less than a 10% interest will still be denied an exemption from withholding tax on interest and dividends where they hold the rights set out in proposed section 128B(3C).

We welcome that, in applying this test, rights that arise because of a breach of debt terms are disregarded under proposed section 128B(3C)(3CC). However, we submit that ordinary third party commercial lenders will often have rights that could be considered to fall with proposed section 128B(3C), even prior to a breach of any debt terms. Some examples of this would include dividend or distribution stoppers and various other rights that go to the financial, operating and policy decisions of the borrower.

We therefore submit that the carve out in proposed section 128B(3C)(3CC) be extended to include any rights that a commercial third party lender would reasonably be expected to have in respect of the debt held by the foreign superannuation fund in the relevant circumstances. We consider that a general carve out in the above form would be preferred over attempting to provide an exhaustive list given the relevant rights that would be held by a commercial third party lender would differ depending on the specific circumstances of the borrower and security arrangements.

The above comments apply equally in respect of the sovereign immunity proposals in Schedule 4 of the ED.

SCHEDULE 4 – SOVEREIGN IMMUNITY

Section 880-105(1)(b) – replacing the managed investment trust (MIT) test with a "fixed trust other than a trading trust" test

According to Section 880-105(1)(b), in order to qualify for sovereign immunity, the sovereign entity must derive or receive income from a trust that is a MIT, or a company. In effect, this requirement excludes

sovereign entities that derive passive income, but do not constitute MITs or partnerships, from accessing sovereign immunity. This approach is overly narrow in scope compared to industry practice.

Given the administrative and financial costs associated with operating a MIT, the inefficiency of sovereign entities operating as MITs for the sole purpose of obtaining or preserving sovereign immunity may deter foreign investment into the Australian market.

As such, we submit that rather than the requirement for a trust to be a MIT in order to qualify for sovereign immunity, the test should be amended such that sovereign immunity is available where the income derived, received or made by a sovereign entity is directly or indirectly from a fixed trust that is not a trading trust.

The proposed amendment maintains a necessary balance between giving effect to the legislative intention of denying access to sovereign immunity where income is derived from an active trading trust; whilst ensuring the threshold for sovereign immunity is not prohibitively restrictive such that Australia remains globally competitive for sovereign investors making passive portfolio investments in Australia.

Section 880-105(1)(d) – replacing the shareholder test with a "common control" test

As currently drafted, all participation interests of sovereign entities within the same foreign country are aggregated for the purposes of determining whether the sovereign entity qualifies for sovereign immunity. This test is overly general and does not account for differences between sovereign wealth funds existing within the same country. For example, in countries with a state-based system, such as the United States and Canada, funds may be representative of different levels of government, i.e. federal and state.

Additionally, sovereign wealth funds can have vastly different constitutions, management and control.

As such, we submit that this test should be changed to a "common control" test, whereby participation interests of sovereign wealth funds are only aggregated for the purposes of the 10% test if they are commonly controlled and managed by the same Board of Directors.

Part 2 section 4(2) – a private binding ruling as at 27 March 2018 should not be needed to access the transitional provisions

Under Part 2 section 4(2), in order to qualify for the sovereign immunity transitional provisions, the sovereign entity must have obtained a private ruling to the effect that the acquired investment asset qualifies for sovereign immunity, which is still valid on 27 March 2018.

However, sovereign entities commonly rely retrospectively upon private binding rulings obtained with respect to previous investments for new investments on the basis that they still meet the requirements outlined in their previously approved private binding ruling, which typically includes no actual or de-facto directors on the board, and participation interest of less than 20%.

In such cases, the private ruling requirement stipulated in the Exposure Draft may be excessively onerous.

If a private ruling is required, we submit that sovereign investors should only be required to have *submitted* a private ruling on or prior to 27 March 2018, for which they subsequently obtain a positive ruling from the ATO.

Part 2 section 5(2) – Deemed sale and purchase

The exposure draft provides that in the instance where a sovereign entity continues to hold a transitional investment after the transitional period, the cost base of the investment would be deemed equal to the market value after 1 July 2026, or the day before the private ruling ceases to apply.

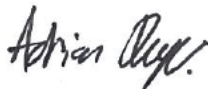
While we welcome this transitional provision, we suggest that the deemed cost base should be the higher of the market value of the investment or the cost base of the investment. This would then be able to cover a situation where the relevant asset has lost value since being acquired.

CONCLUSION

We trust the above comments and recommendations provide useful feedback to Treasury's current drafting of the legislation. As mentioned earlier, we would be happy to provide further details on the above and additional comments on the broader package, if required.

If you have any questions in relation to the above, please contact Varsha Maharaj on [redacted] or [redacted]

Sincerely,



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