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INFRASTRUCTURE PARTNERSHIPS AUSTRALIA
BUILDING AUSTRALIA TOGETHER

13 April 2012

The Manager
International Tax Integrity Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Manager,

Infrastructure Partnerships Australia: submission to the Exposure Draft – Stage One Transfer Pricing Reforms

1. Introduction

Infrastructure Partnerships Australia (IPA) welcomes the opportunity to comment on the Exposure Draft for the *Tax Laws Amendment (2012 Measures No. 3) Bill 2012: Cross-border transfer pricing* (the Exposure Draft).

IPA's major concerns with the Exposure Draft are the potential impacts for shareholder debt and the legislation's inappropriate and overly burdensome retrospective application. Any rule changes in this area could have serious consequences for private investment in infrastructure at a time when governments are already constrained in their capacity to fund projects.

2. About Infrastructure Partnerships Australia

Infrastructure Partnerships Australia is the nation's peak infrastructure body. Our mission is to advocate the best solutions to Australia's infrastructure challenges, equipping the nation with the assets and services we need to secure enduring and strong economic growth and importantly, to meet national social objectives.

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.

Our Membership is comprised of the most senior industry leaders across the spectrum of the infrastructure sector, including financiers, constructors, operators and advisors. Importantly, a significant portion of our Membership is comprised of government agencies.

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

3. The Exposure Draft

On 16 March 2012, Assistant Treasurer, David Bradbury released exposure draft legislation relating to transfer pricing reforms. Under the Exposure Draft a proposed new Subdivision 815-A (Treaty-equivalent cross-border transfer pricing rules) will be inserted into the *Income Tax Assessment Act 1997* (Cth). The proposed Subdivision will apply where an entity gets a transfer pricing benefit and a bilateral tax treaty applies that contains either an Associated Enterprises Article or a Business Profits Article.

The amount of the transfer pricing benefit will be worked out by reference to the anticipated profits of an entity, in accordance with the Associated Enterprises Article or Business Profits Article that applies. Under the proposed legislation, the Commissioner is empowered to make a determination increasing the taxable income or decreasing the losses of an entity that would otherwise receive a transfer pricing benefit.

3.1 Interaction with Thin Capitalisation rules

An area of particular concern for IPA, and a grey area in the proposed legislation, is the interaction between Subdivision 815-A and the thin capitalisation rules in Division 820.

Under the Exposure Draft, the rate of return on a debt interest will first be worked out under the new Subdivision 815-A in accordance with the OECD Guidelines and the Model Tax Convention. This assessment may involve "having regard to an arm's length amount of debt that the entity would have held had it been dealing wholly independently with the other entity, rather than its actual amount of debt."[1]

That rate of return must then be applied to the entity's actual value of debt interest. As a final step, the application of Division 820 may reduce the amounts of debt deductions otherwise allowable if the entity's adjusted average debt exceeds its allowable debt limit.

3.2 Retrospective Application

The Exposure Draft intends the legislation to apply to income years beginning 1 July 2004 onwards.

Proposed Section 815-25 and Section 815-22(3) propose that the OECD Model Tax Treaty and OECD Transfer Pricing Guidelines be utilized as guidance in applying Division 13 and the relevant articles of Australia's Double Tax Treaties. As the full Federal Court in the *Commissioner of Taxation V SNF (Australia) Pty Ltd* (2011) held that the OECD Transfer Pricing Guidelines were not a legitimate aid to the construction of Australia's Double Tax Treaties or effectively Division 13, we believe that the proposed retrospective application of these proposed amendments to Australia's Transfer Pricing Laws are inappropriate and overly burdensome at this time. Prospective application would be far more acceptable and fair to taxpayers at this time.

3.3 Amendments to Transfer Pricing Penalty Provisions

In view of the increasing complexity and more onerous compliance requirements for taxpayers under these proposed amendments, we respectfully submit that the transfer pricing penalty provisions

[1] Explanatory materials: *Cross Border Transfer Pricing Rules*

should be amended to ensure a zero percent penalty where there is a no-fault transfer pricing adjustment i.e. the taxpayer has a reasonably arguable position on its transfer pricing position and has made best endeavors effort to comply with the transfer pricing law. It is important to note that most OECD countries have a zero percent penalty in no-fault taxpayer circumstances.

4. Impact for Infrastructure

IPA is concerned about the impact the proposed rule changes will have for debt in infrastructure projects – both in terms of deterring future investment and the consequences for existing investors.

Under Australia's current thin capitalisation rules, an Australian subsidiary of a foreign parent company is subject to a cap on the amount of debt used to fund its Australian operations and investments. The rules disallow the debt deductions an entity can claim against Australian assessable income when the entity's debt used to fund Australian assets exceeds certain limits. The cap is based on either a 3:1 (so-called "safe harbour") debt to equity ratio, an arm's length debt amount or a measure that looks at the level of worldwide debt (the later in limited circumstances).

In Australia, many social[2] and some economic[3] infrastructure projects have debt to equity ratios which significantly exceed the current "safe harbour" ratio of 3:1. These entities are able to justify a higher level of debt as the cash flows from the project are typically relatively secure over the long-term, enduring beyond one or more economic cycles. The higher level of debt is achievable and is reflective of blue chip payors e.g. Federal, State Governments and major corporations.

Under the current thin cap rules, the Australian entity is able to justify an arm's length level of debt, thereby retaining the tax deductibility of the interest on that debt. The tax deductibility of that debt interest is an important factor in investors' cash flows and after tax rate of return.

Any negative impact on the debt interest tax deductibility, investors' cash flows and after tax rate of return should be avoided, or the costs to the community and to the consumer of infrastructure and related services will rise. This is because the efficient deployment of debt capital translates directly into lower community costs than would apply if additional equity was required for infrastructure projects, given that equity investors typically require higher rates of return than do debt financiers.

The interaction between the proposed Subdivision 815-A and the thin capitalisation rules in Division 820 could have a very negative effect on the costs of all levels of government to access private sector capital participation (for example, through PPPs) to deliver Australia's backlog of social and economic infrastructure.

As well as impacting on future infrastructure investment, the retrospective application of the rules could have serious consequences for existing taxpaying infrastructure entities with high but commercially justifiable gearing ratios. The increased Australian tax costs of denied tax deductions for debt interest payments (that are currently deductible) would also have an adverse cash flow impact on these entities. This could herald increased prices for infrastructure users.

The changes in the Exposure Draft are being proposed in a period of existing budgetary constraint. Governments should be looking to measures that facilitate increased private sector involvement in infrastructure projects, not deter it. The nation's need for critical infrastructure never been greater

[2] Such as schools and hospitals.
[3] Including roads, ports, etc.

and the implications of any measure with the potential to deter private investment in infrastructure must be given appropriate consideration.

5. Future Actions

In making any amendments to the operation of the thin capitalisation rules, the Government must:

a) consider a carve-out for infrastructure projects, considering projects' commercially justifiable debt to equity ratios; and
b) provide appropriate protection for investors in projects where major long term debt is locked in.
c) hold targeted consultations with industry to understand the impact of any potential rule change; IPA appreciates Treasury's undertaking that further feedback and comments will be requested during the legislative drafting process, and we emphasise that this is critical.

If you would like any further information, or to discuss our submission, you can contact our Manager, Policy, Zoe Peters on (02) 9240 2064 or zoe.peters@infrastructure.org.au

Kind regards

BRENDAN LYON
CHIEF EXECUTIVE OFFICER