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INFRASTRUCTURE PARTNERSHIPS AUSTRALIA
BUILDING AUSTRALIA TOGETHER

26 September 2012

Mr Chris Jordan
Chair
Business Tax Working Group
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Jordan,

Re: Submission on the Business Tax Working Group Discussion Paper

1. Introduction

IPA welcomes this opportunity to respond to the issues paper released by the Business Tax Working Group (BTWG) in July. Well-conceived, well-implemented reforms to the tax transfer system present important opportunities to ensure the taxation system both supports and facilitates Australia to achieve core economic and social objectives.

As a framing comment, IPA welcomes the consideration of moves to reduce the company tax rate, however we caution the BTWG that this outcome must not be sought at any cost. Some of the options canvassed in the discussion paper would likely serve to deter efficient investment in the nation's infrastructure, in turn frustrating substantial progress in addressing national productivity challenges.

We therefore submit that measures that would foreseeably create a disincentive for infrastructure investment should not be pursued.

Of particular concern is that some of the base broadening measures proposed would likely have a negative impact on trusts and other flow through vehicles which invest heavily in infrastructure; yet non-corporate entities won't benefit from the cut to the company tax rate. This outcome would be inequitable, with the infrastructure sector effectively paying for a tax cut from which they receive no benefit.

In this context, IPA recommends:

- the BTWG remove the thin capitalisation changes, particularly Option A.1 (*Remove arm's length debt test and reducing safe harbour gearing levels – general entities*) from the base broadening measures recommended to the Treasurer;
    - If changes to thin capitalisation are recommended in the BTWG package:
        - the arm's length debt test must be retained; or

- an effective carve-out for public social and economic infrastructure projects must be included;[1] and

- appropriate protection must be included for projects where major long-term cash flows (such as debt payments or revenue streams) are already locked in;

- the BTWG remove Option A.4 *(Cap interest deductions for all business taxpayers (excluding banks))* from the base broadening measures recommended to the Treasurer; and

- the BTWG remove Option B.13 *(remove building depreciation deductions)* from the base broadening measures recommended to the Treasurer.

There is also some concern that, with budgetary pressures, the negatives may be introduced in the absence of the positives. It must be ensured that the base broadening/revenue growing measures are not introduced without the cut to the corporate tax rate, as has been the case with some other recent tax reforms.

2. About Infrastructure Partnerships Australia

IPA 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.

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 base broadening measures must not impact infrastructure investment

Australia needs more investment in its public infrastructure, rather than less, and some of the reform options canvassed in the Discussion Paper would likely prove counterproductive because they would disadvantage efficient investment into Australian infrastructure.

3.1 The BTWG should remove Option A.1 (Remove arm's length debt test and reducing safe harbour gearing levels – general entities) from the base broadening measures going forward

A significant level of infrastructure investment is undertaken using trusts, or stapled structures involving trusts, including as a means to facilitate non-residents investing in Australian infrastructure. Debt financing is a key feature of infrastructure development and investment, and many trusts investing in infrastructure are therefore subject to the thin capitalisation rules.

[1] IPA would be happy to work with Government to develop an appropriate carve out.

Many social and some economic 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. As such, the Australian entity is able to raise debt from third party arm's length lenders at a level of debt to equity which is in excess of the 3:1 safe harbour amount. The tax deductibility of the interest on this debt is one important factor in investors' cash flows and achieving an appropriate after tax rate of return for their equity.

Each of the options covered on pages 24 to 27 of the Discussion Paper involves a tightening of the thin capitalisation rules. These options would result in a lower level of deductible interest and a corresponding increase in taxable income for affected taxpayers.

By directly increasing tax costs, and thereby reducing the after tax rate of return, the proposed changes to the thin capitalisation rules would have a material impact on investors in current projects, as well as future projects, funded with a majority of foreign equity. By reducing the efficiency of infrastructure investment, the proposed changes to thin capitalisation could also undermine the Government's productivity goals.

Option A.1 is of particular concern. The arm's length debt test is critical to the delivery of major infrastructure projects and facilitation of foreign investment. Its abandonment would have a serious negative impact on the costs of all levels of government to access private sector capital (for example, through PPPs) to deliver Australia's much needed backlog of social and economic infrastructure. The costs to the community and to the consumer of infrastructure sensitive goods and services would therefore rise.

The efficient deployment of debt capital translates directly into lower community costs for both social and economic infrastructure than would apply if additional equity was required, given that equity investors typically require higher rates of return than debt financiers.

These potential changes would come at a time when government budget constraints increasingly require private sector involvement in infrastructure projects and the need for critical infrastructure to expand the nation's economic capacity has never been greater. In the current climate, the implications of any measure which has the potential to deter foreign investment into infrastructure must be carefully considered.

The arm's length debt test was incorporated in the thin capitalisation regime to recognise *'that some funding arrangements may be commercially viable notwithstanding that they exceed the prescribed limits. It also makes the rules more consistent with Australia's DTAs.'*[2] These reasons remain valid, and funding arrangements for infrastructure projects fit this description.

Existing projects

The changes to thin capitalisation would also have dire consequences for existing taxpayers with high but commercially justifiable gearing ratios, and adequate transitional provisions would therefore need to be included if the proposed changes are implemented.

The increased Australian tax costs of denied tax deductions for currently deductible interest payments would have an adverse cash flow impact on existing taxpayers. In PPPs, consortium equity takes tax risk. The proposed changes to thin capitalisation would impact this, and changes in cash flow would impact debt covenants and project IRR.

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[2] Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001

Existing projects could also be negatively affected by the incurrence of potentially high break costs if they were to de-lever to lower levels. The break costs potentially relate to both the underlying debt, as well as any associated hedges (often in PPPs, there will be a long-term hedge but much shorter-term debt that will be refinanced).

Again, this would herald increased prices (in circumstances where the taxpayer had flexibility to change the pricing structure) or, in projects operating under regulated pricing or availability based models (and hence no or limited ability to amend the pricing structure), would result in significant reductions in returns on equity and, potentially, service delivery issues.

Inequity

The significant negative impacts of the changes to the thin capitalisation rules – and particularly the removal of the arm's length debt test – for those projects undertaken in a trust or partnership structure would not be offset by a reduction in the corporate tax rate.

The thin capitalisation rules apply to all types of entities including trusts and partnerships. However, in almost all cases, these non-corporate entities do not pay corporate tax. The taxable income of the trust is instead assigned to the investors in the trust, in proportion to their ownership interest.

Investors in trusts and partnerships may not benefit from the cut to the corporate tax rate, yet would be adversely impacted by the changes to the thin capitalisation rules proposed to fund the cut.

In order to address this inequity, and to reduce the negative impacts on infrastructure investment, if changes to thin capitalisation are recommended in the BTWG package:

- the arm's length debt test must be retained; or
- a carve-out for infrastructure projects must be included; and
- appropriate protection must be included for projects where major long-term debt is locked in.

3.2 The BTWG should remove Option A.4 (Cap interest deductions for all business taxpayers (excluding banks)) from the base broadening measures recommended going forward

Capping interest deductions for all businesses on EBITDA would have a significant negative impact on Greenfield infrastructure projects which typically experience a ramp up in revenue over a significant project life. Furthermore, as there is typically an extended construction period in relation to the asset during which no income is derived, depending upon the applicable accounting treatment, an EBITDA test may effectively result in a total or substantial denial of interest deductions incurred during the construction phase.

An EBITDA approach discriminates against asset intensive industries, such as the infrastructure and property industries, where significant capital outlays are required to generate an appropriate level of income return. As such, interest expense would be expected to represent a greater proportion of EBITDA compared with other industries and an EBITDA approach is therefore likely to result in greater denial of interest deductions.

IPA does not support this approach.

3.3 The BTWG should remove Option B.13 (remove building depreciation deductions) from the base broadening measures recommended going forward

Option B.13 – removing capital works deductions – would have a material impact on project funding, and would also change the economics of existing projects that currently claim the deductions.

Capital works deductions fund tax deferred distributions which are valued by equity investors. That is, a tax timing benefit impacts the cost of equity from taxable sources like complying superannuation funds, as well as foreign and other taxable domestic infrastructure investors.

This is particularly important for leasehold concessions where the investor hands back the asset at the end of the concession, and the asset may have a significantly longer life than the concession period.

4. Further contact

Should you require further information, I invite you to contact our Manager, Policy, Zoe Peters, on (02) 9240 2064.

Yours sincerely,

BRENDAN LYON
CHIEF EXECUTIVE OFFICER