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AustralianSuper

An Industry SuperFund

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Division Head
Corporate and International Tax Division
The Treasury
Langton Crescent
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Stapled Structures Consultation Paper
AustralianSuper Submission

Dear Sir/Madam,

AustralianSuper ('the Fund') is an industry superannuation fund run only to benefit our 2.1 million members, and one of Australia's largest public offer superannuation funds. We invest more than $105 billion of member funds globally, and across asset classes including equities, fixed income securities, real estate and infrastructure. The Fund is also amongst Australia's largest taxpayers, having made tax payments in 2016 of more than $800 million.

Over $8 billion of member funds are currently invested directly and indirectly in Australian infrastructure that is pre-dominantly owned in stapled structures. Over the last four years, the Fund has been Australia's largest private infrastructure investor having been a member of the successful consortiums for the acquisitions of Ausgrid, Queensland Motorways, and NSW Ports. The application of member funds towards investment in these assets has been made in accordance with the prevailing regulatory and legislative framework and economic environment applicable to the each asset at the time of their acquisition. All of these acquisitions have involved partnering with other investors that would also be affected by any changes resulting from the Consultation, the State Governments and the Australian Taxation Office as appropriate.

The Fund is responding to the Stapled Structures Consultation Paper ('the Consultation') on the basis that any resulting change to the existing taxation laws as they apply to infrastructure investment has the potential to adversely impact the value of investments made on behalf of our 2.1 million members and, by extension, each of their superannuation account balances. It should be noted that all of our members are Australian workers, and as such our investments are made solely with the benefits of Australian superannuants in mind.

Please note that this submission addresses issues raised by the Consultation only in respect of the use of stapled structures in the Australian infrastructure sector. Although the Fund is a significant investor in Australian real estate, we have not sought to address any issues posed with respect to the use of stapled structures in the real estate sector. Additionally, in order to not lose key messages we have attempted to keep our responses brief.

Executive Summary

We have set out below our responses to each of the questions raised by the Consultation that the Fund considers critical. Our responses to other questions raised by the Consultation have been included in Appendix A. Our submission reinforces the following key messages:

1. The Fund supports the concept of flow through taxation treatment for Australian infrastructure investments that levies tax on investors at their prevailing tax rate and mitigates double taxation.
2. The Fund supports an effective tax rate for infrastructure investment which is both globally competitive and equalising for both domestic and foreign institutional investors.

3. Any changes as a result of the Consultation should preserve the flow through treatment of existing infrastructure investment vehicles and avoid value destruction to the significant private investment made in Australian infrastructure facilitated by deliberate state and federal policy.

4. Given the significant commitment already made and future need to attract private capital to Australian infrastructure from both domestic and foreign investors, any changes as a result of the Consultation should be thoroughly tested with key industry stakeholders prior to their finalisation and adoption.

5. Failure to preserve flow through treatment and effectively consult with industry to any changes will adversely impact the value of existing infrastructure investments and the cost and availability of capital for future investment in Australian infrastructure.

The Fund would welcome the opportunity to discuss our responses with you in more detail.

Response to Question 2: What impact would the loss of an ability to make cash distributions at the early stages of a project have on the attractiveness of long-term infrastructure investment for investors? Are there alternative ways to address this problem, such as used in other countries?

In our opinion the use of stapled structures is driven by the ability to access both flow through taxation treatment and cash distributions from the date of investment. This is the same rationale applied to the use of equivalent flow through vehicles in foreign jurisdictions, such as limited liability companies in the United States ('the US') and limited liability partnerships in the United Kingdom ('UK'). These vehicles are discussed further below.

There are a number of capital pricing and availability issues which would be impacted by the loss of early stage cash distributions and consequently the relative attractiveness of such projects. These issues are summarised below.

Smaller Investor Universe

Certain investors and investment vehicles require or favour regular distributions from their investments (e.g. pension products and defined liability pension schemes which are required to make regular payments to their product owners and members). Such providers of capital would not be available to invest in infrastructure which has a deferred distribution profile. Other investors will have a reduced investment appetite for such deferred distribution profiles as a result of the higher illiquidity associated with that investment. The overall result is a reduction in the available pool of capital.

Higher Cost of Capital

Deferred distributions are worth less to an investor given the negative impact of the "time value of money". Hence they will require a higher return (or lower purchase price) to compensate. Further, a cash return holds less risk to an investor than an unrealised capital return. So if more of an investor's total return is derived from capital value appreciation versus cash distributions, that investor will generally seek a higher return to compensate for the additional risk.

Value Loss

Infrastructure assets are very long life, high capital cost and depreciable assets. Holding such assets through flow through vehicles eliminates any risk of cash traps and franking credit traps. Elimination of flow through vehicles will introduce both timing losses and permanent losses from trapped cash and franking credits, which will add to the overall cost of an infrastructure project and increase the effective tax rate above the prevailing rate applicable to that investor.

In contextualising the above issues, the Fund is a defined contribution superannuation scheme with strong cash inflows and a growing member base. We are better equipped than most investors to invest significant capital in long life illiquid infrastructure projects. However, our capacity and desire to invest in such projects is finite and good investment opportunities compete for our capital. Loss of flow through vehicles for Australian infrastructure will reduce the total pool of available capital we wish to invest in illiquid investments. Deferral of investment returns (via deferred distributions) will increase the risk profile of an investment and thus our required return. And any trapped cash or franking credits in a project vehicle will be disregarded for investment return purposes, thus adding to the overall cost of an infrastructure project.

There are a number of examples globally of jurisdictions that permit investment in infrastructure via flow through vehicles. Our comments below are limited to the US, UK, Germany and France. In each of these jurisdictions a number of flow through entities are used to avoid the matters listed above. These entities are not exclusively used for infrastructure investment and can also be used for real estate.

In the US staples are not needed for flow through treatment as the following entities are available as alternatives to REITs:

1. Limited Liability Companies (LLC). An LLC is flow through for US corporate tax purposes and tax is paid at the shareholder level;
2. Limited Liability Partnerships (LLP). An LLP is flow through for US corporate tax purposes and tax is paid at the partner level; and
3. Private Trusts. These entities are flow through for US corporate tax purposes and tax is paid at the beneficiary level.

It is important to note that as infrastructure is not ordinarily widely held (typically due to the participation of particular types of investors), REITs are not commonly used for infrastructure. This is not because of the anti-staple rule in the REIT legislation, but because the LLC, LLP and Private Trust structures achieve the same key benefits of REITs in a very straight forward way.

In the UK the most common form of ownership is the LLP which operates in the same manner as LLPs in the US.

Both Germany and France have introduced special fund regimes the consequences of which allow distributions from the fund structures to investors without entity level taxation. These structures are in addition to LLPs which are also commonly used. The German regime compares to the Australian MIT regime because a German Special Fund can only be set up by a regulated fund manager.

We have set out further detail supporting these comments at Appendix A in our responses to Questions 3 and 4.

Question 5: How important is tax in determining the international competitiveness of Australia as a foreign investment location for assets and activities typically placed in stapled structures?

Tax is of fundamental importance in determining the international competitiveness of Australia as a foreign investment location for infrastructure investment. Further, and by implication, it is of fundamental importance to domestic institutional investors as well as the relative attractiveness of infrastructure to other assets classes competing for capital.

Ultimately investors will assess the attractiveness of any given investment on an after tax basis (in the Fund's case this means a return "in the hands of our members"). If there is significant disparity in either the prevailing tax rate of investors or the tax burden of various jurisdictions, this will adversely impact the disadvantaged investor and disadvantaged jurisdiction by driving disadvantaged capital to more attractive after tax investments and jurisdictions.

The Fund's experience in evaluating infrastructure investment in the UK and the US is with tax regimes that:

- facilitate access to flow through taxation treatment;
- impose effective tax rates comparable to our Australian effective tax rate;
- provide concessions for superannuation fund investors in certain circumstances; and
- have well established legislative frameworks for infrastructure investment and flow through vehicles that operate to alleviate tax uncertainty for investors.

Consequently this allows the Fund to assess investment opportunities and allocate capital in these jurisdictions on a relatively equal tax footing. A higher tax burden of a given jurisdiction would place a higher pre-tax return hurdle on prospective opportunities and thus reduce its attractiveness to the Fund. The same is likely to be true for foreign institutional investor assessing infrastructure investments in Australia.

In addition to the tax rate, the ability to access flow through investment vehicles for cash and tax proposes (including the MIT regime for non-residents) will also be critical to the attractiveness and competitiveness of Australia for both domestic and foreign infrastructure investors. Our position on the issue of cash distributions was addressed in response to question 2 above. We make the following additional observations:

1. In our view the MIT withholding tax rate of 15% is not unreasonable. This is equal to the rate applicable to Australian superannuation funds and comparable to other foreign jurisdictions (for example, the UK). On the basis that the MIT regime was introduced to make Australia more attractive to foreign investors (without penalising local institutional investors) we see no reason for not maintaining this regime and tax rate.
2. In the absence of the MIT regime, withholding tax at 30% would make Australia uncompetitive against other key jurisdictions for tax exempt funds however for taxable foreign investors the issue then becomes a question of foreign tax credit capacity.
3. In substance the global tax rate comparisons should be with the UK (17%), the US (that provides a FIRPTA exemption for certain investors) and Germany (15% for the special fund regime).
4. Our expectation is that foreign investors would prefer a single regime that was flow through. The rate of withholding then becomes a policy issue for global competitiveness whilst ensuring the ongoing competiveness of Australian superannuation funds vis a vis foreign investors. It is better to have clear guidance of the tax rules and let the market decide as opposed to have no clarity, uncertainty and perceived threats to sovereign risk status.

Question 11 and 12: If the tax advantages of stapled arrangements are removed, does Australia need specific concessions for critical infrastructure investment? If Australia does need such concessions for critical infrastructure investment, what should be the form of those concessions?

The Fund supports the concept of flow through taxation treatment for Australian infrastructure investments that levies tax on investors at their prevailing tax rate and avoids double taxation. The costs and impacts of removing the tax advantages of flow through vehicles are detailed in our responses to question 2 above and question 13 below.

Consequently, the Fund does not object to removal of tax advantages of stapled arrangements to the extent they are replaced with effective flow through vehicles for infrastructure investments (with a globally attractive and competitively neutral withholding tax rate for non-residents) coupled with an appropriate transition period and regime to ensure preservation of value in the billions of dollars in private capital invested in Australian

infrastructure to date. This would also ensure the continued attractiveness of Australian infrastructure to both domestic and foreign investors without the need for further specific tax concessions.

An ideal circumstance would be to eliminate the need for staples by enabling Australian infrastructure investments to be housed in a single flow through vehicle. This could be achieved by making amendments to Division 6C, which governs the circumstances under which a trust will be treated as a corporate for income tax purposes. This would require careful consideration of the definition of "infrastructure" for the purposes of accessing flow through tax treatment to ensure it is capable of surviving the evolution of what constitutes infrastructure, and testing with key industry stakeholders prior to any legislative change.

Assuming a single flow through regime is adopted, the next issue to consider is an appropriate withholding tax rate for foreign investors. In our view, an appropriate withholding tax rate should:

- Create an equal playing field as concerns effective tax rates between the Fund (and other Australian institutional investors) and foreign institutional investors; and
- Facilitate Australia's ability to continue to attract foreign capital.

The outcome of adopting a single flow through regime with an appropriate withholding tax rate should achieve:

- The creation of a single, simple regime for infrastructure investment that is adequately governed by tax legislation.
- An increased efficiency of capital through the eradication of the current uncertainty surrounding the use of stapled structures and in particular the risks associated with allocation of revenue as across both sides of the staple.
- An appropriate amount of tax revenue for Australian treasury whilst maintaining Australia's global competiveness in attracting foreign capital.

Ensuring competitiveness of Australian superannuation funds

As an additional point, the Fund would like Treasury to address the position of the tax exemption provided to foreign pension funds on shareholder debt to associate or related party vehicles (section 128B(3)(jb)). The effect of this tax exemption is to reduce the interest rate ordinarily applicable to a non-resident investor from 10% to zero. In our view, this exemption should be limited to circumstances where foreign pension funds provide debt to third parties located in Australia.

Question 13: If tax laws are amended to remove the tax advantages of stapled arrangements, what impact do you consider this would have on the Australian economy, including the cost of capital, level of investment and price of assets? Please include any supporting evidence.

As illustrated in our responses to the above questions, the key advantage of stapled arrangements is the ability to access flow through cash and tax treatment for infrastructure investments. This reduces the overall cost of infrastructure assets (particularly new build projects) and/or increases the net present value of the investment.

Whilst we are not in a position to quantify the impact the loss of this tax concession on the Australian economy, we can illustrate what impact this change would have on Australian infrastructure investment and on the Fund's members. We have identified in response to question 2 above that value loss to our members will be one consequence of removing the tax advantages of stapled arrangements.

For the Fund, our valuations of infrastructure investments use the market practice of discounted cash flow valuation by applying an internal rate of return ('IRR') to compensate for the perceived risk and illiquidity of the investment relative to other assets of the Fund. Cash and franking credit traps will be adverse to investment values using this discounted cash flow valuation methodology.

Removing flow through treatment for Australian infrastructure investment and imposing a 30% tax will have the detrimental impacts as outlined below.

Increased cost of capital for investors

The stapled structures in which we are currently invested would be at risk of no longer satisfying their debt service cover ratios. In the extreme, this would require replacing existing and relatively cost effective debt with new more expensive equity which would immediately reduce the value of the Fund's existing investment.

The risk of cash and tax traps for holding infrastructure assets in non-flow through vehicles will place an additional cost on such assets through a higher required rate of return on capital and higher effective tax rate (as explained in our response to question 2).

Decreased ability to attract foreign capital

Going forward, we would expect that Australia will be disadvantaged in competing for foreign capital with other foreign jurisdictions (including key economies such as the US, UK and Germany) given their use of transparent entities, lower effective tax rates and certain concessions for pension fund investors (as set out in our response to question 2). One might argue that reduced foreign capital is advantageous for the Fund in terms of lower competition for secondary market infrastructure auctions and State asset privatisations. However, the Fund actively invests and bids alongside foreign pension and sovereign wealth funds because:

- infrastructure assets are often very large and require significant capital;
- foreign investors bring expertise and intellectual property to the benefit of the infrastructure project and by extension the domestic economy; and
- foreign investors are a crucial source of ongoing liquidity for the future sale of infrastructure investments by domestic investors such as the Fund.

If foreign investors cease to invest in Australian infrastructure, the Fund would impose a premium on our required rate of return to compensate for the perceived reduction in liquidity upon divestment of the investment. By extension, independent valuers may seek to increase the applied discount rate to existing infrastructure investments for the same illiquidity factor. This would adversely impact current investment valuations (i.e. price of assets) and therefore our member account balances.

Increase the cost of building new Australian infrastructure assets

Due to the nature of infrastructure assets, the use of a corporate structure for their ownership would increase the cost of building these assets going forward due to cash and franking traps (owing to the difference between accounting and tax treatment of capital expenditures), and double taxation for foreign investors. Further, investors are likely to apply a higher discount rate to such investments given distribution deferral and heightened risk of illiquidity.

As a result of this increased cost, our expectation is that this will depress valuations for infrastructure projects which may then act as a disincentive for State governments to recycle capital for new infrastructure projects. Further, the higher cost of building new infrastructure may marginalize its economic value and change a proponent's investment decision previously in support of such project. Given Australia's anticipated need for new infrastructure over the coming years, these effects could have far more serious ramifications for the Australian economy as a whole.

Question 16: Would the impact be different for new and existing investment and entities? If so, how?

Further to our response to question 13, the effects of any legislative amendments that operate to remove flow through treatment for Australian infrastructure and impose a 30% tax rate would manifest themselves differently in respect of new and existing investments.

For existing infrastructure investments, any changes would create the potential for value destruction (in the event of inadequate grandfathering provisions) on the basis that these investments were in most cases acquired through State Government privatization processes and priced on the basis of the existing legislative framework and appropriate dealings with the ATO.

This can be distinguished from the impact on future infrastructure investment and any privatization processes which will be valued based on higher required rates of return for investors and the increased cost of delivering new Australian infrastructure projects.

So whilst the impact on existing and new investments will be different, each will be detrimental and adverse to investors and users of infrastructure services.

Questions 17, 18, 19 and 20: What is the typical term of external third party finance for stapled groups? Should pre-existing structures and instruments issued prior to any new taxation laws be grandfathered? What is an appropriate transition period and transitional arrangements for existing staples? What would be the types of compliance and other transaction costs (such as stamp duty) of undertaking such a restructure? Should specific tax relief be provided to facilitate a restructure?

We have grouped these questions together as they are all related to transitional measures.

Put simply, if older structures are not completely grandfathered, it is essential that infrastructure investments transition to an alternate regime utilising flow through vehicles with associated relief for transaction costs, in particular state based stamp duty. A complete grandfathering is prima facie attractive, however, we recognise that this would be unwieldy and potentially inhibit organic growth of existing structures similar to the unintended effect of subdivision 124-Q of the *Income Tax Assessment Act 1997*.

Introduction of an alternate flow through regime for infrastructure investments such as the limited liability company structure in the US would preserve the value in existing infrastructure investments, many of which were made under deliberate State and Federal policies of attracting private capital to infrastructure investments and executed under agreed Tax Deeds with the Australian Taxation Office.

Transition arrangements to an alternate flow through regime will be critical to value preservation and mitigation of sovereign risk, particularly given the significant recent investments made under privatisation programs and the significant transaction costs incurred. In addition to avoiding repeat payment of transaction costs, other matters reliant on an appropriate transitional regime include:

- For commercial arrangements to be re-negotiated, often with the State and taking into account the volume of projects and project investors that will be engaging with State and financial institutions, both of which have limited resources;
- For financial arrangements to be restructured and often, for existing facilities to be refinanced;
- For State Government to enact stamp duty relief for resulting restructures as appropriate; and
- For the relevant legislation encompassing the new regime to be able to be reviewed and amended as necessary prior to the transitional period ending.

Debt Arrangements

Due to the capital intensive nature of infrastructure and the stable income flows, gearing can be higher than other assets and businesses. Due to this and the long duration of infrastructure projects, there is a diversity in financial instruments utilised to finance infrastructure. For example, older projects were financed with 20-30 year bond instruments. Currently, infrastructure assets and projects regularly access domestic and foreign debt capital markets to raise up to 15 year debt instruments. For example, in the past 12 months, Transurban Queensland (owned 25% by the Fund) has issued 10, 12 15 and 18 year debt instruments in the US and European debt capital markets.

Preservation of flow through vehicles in place of stapled structures should not adversely impact these existing debt structures subject to the appropriate transition regime to facilitate the restructure of the borrower entity. However, any loss of flow through status is likely to adversely impact the debt serviceability of a borrowing entity under current stapled structure arrangements. This will have material commercial ramifications across borrowers and the debt markets through the cascading impacts of credit rating downgrades, increased credit spreads, early repayment of debt instruments (if allowed for under the relevant debt terms), degearing of capital structures (replacing cheaper debt with more expensive equity), and reduced investor demand for both debt and equity funding of infrastructure as a result of the perceived increase in associated sovereign risk.

Existing Projects

Existing structures should not be prejudiced (subject to no tax dispute). For example, the Fund invested into Ausgrid less than 6 months ago. The projected asset life is 99 years and it is subject to an agreement entered into with the Australian Taxation Office that will run the entire term subject to the occurrence of specific events (including a change in tax law). For a change of law to occur so immediately after financial close which alters the economics of the transaction and effectively terminates the arrangement would have a significant impact upon the perception of the stability of the Australian taxation and investment environment.

Our responses to previous questions highlight the value destruction associated with abolishing flow through structures for existing investments.

Period for Transitional Rules

This is a complex issue and it is not considered possible to provide a meaningful response at this stage. We have set out some key considerations above and highlight that it took several years for the main States to implement Stamp Duty relief for subdivision 124-Q rollover relief (and Tasmania still has not enacted relief).

In contrast, compensating adjustments (for example a single flow through vehicle with a concessional tax rate and potentially repeal of section 128B(3)(jb)) may make restructuring potentially more simplified.

This is an area that needs to be discussed further in order to accommodate a diverse group of infrastructure investors in Australia both in the listed and non-listed spheres.

Closing remarks

As illustrated by our responses set out above, the issues raised by the Consultation are numerous, complex and have the potential to impact different asset classes and various types of investors. Accordingly, the Fund urges Treasury to:

- Preserve and provide further legislative clarity concerning the concept of flow through taxation treatment for Australian infrastructure investments such that investors are taxed at their prevailing tax rate and risk of double taxation is mitigated.

- Determine a non-resident tax rate for infrastructure investment which is both globally competitive and equalising for both Australian and foreign institutional investors.
- Ensure any legislative change as a result of the Consultation preserves the flow through treatment of existing infrastructure investment vehicles and avoids value destruction to the significant private investment made in Australian infrastructure facilitated by deliberate state and federal government policy.
- Thoroughly test any changes as a result of the Consultation with key industry stakeholders prior to their finalisation and adoption given the significant capital commitment already made and the future need to attract private capital to Australian infrastructure from both domestic and foreign investors.

The Fund considers the issues raised by the Consultation as particularly significant given the potential implications for our 2.1 million members. Accordingly, we would welcome the opportunity to discuss the responses set out in this submission with you in more detail.

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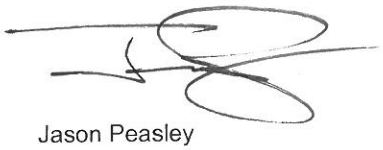
Should you have any questions on any of the matters raised in this submission, please contact Gina Maio, Transaction Tax Manager on 03 9200 3654 or via gmaio@australiansuper.com.

Yours sincerely



Jason Peasley
Head of Mid Risk Portfolios

Yours sincerely

Nik Kemp
Head of Infrastructure

Appendix A

Response to Question 3: Are there other countries where the use of stapled structures is common? If so, please provide details, including an outline of the tax rules applicable to stapled structures.

Further to our response at Question 2, staples are not necessitated in the US, UK, France or Germany as there are special regimes which allow flow through tax treatment irrespective of the nature of the investment. Those regimes do not have rules which convert the vehicle to a taxable entity. In particular we reiterate the comments made in Question 2 that most infrastructure investments are made by consortiums with a small number of investors. This is consistent across infrastructure investment globally and therefore the use of LLPs adequately deals with the flow through taxation issues in virtually all foreign markets.

Staples developed in Australia initially because a public flow through vehicle would be deemed to be a taxable entity pursuant to Division 6C. If Division 6C, the MIT rules and Division 5A are considered together there would not appear to be an alternative to staples in the Australian tax market. If there is no rule which deems a flow through vehicle to be taxable there would be no need for staples in the public context. Further, if Division 6C and the MIT rules were modified there would be no need for staples in the non-listed context.

The reason for staples commences with the limited partnership rules in Australia. As a consequence of Section 94J of the Income Tax Assessment Act 1936 an Australian limited partnership is treated as a company for most of the purposes of the income tax legislation. Accordingly the most common global form of flow through entity is not available in Australia.

Absent limited partnerships the only remaining flow through form for collective investment is the unit trust. The definition of *trading business* in Section 102M "means a business that does not consist wholly of "eligible investment business" will become a trading trust Accordingly absent Sections 102MB and 102MC to achieve flow through tax treatment of a public trading trust it is necessary to limit the interests of the trust to "eligible investment business".

Accordingly in order to preserve flow through taxation for any public trust it is necessary to have a staple as no other flow through vehicle exists under Australian tax law. Additionally as Section 275-10(4)(a) of the Income Tax Assessment Act 1997 would deny MIT status to a trust that controlled a trading trust in the circumstances of a private trust it is necessary to segregate the operating activities of the infrastructure asset to ensure that the MIT status of the relevant trust is maintained.

Response to Question 4: Are there other countries which provide specific tax concessions or a separate regime for infrastructure investments? If so, please provide details of the concessions or regimes.

Leaving aside the comments made to Questions 2 and 3 about flow through taxation we set out some brief comments on infrastructure tax issues globally.

Germany

The level of infrastructure shortfall in Germany and the alternatives the German government is looking to introduce to encourage foreign investment in German infrastructure are well known[1].

The 2015 amendments of the German Investment Act (Investmentgesetz) are intended to introduce a flexible institutional fund regime. Two new rules liberalise the German market and grant access to a 15% tax rate to investors. Firstly, the new German Investment Act provides for a more liberal regulatory framework for investment management companies. Secondly, the new law provides for a number of changes including the introduction of two new fund categories (namely infrastructure funds and 'Other Funds' ('Sonstige Sondervermögen')).

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[1] http://www.globalgovernmentforum.com/germany-announces-299bn-infrastructure-investment/

At the same time, the legal framework for funds established exclusively for institutional investors (so-called 'special funds', Spezialsondervermögen) has been broadly liberalised and made more flexible.

The purpose of infrastructure funds is to provide both institutional investors and retail investor's access to the public private partnership ('PPP') market. Infrastructure funds can invest in project entities involved in PPPs. These equity participations together with properties that serve public purposes and usufructuary rights relating to properties (Nießbrauchsrech-te) must constitute at least 60 percent of the value of the fund's assets. Usufructuary rights are similar to a beneficial right under a trust. An example would be the right to use water from a stream to generate electrical power. The right to use the water would be a protected right under civil law even though the water is not owned by the user.

The new investment fund type designated 'Other Funds' (Sonstige Sondervermögen) is intended to create a regulatory framework for innovative fund products which do not qualify as UCITS funds.

German special funds may be held only by institutional investors which are not individuals.

US

The US does not have any general rules on infrastructure. Rather they deal with encouraging infrastructure investment in three different ways:

1. Entity taxation is largely not relevant given the alternatives to a taxable company (refer our responses at Questions 2 and 3);
2. Taxation of income from assets which are capital intensive are concessionally taxed through generous earnings stripping rules, a wide debt portfolio exemption mechanism, broad treaty network and concessionary capital allowance rules; and
3. Exemptions for certain classes of investors who would ordinarily invest in infrastructure (for example, the recent changes introduced by the PATH Act that provide an exemption from FIRPTA for qualifying foreign pension funds in certain circumstances).

Taxation of income

Notwithstanding that the US has a high headline corporate rate plus State income taxes, the effective tax rate is much lower with capital intensive industries. This is largely driven by two key elements, being accelerated depreciation and ability to utilize shareholder leverage

Unidentified intangibles are amortized over 15 years on a straight line basis and prepaid expenses are amortized over the life of the prepaid term. Other than land, everything else is amortizable. This can be contrasted with the Australian limitations around section 40-880 and CGT assets which defer the amortisation of many costs associated with infrastructure projects. In simple terms the purchase of a concession agreement from a State Government will be amortisable over 15 years whereas in Australia it would be capital and non-deductible.

The US has earnings stripping rules and no codified thin cap rules. They are not a per se limitation around use of shareholder debt. Key issues to be worked through on US leverage are:

1. Earning stripping rules are based on section 163(j) which defers interest deductions where the interest deductions are greater than 50% of adjusted taxable income. Adjusted taxable income is the taxable income of the entity increased by all non cash deductions. Where the acquisition of the concession agreement is treated as amortisable over 15 years this is a very generous rule. Unlike Australia interest deductions are not permanently disallowed merely deferred.
2. Broad treaty network where shareholder debt will be subject to withholding at 10% or less.
3. Broad debt portfolio exemption rules which, due to the depth and breadth of the US debt markets (including subordinated debt), facilitate easier raising of debt.

US tax exemptions on sale

There are two broad exemptions being:

1. Qualified foreign pension funds; and
2. Sovereign investors.

FIRPTA was enacted by Congress in 1980 in an attempt to ensure that non-U.S. persons did not receive more a favourable tax treatment than U.S. persons on the disposition of U.S. real property by imposing at least one level of U.S. income tax on dispositions of U.S. real property by non-U.S. persons. Under FIRPTA, gain recognized by non-U.S. persons from investments in "United States real property interests" (USRPIs) are treated as income effectively connected with the conduct of a U.S. trade or business and is subject to U.S. federal income and withholding tax regardless of whether the non-U.S. person conducts any activity in the United States.

Prior to the Act (the PATH legislation), foreign pension funds or foreign retirement plans were subject to FIRPTA.

Under the Act, a "qualified foreign pension plan" will no longer be subject to income or withholding tax under FIRPTA upon the disposition of a USRPI. For purposes of this rule, a qualified foreign pension plan is defined as any trust, corporation, or other organization or arrangement —

1. which is created or organized under the law of a country other than the United States,

2. which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees),

3. which does not have a single participant or beneficiary with a right to more than 5% of its assets or income,

4. which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and

5. with respect to which, under the laws of the country in which it is established or operates, (a) contributions to such trust, corporation, organization or arrangement which would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (b) taxation of any investment income of such trust, corporation, organization or arrangement is deferred or such income is taxed at a reduced rate.

In addition to the exemption for qualified foreign pension plans, Section 892 provides foreign governments and their controlled entities (except for controlled commercial entities) exemption from US tax for income from investment in stocks, bonds and domestic securities

- A "controlled entity" generally means an entity that is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities
- Foreign governments are generally subject to US tax on income from investments in US real property
    - — Foreign governments are subject to FIRPTA tax on gain from the disposition of a USRPI unless regulations provide otherwise
    - — The regulations provide that foreign governments are subject to US tax on gain from the disposition of all USRPIs except for shares in a non-controlled USRPHC or REIT.
    - — This requires that the foreign government holds <50% interest and does not have negative control rights

The exemption does not apply to income from a controlled commercial entity or disposition of a controlled commercial entity.

Controlled commercial entity is an entity engaged in commercial activities anywhere in the world if a foreign government holds, directly or indirectly:

1. 50% or more of the total interests by vote or by value; or
2. any other interest that provides effective practical control of such entity.

Conclusion

The combination of taxation of income rules and the exemption from FIRPTA for qualified foreign pension funds and sovereign investors makes the US the most favourably tax regime for infrastructure in the world.

UK

Sovereign immunity

The UK by 2020 will have a 17% rate of corporate tax. In effect no special tax regimes are necessary to encourage infrastructure investment. Nevertheless there are two categories of concessions available for infrastructure:

1. Sovereign immunity; and
2. Exemption from earning stripping regime

HMRC stated policy is "that one Sovereign should not subject another to its municipal laws", as a general principle of international law. Published guidance on this area is very limited. Please see - https://www.gov.uk/hmrc-internal-manuals/international-manual/intm368520

HMRC's published view notes that "SI does not apply to income arising to and beneficially owned by a legal entity that is separate from the foreign Government, even though that government may own the whole of the share capital." Nevertheless based advice from our adviser HMRC will grant SI to a separate legal entity provided that entity is wholly government owned Government.

Sovereign immunity can be granted to both government bodies and entities that are connected with the sovereign body.

For a non-government entity, it must demonstrate that the income earned from its foreign investments does, in fact, flow through to a sovereign and that this income is then used for the benefit of that sovereign.

Sovereign immunity provides an exemption from UK direct taxes for sovereign bodies/entities on income and gains. It does not apply to indirect taxes such as VAT and stamp taxes.

Over the last few years our advisers have seen the UK's SI regime develop such that directly held subsidiaries incorporated in the jurisdiction of the SI entity may qualify for SI if the direct link to the SI body can be demonstrated.

Based on our advisers' recent experiences HMRC have also confirmed they are happy transparent vehicles such as partnerships do not taint access to SI. With a partnership both the limited partner and general partner would need to qualify

SI does not apply to commercial income. The rules closely follow the US on Section 892. Broadly the following limitations apply:

1. The sovereign cannot control a commercial enterprise. Control begins at 50% however veto rights over business decisions as opposed to asset protection may give rise to the control;
2. Generally anything outside of infrastructure or real estate will be considered on a different basis ie much more difficult to argue the income is not commercial income

Interest deductions

Proposals for denial of interest deductions in the UK have been published with the Budget on 16 March 2016 and new rules are expected to take effect from April 2017.

The basic premise is to restrict relief for a group's overall UK net interest expenses by reference to a fixed ratio, being 30% of UK EBITDA, subject to the alternative of a worldwide group ratio test applied locally if that leads to a better result for the taxpayer (based on the overall group borrowing position, using a net interest to EBITDA ratio for the worldwide group).

In order to ensure that the restriction does not impede the provision of private finance for certain public infrastructure in the UK where there are no material risks of BEPS certain amendments have been introduced.

The amendments proposed a widening of the exemption. The wider exemption will apply on a company-by-company basis under which 'Qualifying Companies' (ie, those which only generate operating income from qualifying activities and have no financial income other than from other qualifying companies, along with meeting certain other criteria) will be fully excluded from their group's interest restriction calculations, with the exception of any 'non-qualifying interest expenses'.

Non-qualifying interest expense is broadly interest paid to related parties or lenders which do not only have recourse to the income or assets of the Qualifying Company, or where guarantees have been provided by a non-Qualifying Company.

The exemption will target companies that generate operating income from the provision, upgrade or maintenance of public benefit infrastructure and the undertaking of public benefit services or integral services using that infrastructure. Public benefit services will be defined more broadly than was previously announced and will include services that are procured by a public body (or its wholly owned subsidiary), provided in consequence of specific arrangements made by Parliament, or services performed in the interest of national security.

In addition, the provision of rental property to unrelated parties is also expected to come within the exemption. Within the announcements is confirmation that the exemption can be expected to apply to activities including water, gas and electricity transmission, interconnectors, distribution and supply, thermal (coal and gas), renewable and nuclear energy generation, port and airport operators, and the rail network.

In each case the activity will need to be governed by specific legislation or be regulated by bodies established by statute. In certain cases, the draft legislation is also to permit the deductibility of interest payable to related parties to be grandfathered to the extent the loan was agreed prior to the publication of the May consultation document. This will only apply where 80% of the Qualifying Company's expected income has been materially fixed for 10 years or more by long-term contracts with, or procured by, public bodies or their wholly owned subsidiaries.

Conclusion

The combination of taxation of income rules and the reduction in corporate tax rates makes the UK a favourable destination for global infrastructure investment.