Tax loss incentive for designated infrastructure projects

Discussion Paper
October 2011

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CONSULTATION PROCESS

REQUEST FOR FEEDBACK AND COMMENTS

The Government seeks your feedback and comments on the issues outlined in this discussion paper. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

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Closing date for submissions: 9 December 2011

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FOREWORD

I am pleased to release this discussion paper on the Government's proposal to introduce new rules for tax losses that are attributable to designated infrastructure projects.

These important changes which were announced in the 2011-12 Budget, will allow the value of carry forward tax losses that are attributable to designated infrastructure projects to be uplifted by the 10 year Government bond rate. In addition, tax losses that are attributable to designated infrastructure projects will also be exempt from the continuity of ownership test and the same business test.

This new tax incentive is part of the Government's ongoing commitment to promote private investment in infrastructure projects designated to be of national significance. It is also part of a broader package of reforms to build the infrastructure Australia needs to compete in the 21st century.

The purpose of the discussion paper is to provide interested parties with an opportunity to comment on the design and implementation details of the proposal.

I look forward to receiving the community's views.

The Hon Bill Shorten MP
Assistant Treasurer and Minister for Financial Services and Superannuation

1. Overview

1. On 10 May 2011, the Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP, and the Minister for Infrastructure and Transport, the Hon Anthony Albanese MP, jointly announced that the Government would introduce a new infrastructure tax incentive to promote private investment for infrastructure projects designated to be of national significance. This infrastructure tax incentive is part of a broader package of reforms to build the infrastructure Australia needs to compete in the twenty-first century.

2. This discussion paper forms the basis for consultation on the proposed design of the infrastructure tax incentive and, in broad terms, the way the proposal may be implemented. The purpose of the discussion paper is to provide interested parties with an opportunity to comment on the design and implementation details of the proposal.

2. Background

2.1 Infrastructure projects

3. Infrastructure projects require extensive planning, incur significant capital expenditure and manage project risks over long time horizons. In particular, there is often a delay between incurring construction expenditures and generating peak revenues – such as in relation to a road toll project. As a result, infrastructure projects tend to have a different risk profile compared to some other investment classes.

4. An infrastructure project commonly has an ownership structure that includes companies and trusts. Companies are characterised by limited liability and can pay franked dividends while non-operating trusts have the flow through treatment of distributions. The various tax implications that arise from these structures play a role in each phase in the life of an infrastructure project.

5. These projects inherently have long lead times between incurring deductions in the construction phase and earning assessable income in the operational phase. Tax losses are therefore accumulated and carried forward to later income years awaiting the receipt of income.

6. The income tax law specifically allows companies and trusts to deduct these carry forward losses in future income years subject to integrity rules.

2.2 Operation of the current loss recoupment rules

7. The loss recoupment rules are contained in:

- for companies – Part 3-5 of the *Income Tax Assessment 1997* (ITAA 1997); and
- for trusts – Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936).

2.2.1 Company loss recoupment rules

8. Under the company loss recoupment rules, a company can deduct prior year tax losses, or apply net capital losses, only if it satisfies the continuity of ownership test or the same business test (section 165-10 of the ITAA 1997).

9. The continuity of ownership test is satisfied if the same persons have more than 50 per cent of the company's voting power, rights to dividends and rights to capital distributions at all times during the ownership test period (section 165-12 of the ITAA 1997). The ownership test period is generally the period from the start of the income year in which the loss was incurred (the loss year) to the end of the year in which the loss is sought to be recouped (the claim year).

10. Generally, a company must trace ownership through to the ultimate beneficial owners of the shares in the company to determine whether the continuity of ownership test is satisfied.

11. To reduce compliance costs, these rules are modified for widely held companies and certain other types of companies (Division 166 of the ITAA 1997). Under the modified continuity of ownership test, broadly:

- the ownership is tested at certain points in time (rather than throughout the whole of the period from the start of the loss year to the end of the claim year); and
- concessional tracing rules apply so that it is not necessary to trace ownership through to the ultimate beneficial owners of the shares in the test company in some circumstances.

12. The same business test is satisfied if the company is carrying on the same business in the claim year as it carried on immediately before the test time (section 165-12 of the ITAA 1997). For these purposes, the test time is generally the time that the company failed the continuity of ownership test. However, if it is not practicable for the company to show that it has satisfied the continuity of ownership test, the test time is generally the start of the loss year.

2.2.2 Trust loss recoupment rules

13. The trust loss rules allow a deduction for prior year tax losses and certain debt deductions of a fixed trust if it satisfies the 50 per cent stake test, which is similar to the continuity of ownership test for companies. The operation of the rules depend on whether the trust is:

- a fixed trust that is not a widely held unit trust (Subdivision 266-B of Schedule 2F to the ITAA 1936);
- an unlisted widely-held trust (Subdivision 266-C of Schedule 2F to the ITAA 1936);

- a listed widely-held trust (Subdivision 266-D of Schedule 2F to the ITAA 1936); or
- an unlisted very widely-held trust or wholesale widely-held trust (Subdivision 266-E of Schedule 2F to the ITAA 1936).

14. The trust loss rules allow a deduction for prior year tax losses and certain debt deductions of a non-fixed trust if it satisfies the 50 per cent stake test (if applicable), the pattern of distributions test and the control test.

15. Trusts cannot deduct their tax losses under the same business test unless they are listed widely held trusts (Subdivision 269-F of Schedule 2F to the ITAA 1936).

2.2.3 Special rules for consolidated groups

16. Under the income tax consolidation regime, a group of Australian resident entities wholly owned by an Australian resident company can choose to form a consolidated group. Specific rules also allow certain resident wholly owned subsidiaries of a foreign holding company to form a multiple entry consolidated group (MEC group).

17. Following a choice to consolidate, the consolidated group is treated as a single entity for income tax purposes. Subsidiary entities lose their individual income tax identity on entry into a consolidated group and are treated as parts of the head company.

18. When an entity that has unused tax losses is acquired by a consolidated group and becomes a subsidiary member of the group, any unused tax losses of the joining entity can be transferred to the head company of the group provided that, broadly:

- if the joining entity is a company, the company passes a modified continuity of ownership test or modified same business test at the joining time (Subdivision 707-A and 707-B of the ITAA 1997); or
- if the joining entity is a fixed trust, it satisfies the 50 per cent stake test at the joining time (Subdivision 707-A of the ITAA 1997); and
- if the joining entity is a non-fixed trust, it satisfies the 50 per cent stake test (if applicable), the pattern of distributions test and the control test at the joining time (Subdivision 707-A of the ITAA 1997).

19. The head company can only utilise tax losses if it passes the continuity of ownership test and control tests or the same business test in the general loss recoupment provisions. If the loss is a transferred loss, the ownership test is modified by Subdivision 707-B of the ITAA 1997.

20. If the joining entity's tax losses can be transferred to the head company, the available fraction rules determine how much of the transferred loss can be used by the head company in a particular year (Subdivision 707-C of the ITAA 1997).

21. The rules relating to the transfer and utilisation of tax losses are modified for MEC groups (Subdivision 719-F of the ITAA 1997).

2.3 PROBLEMS WITH THE LOSS RECOUPMENT RULES FOR INFRASTRUCTURE PROJECTS

22. The following extract from Regulation Impact Statement for the *Infrastructure Taxation Incentive Proposal* outlines the problems that currently arise with the operation of the existing loss recoupment rules for infrastructure projects.

> *Consultation with industry has identified the risk of trapped losses as being significant in some cases, raising the project financing costs and hence reducing infrastructure investment. While the tax system already contains many provisions that reduce the risk of losses being trapped or to prevent significant delays in their usage – for example, consolidated groups can offset losses from one part of the group against income from another, while certain deductions for research and development expenditure are immediately refundable – such arrangements are of limited use for infrastructure projects due to the way they are structured and the types of expenditure they incur.*
>
> *As infrastructure projects often have significant lead times between when the investment is made and when income is earned, this can result in project losses being trapped or only being used after a considerable lag. Where losses are trapped or there is considerable lag between when they are incurred and used, the project's required rate of return (hurdle rate) increases. When a project's hurdle rate of return is higher than it otherwise would have been, the project may not proceed.*
>
> *The problem can also be illustrated as one of relative effective tax rates between alternative investments within the economy. For example, most major mining projects will see the costs written off against current income as they are incurred (or the capital is depreciated). In this situation there is no risk of trapped losses and hence the value of the losses is not reduced by any delay in being able to utilise them. For a stand-alone infrastructure project, losses may not be able to be used or may only be used after a considerable lag. The effect is a higher effective tax rate on the infrastructure project than the mining project.*
>
> *In its submission to the Australia's Future Tax System (AFTS) Review Panel in October 2008, Infrastructure Partnerships Australia (IPA) identified the problem this way:*
>
> > *Restrictions on the use of tax losses in the infrastructure context: The long life of infrastructure imposes considerable risk on the likely returns for new investment. The extent to which Australia's tax system restricts access to early stage tax losses in infrastructure projects is a major problem or inefficiency in the tax treatment of major public infrastructure projects.*
> >
> > *Early stage tax losses in infrastructure projects are generated from the typically large capital allowance and interest expenses deductions involved in major infrastructure development and, also, the delay involved in these projects commencing to produce income.*
> >
> > *In some cases, investors may wait until an infrastructure project commences to produce income in order to utilise those tax losses, but in most cases, it is more efficient to use them as soon as possible, maximising their value. For instance, interest costs incurred during the construction period are usually deductible during that period even though the project in question may have no revenue (i.e. the interest*

costs are treated as a loss). Such a loss can normally be carried forward and progressively offset against profits during the operational phase of a project.

The ability to use carried forward losses depends on continuity of ownership and the same business test. Should a change in majority ownership in the entity occur early in the life of the project before those losses are fully offset against profits, those losses cannot be deducted by the new owner against future project profits. Instead, in these circumstances, profits from the project are arguably taxed on an illusory basis during the operational phase because the tax treatment of the project's profits fails to take into account the significant sunk costs incurred at the outset of the project (that is, interest incurred during construction).

IPA contends these restrictions imposed on the ability of taxpayers to use carried forward losses is a disincentive to private investment in assets with a higher risk profile, such as infrastructure assets.

3. POLICY DESIGN

23. It is proposed to introduce new rules for tax losses that are attributable to a designated infrastructure project which:

- uplift the value of carry forward tax losses by the 10-year Government bond rate; and
- exempt the tax losses from the continuity of ownership test and the same business test.

24. The new rules will apply from the date of Royal Assent of the enabling legislation.

3.1 DESIGNATED INFRASTRUCTURE PROJECTS

25. The new rules for tax losses will only apply to designated infrastructure projects that are considered to be of national significance. A project will be a designated infrastructure project if the project is on the Infrastructure Australia's National Priority List of projects and considered 'Ready to Proceed' or 'Threshold' and is approved by a decision maker.

26. Projects are included on Infrastructure Australia's National Priority List of projects[1] if they are:

- above a capital expenditure threshold of $100 million; or
- a Regional Infrastructure Fund project, a flagship project or a project that demonstrates unique national interest qualities.

1 See Infrastructure Australia's national priority list guidelines at http://www.infrastructureaustralia.gov.au/reform_investment

27. The decision maker will be empowered to confer designated infrastructure project status on privately financed public infrastructure of national significance based on a range of criteria. This decision maker will rank designated infrastructure projects against relevant criteria and publish these rankings on a regular basis to ensure that there is a clear, objective and transparent process that provides certainty for investors.

28. In order to manage the potential cost to revenue and ensure that the highest value projects are supported, the decision maker will rank projects within a global capital expenditure cap of $25 billion over the period from Royal Assent of the enabling legislation to 30 June 2017.

29. Projects will be assessed and, if suitable, approved on a first come basis until the global capital expenditure cap is reached. Once the cap is reached, no further projects will be approved as a designated infrastructure project. In addition, once a project commences, its designated status is irrevocable.

30. To ensure benefits to the community are maximised, the following criteria will be used by Infrastructure Australia for ranking projects:

- the ratio of economic benefits to economic costs;
- the corporate governance arrangements in place;
- the availability of the project to multiple users; and
- the benefit to the broader community.

3.2 Entity or consolidated group whose sole business is a designated infrastructure project

31. The new tax loss rules will only apply to an entity or a consolidated group whose sole business consists of a designated infrastructure project (a designated infrastructure project entity or consolidated group).

32. Although the new tax loss rules will not apply to consolidated groups that carry on a range of activities, the head company of a consolidated group can set up an entity or a group of wholly-owned entities to carry on a designated infrastructure project and elect that the entities remain outside the original group. Alternatively, if a consolidated group acquires an entity or a group of wholly-owned entities that carry on a designated infrastructure project, the head company can elect for the entities to remain outside the original group.

33. The new tax loss rules will then apply to the entities that remain outside the original consolidated group for the period their sole business consists of a designated infrastructure project.

34. Where a group of wholly-owned entities remain outside a consolidated group and carry on the same designated infrastructure project, the entities can elect to form a consolidated group.

35. A designated infrastructure project entity that is excluded from a consolidated group will continue to be a wholly-owned subsidiary of the head company. This may be relevant for the purposes of the indirect value shifting rules in Division 727 of the ITAA 1997 and the loss transfer rules.

3.3 Designated infrastructure project tax losses

36. The tax losses attributable to a designated infrastructure project for an income year will be worked out by deducting the entity's allowable tax deductions from its assessable income for that income year.

37. The entity's allowable tax deductions and its assessable income will be worked out by applying the ordinary income tax law. That is, section 36-10 of the ITAA 1997 will apply to work out the amount of the tax loss for the entity. This section operates to work out the tax losses of both companies and trusts.

38. A tax loss will arise in relation to a designated infrastructure project if the allowable tax deductions attributable to the project exceed the assessable income attributable to the project.

39. Where the new tax loss rules apply, the tax losses attributable to a designated infrastructure project will only be applied to reduce future assessable income arising from the project.

40. If a designated infrastructure project is sold to another entity, the accumulated tax losses attributable to a designated infrastructure project can be transferred to the other entity or consolidated group where the sole business of the entity or consolidated group being acquired consists of the designated infrastructure project.

41. Apportionment rules will apply to designated infrastructure project tax losses where only a part of the project is transferred based on the market value of the project at the time of the transfer.

3.4 Uplifting carry forward designated infrastructure project tax losses

42. The balance of accumulated tax losses attributable to a designated infrastructure project that remain unutilised at the end of an income year and are carried forward for use in a later income year will be uplifted at the end of each later income year by applying the formula:

$$\text{Accumulated tax losses attributable to a designated infrastructure project} \times \text{10-year Government bond rate at the end of the income year}$$

43. The 10 year Government bond rate is currently 5.75 per cent.

3.5 Utilisation of designated infrastructure project tax losses

44. The normal rules relating to the utilisation of tax losses will apply to tax losses attributable to a designated infrastructure project (sections 36-15 and 36-17 of the ITAA 1997). However, the following modifications will be made to the continuity of ownership test and the same business test.

3.5.1 Switching off the continuity of ownership test and the same business test

45. Where a designated infrastructure project entity is a company and the company is not part of a consolidated group, the continuity of ownership test and the same business test will not apply to the

tax losses attributable to the project. That is, section 165-10 of the ITAA 1997 will not apply to tax losses attributable to the designated infrastructure project.

46. Similarly, if the designated infrastructure project entity is a trust, the trust will be an excepted trust for the purposes of the definition in section 272-100 of Schedule 2F to the ITAA 1936. As a result, the trust loss provisions in Schedule 2F of the ITAA 1936 will not apply to the tax losses attributable to the designated infrastructure project.

47. Where a designated infrastructure project entity or consolidated group joins a consolidated group, the rules relating to the transfer of tax losses to the head company of a consolidated group in Division 707 of the ITAA 1997 (which include the continuity of ownership test, the control tests, the same business test and modified ownership tests) will be switched off. However, the available fraction rules will continue to apply to determine how much of the transferred losses can be used by the head company in a particular year.

48. As a result, a designated infrastructure project entity or consolidated group will not use the rules in Subdivision 165-B of the ITAA 1997 to work out the taxable income or tax loss in an income year where there is a change in ownership or business.

3.6 Cancellation of designated infrastructure project

49. Where a designated infrastructure project ceases or is cancelled but the entity continues to exist, any tax losses attributable to the designated infrastructure project will remain in the entity. The deductibility of those tax losses after the designated infrastructure project is cancelled will be subject to the normal loss recoupment rules (continuity of ownership test and the same business test for companies, the 50 per cent stake test for fixed trusts, and the series of tests for non-fixed trusts).

50. If new businesses begin to be conducted through the entity after the cessation or cancellation of the designated infrastructure project, the anti-income injection provisions in Division 175 of the ITAA 1997 for companies, and Division 270 of Schedule 2F to the ITAA 1936 for trusts, would apply in the normal way.

51. If the designated infrastructure project entity is wound up, any undeducted tax losses will be lost. This outcome is consistent with what happens when companies are deregistered or trusts are terminated.

3.7 Entities or consolidated groups that carry on unrelated activities

52. The new tax loss rules will cease to apply to tax losses that are attributable to a designated infrastructure project when an entity or consolidated group carries on activities that are unrelated to the designated infrastructure project or the entities become a member of a consolidated group that carries on activities that are unrelated to the infrastructure project. As a result, the tax losses will cease to be uplifted from the start of the income year that the unrelated activities commenced and the loss recoupment rules (that is, the continuity of ownership test and same business test) will apply to the loss from that time.

53. In addition, if an entity or consolidated group carries on activities that are unrelated to a designated infrastructure project consolidated group and the entity or consolidated group is a wholly-owned subsidiary of a consolidated group, the entities or group will be required to join the main consolidated group.

54. If the designated infrastructure project entity or consolidated group is a wholly-owned subsidiary of the consolidated group before the joining time, the tax cost of the designated infrastructure project entity or consolidated group's assets will be retained when it joins the consolidated group. If the designated infrastructure project entity or consolidated group is not a wholly-owned subsidiary of the consolidated group before the joining time, the tax cost of the designated infrastructure project entity or consolidated group's assets will be reset when it joins the consolidated group.

55. The tax treatment that will apply to losses of the wholly-owned subsidiaries that join the main consolidated group will be similar to the application event approach used in section 719-300 which applies when a new eligible tier-1 company becomes a member of a MEC group. That is:

- the designated infrastructure losses will be treated as transferred losses from the time the unrelated business commenced;
- any group losses held by the consolidated groups ongoing head company will be treated as transferred losses of the expanded group;
  - This ensures they form a loss bundle for which an available fraction is calculated. The losses will not be tested and transferred. Rather they will be treated as if they had passed the transfer tests and were transferred to the head company under Subdivision 707-A at the time the new group joined.
  - This deemed transfer ensures Subdivision 707-C applies appropriately to determine how much of the losses can be used for an income year.
- the existing rules relating to the transfer of tax losses to the head company of a consolidated group and available fractions will apply to the tax loss; and
- if the consolidated group has both group losses and transferred losses when the designated infrastructure entity or consolidated group joins the group, the groups available fractions for its group and transferred losses will be adjusted so their total does not exceed what would otherwise have been the available fraction for the group losses.

4. Date of effect

56. It is proposed to apply the new rules for tax losses attributable to designated infrastructure projects from the date of Royal Assent of the enabling legislation.