INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

2 September 2022

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SUBMISSION TO THE TREASURY ON GOVERNMENT ELECTION COMMITMENTS: MULTINATIONAL TAX INTEGRITY AND ENHANCED TAX TRANSPARENCY

Infrastructure Partnerships Australia appreciates the opportunity to provide a submission on the Treasury Consultation Paper on *Government Election Commitments: Multinational Tax Integrity and Enhanced Tax Transparency* (**Treasury Consultation Paper**), issued in August 2022. Further, we thank you for the opportunity to discuss the proposed reforms with you on 26 August 2022.

Infrastructure Partnerships Australia is an independent think tank and executive member network, providing research focused on excellence in social and economic infrastructure. We exist to shape public debate and drive reform for the national interest. As the national voice for infrastructure in Australia, our membership reflects a diverse range of public and private sector entities, including infrastructure owners, operators, financiers, advisers, technology providers and policy makers.

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 opportunities and challenges ahead.

1. Background & Content

The Treasury Consultation Paper seeks consultation and addresses the new Federal Government's election commitments to firstly, strengthen the interest limitation rules for multinationals, secondly, introduce a new rule limiting the deductibility of payments related to intangibles and royalties that lead to insufficient tax paid, and thirdly, enhance tax disclosure and transparency rules for multinationals.

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These proposals were the subject of a media release dated 27 April 2022 issued by the Hon. Jim Chalmers MP, Shadow Treasurer, and his colleagues, prior to the 2022 federal election.

You have requested comments on the policy issues and implementation considerations related to these three proposals and we are pleased to provide our more detailed comments and recommendations below, most particularly on the first proposal dealing with proposed amendments to the Interest Limitation Rules/Thin Capitalisation Rules.

2. Multinational Interest Limitation Rules

In addressing the proposed amendments to the Interest Limitation Rules, we note firstly, that the Treasury Consultation Paper proposes replacing the current asset-based safe harbour test (debt/asset test) with the fixed ratio rule based on earnings, i.e. limiting net interest deductions to a percentage of Earnings before interest, taxes, depreciation, and amortisation (**EBITDA**). Secondly, the Federal Government recognises that entities can be highly geared on commercial (**arm's length**) terms allowing them to claim higher levels of deductions, which can be substantiated under the **Arm's Length Debt Test (ALDT)** or the worldwide gearing test. These in principle statements are set out on page six of the Treasury Consultation Paper.

We highlight that many social and economic infrastructure projects have gearing ratios which significantly exceed the current safe harbour debt amount and the proposed fixed ratio rule, based on 30 per cent of EBITDA.

These projects or 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. Thus, these Australian infrastructure entities are able to raise debt from third party arm's length lenders at a level which is in excess of the current safe harbour debt amount and the proposed fixed ratio rule. The tax deductibility of the interest on such debt is an important factor in investors' cash flows and in achieving an appropriate after-tax rate of return on their equity.

The OECD/G20 Report on Limiting Base Erosion involving Interest Deductions and Other Financial Payments, Action 4-2016 Update (**OECD/G20 Report**) (to which you refer in the Treasury Consultation Paper), while recognising the importance of the arm's length test, states at paragraph 12, page 24 that "An advantage of an arm's length test is that it recognises that entities may have different levels of interest expense depending on their circumstances."

Otherwise, the OECD/G20 Report, while offering guidelines and suggestions, also recognises the importance of individual countries introducing and applying interest limitation rules that best suit their particular circumstances (i.e. coherent and consistent solutions) including dealing with tax minimisation behaviours.

In our view, the ALDT must be retained and available as an alternative to the fixed ratio rule (based on EBITDA).

The ALDT must be available to key capital intensive/heavy asset owning sectors including infrastructure, property and mining/resources, noting the generally long-term nature of these infrastructure projects and the preponderance of highly regulated and/or contracted assets.

The ALDT is critical to the delivery of major infrastructure projects and the facilitation and encouragement of foreign investment. Any intention to abandon or reduce its use as an alternative thin capitalisation test, would have a serious negative impact on the costs of all levels of government to access private sector capital (for example, through Public Private Partnerships (**PPPs**)) to deliver Australia's critical social and economic infrastructure. Infrastructure is a significant contributor to economic activity including enhanced productivity across the nation.

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

Any action to modify or otherwise restrict access to the ALDT will come at a time when government budgetary constraints increasingly require private sector involvement in infrastructure projects. Further, the need for critical infrastructure to expand the nation's economic capacity and defence related facilities, has never been as pronounced.

The ALDT was included 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 double tax agreements (**DTA's**)', as per the Explanatory Memorandum to the *New Business Tax System (thin capitalisation) Bill, 2001 (Cth)*.

Most importantly, any modifications to or limitations to access to the ALDT (including any potential move to prioritise the fixed ratio rule based on EBITDA) would likely 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, an EBITDA-based test could effectively result in a total or substantial denial of interest deductions incurred during the construction phase.

Put simply, an earnings-based test (based on EBITDA) doesn't work for the infrastructure sector and would be highly discriminatory against asset intensive industries, including the infrastructure, property and mining/resources sectors.

It is important to highlight that the Board of Taxation conducted a review and provided its report on the ALDT in December, 2014 and emphasised, amongst other things, the following:

- The 'ALDT is, in a sense, the 'central plank' of the thin capitalisation rules, which aim to allow debt deductions only for commercially justifiable levels of debt'.
- The 'safe harbour' and the 'worldwide gearing ratio' tests are the 'shortcut' for most taxpayers wanting to establish that they are claiming reasonable levels of debt deductions at arm's length.
- Taxpayers that rely on the ALDT are generally the kind that contribute significant economic activity within the services, resources and infrastructure industries.
- The ALDT is an important 'integrity measure' within the thin capitalisation rules.
- No critical distinction was attributed to Related Party versus Third Party debt and each could be appropriately dealt with and tested under the ALDT. We note the extensive use of 'Fin Co's' in various infrastructure projects.
- Generally, no limitation should be placed on taxpayers that are eligible to access the ALDT.
- Greater flexibility should be provided with respect to the recognition of explicit credit support in applying the ALDT.

While noting the importance of OECD/G20 guidance, it is critical to highlight that Australia cannot be directly compared to countries like the United Kingdom (**UK**) and the United States (**US**) regarding the potential use of the fixed ratio rule/EBITDA test when the differential in corporate tax rates is so significant. For example, the UK's 19 per cent versus the US' 21 per cent versus Australia's 30 per cent.

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The potential adverse impact of the introduction of a fixed ratio test is likely more significant and inequitable in an expected rising interest rate environment.

The commencement date of any proposed changes needs to be carefully considered. The Government's initial announcement indicates that the measures would apply from as early as 1 July 2023. A potential start date of 1 July 2023 does not give much time for stakeholders to consider and be prepared for the new law, noting that taxpayers currently require further information to be able to assess the impact of the measures and to understand the consequences on existing and proposed investment activities.

Any proposed changes to the thin capitalisation rules should only be implemented following careful consideration of challenging transitional and financing issues (for example, breach of debt covenants caused by the denial of debt deductions under the fixed ratio rule).

Further, if 1 July 2023 is the committed earliest start date for the measures, we request that it applies to income years which commence on or after 1 July 2023. Having the measures start at the commencement of a new tax year will make it easier for taxpayers to manage and apply the new rules for the full income year.

Given the OECD/G20 guidance and comments on targeted anti-abuse/integrity rules, we query and reference alternative methods of pursuing excessive interest deductions under existing anti-avoidance/integrity rules, including Part IVA, transfer pricing rules and diverted profits tax.

While countries such as the UK have implemented an exemption in relation to the debt funding of Public Benefit Infrastructure projects (which very broadly applies to UK infrastructure projects provided to a regulated infrastructure or public body), in practice we are aware that this exemption has not been widely taken up by taxpayers in the UK. This is due to a combination of factors, including:

- making the exemption has the impact of setting the relevant entity's tax-EBITDA to Nil such that there is no capacity for the entity to get any interest deductions for related party/shareholder debt, and

- that there is a requirement to make an irrevocable (for a period of at least five years) election for the exemption to apply. Making the election irrevocable has generated concern that future potential buyers/investors may struggle to use debt to fund their acquisition/investment because tax deductions for their debt may be denied.

We have included in Appendices 1 and 2 commentary on some common structures used in relation to a PPP Securities Licence structure (Appendix 1) and a Renewable Energy structure (Appendix 2).

3. Adopting an Earnings-Based 'Safe Harbour' Test – response to questions

We detail below further observations that are relevant to certain specific questions posed in the Consultation Paper.

3.1. *[Question 1] Considering the policy intent of limiting debt deductions to genuinely commercial amounts, should the fixed ratio rule rely on accounting or tax figures? On what basis do you say this?*

- Tax EBITDA seems to be preferred as it provides a common set of rules for all taxpayers whereas accounting outcomes can be impacted by accounting policy choices. In addition, as highlighted in the Consultation Paper, tax EBITDA aligns more closely to cash flow and is therefore a better reflection of an entity's capacity to meet its interest payment obligations.
- Using an accounting-based EBITDA may mean the inclusion of unrealised gains and losses and other non-deductible expenses such as impairment losses which has the potential to distort outcomes and create volatility.
- The membership of a consolidated financial group will not always align with the taxpayer or the tax consolidated group.
- There is greater integrity in using EBITDA based on tax outcomes as it can be based on information reported in annual income tax returns which is also a more readily verifiable outcome for the Australian Taxation Office (**ATO**) to administer, as opposed to EBITDA that relies on financial accounting rules which can be subject to change or financial reports that may not be audited.

3.2. [Question 2] Will the move to a fixed ratio based on earnings impose additional compliance costs on taxpayers? Can these costs be quantified?

- The majority of inbound and outbound taxpayers currently use the existing safe harbour debt test in Australia's thin capitalisation rules. Replacing this test with a fixed ratio test based on earnings is a substantial legislative change which will give rise to upfront compliance costs for taxpayers as they understand the new measures, adapt systems and processes to comply and potentially adjust their capital structure in respect to the financial impact of the change.

- The introduction of a new earnings-based test should be seen as removing complexity from the tax law. The new measures should be drafted to exclude purely domestic entities and groups where there is no scope for any international profit shifting of interest costs to related parties.

- The volatility associated with earnings (as opposed to assets) adds significant complexity to the ability to forecast outcomes, thereby increasing costs and potentially complicating investment decisions. In some cases, changes to the tax assumptions in existing forecasts may trigger a review of existing debt in place, adding to the compliance costs associated with this change. In this respect, the inclusion of transitional measures allowing taxpayers additional time to resize their debt in compliance with the new fixed ratio rule or allowing grandfathering of existing debt would be appropriate.

3.3. [Question 3] What factors influence an entity's current decision to use the safe harbour test (as opposed to the arm's length debt test or the worldwide gearing test)?

- Taxpayers generally adopt the safe harbour test as it is less costly to apply. They only then resort to the other tests where the maximum allowable level of debt outcome would be a higher amount, as permitted by the legislation. The legislation provides for a choice that is in the best interests of the taxpayer, and therefore taxpayers evaluate the cost/benefit of applying the safe-harbour, or an alternative method in circumstances where debt deductions are denied under safe-harbour.

3.4. [Question 4] Are there specific types of entities currently using the safe harbour test that would be affected by the introduction of a fixed ratio (earnings based) rule? If so, how would they be affected?

- Taxpayers operating in industries that require significant upfront capital investment and which have a long lead time before they become profitable or taxable would be adversely affected. This includes taxpayers in the infrastructure sector (particularly those which may require plant and equipment capital works including assets to be constructed or purpose built). The existing safe harbour asset-based test allows these entities to claim tax deductions and create tax losses on a level of gearing based on the value of the capitalised assets during the early stages of a project when they are unlikely to have any or substantial income. A denial of debt deductions during the initial stages of a project under the fixed ratio test significantly impacts the cost of capital, and in

some cases, makes such projects economically unviable. A carry forward of denied deductions may not prevent permanent denials as the infrastructure sector has higher levels of gearing due to the fact this sector typically has long term contracted cashflows or regulated cashflows that are reasonably predictable. This means that it is unlikely that there would be any excess capacity in later income years that could be utilised by debt deductions carried forward.

- Taxpayers may also be adversely affected by the introduction of a fixed ratio rule in situations where the financing for a project sits in a separate entity to the operating entity (typically where the earnings arise). This is most likely to occur in structures involving flow through entities such as trusts, but can also arise with companies that are not part of a tax consolidated group. A group approach may be required to resolve this issue (see further comments below regarding a group-based test).

- In addition to those taxpayers and sectors highlighted above, structures involving flow through entities such as trusts and partnerships may unintentionally benefit from the move to a fixed ratio rule based on earnings. For example, as earnings flow up a chain of trusts, each trust would be able to deduct interest expense against the same underlying pool of earnings if trust distributions are treated as earnings by the upstream trust. Specific integrity measures may be required to ensure that income flowing through associate entities does not create additional interest deductions via a multiplier effect. Conversely, an ability for an upstream trust to utilise excess capacity of the downstream associate entities under the safe harbour debt test needs to be retained.

3.5. [Question 7] Are there specific sectors more likely to experience earnings volatility that may cause entities to explore using one of the alternative tests instead (e.g. arm's length test)?

- Industries with highly volatile earnings are likely to be inappropriately impacted by the introduction of a new fixed ratio rule. Infrastructure sectors with highly volatile earnings/profits relative to asset value, as demonstrated by the past few years, include transport related assets (such as airports and toll roads) and energy assets exposed to merchant risk and fuel price fluctuations (including renewable and non renewable based generation). Entities operating in these industries are more likely to explore using the alternative tests to deal with earnings volatility if the proposed rules do not adequately accommodate the issue of earnings volatility.

- The OECD Action 4 report suggests two alternative solutions to deal with earnings volatility - using average figures for EBITDA, or allowing carry-forward or carry-back of denied deductions and/or unused interest capacity. Whilst both of these can deal with earnings volatility to an extent, in our view carry-forward or carry-back should be preferred to averaging as averaging only protects from short term volatility, and does not assist entities that incur interest costs to fund long term projects where earnings may be delayed for several years. As such, in our view the ability to carry-forward or carry-back denied deductions and/or unused interest capacity should be a feature of the new rules to deal with volatility without these entities having to move to an alternative test such as the ALDT with significantly higher compliance costs.

3.6. [Question 8] What features of fixed ratio (earnings-based) rules in other jurisdictions are most significant (relevant) for implementing a fixed ratio rule in the Australian context?

- As highlighted above, transitional rules should be developed to assist taxpayers to adapt to the proposed changes. For example, when the EU implemented interest limitation rules via the adoption of the Anti-Tax Avoidance Directive, Member States were given the option to exclude loans concluded before 17 June 2016 (except where there is a subsequent modification to the loan). Whilst we acknowledge that a broad carve out for existing loans may not be appropriate given the Government's intent, an alternative may be to provide a transitional period where entities with existing debt can continue to rely on the current safe harbour debt test until they restructure their financing arrangements.

3.7. [Question 11] What types of entities currently use the existing worldwide group (WWG) test?

- In our experience, the existing WWG test tends to be used by domestic taxpayers with only Australian operations that may be classified as outward investing entities as a result of being considered an associate entity to another outward investing entity. The WWG test is often used in these circumstances as a backup test where the safe harbour test may be breached. While usage of the WWG test as a primary test has been low in the past, we expect this to increase with the proposed introduction of the fixed ratio rule.

3.8. [Question 12] Would introducing a fixed ratio rule encourage entities not currently using the arm's length debt test to shift to an arm's length test? If so, why? Are there specific sectors where this type of behavioural response is likely to be more evident? And [Question 14] To what extent does

the current arm's length debt test permit BEPS practices to occur? What changes should be made to ensure that the arm's length debt test compliments the rule?

- Our view is that the ALDT, as currently legislated, does not pose a threat to the effectiveness of the fixed ratio rule (whether earning based or asset-based) and as such there is no need for it to be modified in the context of the proposed thin capitalisation reform.

- The complexity associated with the ALDT and the rigour required in conducting such analysis, increases the cost for taxpayers to rely on this test. These characteristics, however, mitigate the risk of misconduct or arbitrage associated with the use of the test and contributes to ensuring that the ALDT supports commercial (or arm's length) levels of debt. This complexity is to some extent necessary due to the requirement both to take specific taxpayer circumstances into account and to make certain factual assumptions that ensure the ALDT is applied to the taxpayer on a 'standalone' basis (eg by disregarding credit support provided by associates and any non Australian business).

- The key integrity concerns raised in the Consultation Paper appear to be in respect of the use of ALDT to support excessive deductions for related party debt. We do not consider that the operation of the ALDT currently poses particular integrity concerns. It is accepted that there may be from time to time disagreement between taxpayers and the ATO as to the quantum of debt available under the ALDT, but this is an ordinary feature of any test under the Australian tax law that requires a commercial comparison or 'market valuation' consideration. Integrity issues concerning use of related party debt are adequately and appropriately addressed by the existing transfer pricing laws, the Commissioners power under the ALDT provisions to substitute another amount that he considers "better reflects" the ALDT assumptions and factors, and the general anti avoidance provisions.

- Taxpayers that rely on the ALDT do so in the knowledge that a higher level of analysis and documentation is required by the law (and consequently higher compliance costs are incurred) to support the position taken. The increased compliance costs are driven by the nature of the analysis. The ATO has recently released Taxation Ruling TR 2020/4 and Practical Compliance Guideline PCG 2020/7 to provide a framework for understanding the operation of the law and the approach to documentation expected of taxpayers applying the ALDT. These documents go some way towards addressing some of the uncertainty surrounding the application of the ALDT and

managing the compliance costs and risks associated with lower integrity risk taxpayers. Notably, for some taxpayers, the fixed ratio rule may support similar (or higher levels) of gearing than the ALDT. Accordingly, there are likely to be some taxpayers that will switch from the use of the ALDT to the fixed income rule.

- The Consultation Paper identifies that the introduction of a fixed ratio rule may encourage entities to begin using the ALDT. While this may be the case for some taxpayers, particularly those which may have low earnings in initial years, this is not the universal position. Further, adoption of the ALDT is not expected to be driven by base erosion planning but rather a consequence of the fixed ratio rule not allowing an arm's length outcome to be supported. In fact, for certain taxpayers where an earnings based safe harbour test creates a higher level of deduction than the existing asset based safe harbour test (for example, entities with strong earnings and off-balance sheet assets), shifting from the ALDT to the EBITDA test may be adopted if there is less compliance associated. Notwithstanding, we disagree that this behavioural response in any way undermines the Federal Government's policy intent. The Federal Government's announcement clearly outlined an intention to retain the ability to claim higher deductions under the ALDT. Therefore, any such behavioural response by some taxpayers prepared to assume the additional compliance burden required to apply the ALDT would be entirely consistent with the policy. We note that existing integrity rules would adequately address any behavioural response beyond simply choosing an available method for determining the level of debt deductions (for example, changing the structure or quantum of debt).

- Retention of the ALDT is an important factor in determining the impact of the overall changes to various sectors and may be a positive factor in determining the need for carve outs and/or transitional periods.

4. Deductions for Payments relating to Intangibles and Royalties paid to low or no tax Jurisdictions

We note at a high level that this proposal is potentially far broader than as previously foreshadowed in the Federal Government's pre-election commitments, including its media release of 27 April 2022.

Most importantly, many Australian infrastructure projects do not involve the transfer or import of goods apart from potentially during the construction/development phases.

While we note and respect the concern regarding payments for the use of intangibles directed to tax havens or other low/nil tax jurisdictions, we generally believe that these arrangements are best dealt with on a case by case basis and including by recourse to existing anti-avoidance/integrity rules including Part IVA, transfer pricing rules and diverted profits tax.

5. Multinational Tax Transparency

Infrastructure Partnerships Australia supports corporate public tax transparency and the voluntary publishing of tax information together with commentary that explains and clarifies corporate tax positions to the public. The release of tax numbers by themselves can be misunderstood and misused.

The Board of Taxation (**Board**) developed the Tax Transparency Code (**TTC**), a set of principles and minimum standards to guide medium and large businesses on public disclosure of tax information. This voluntary code was designed to encourage greater transparency by the corporate sector and enhance the community's understanding of the corporate sector's compliance with Australian tax laws. The Board holds a register of Australian and foreign corporate taxpayers that have signed up to the code and provides a link to their tax transparency reports. There are currently some 200 signatories to the voluntary TTC.

The Board commenced a post-implementation review of the TTC and is proposing amendments to the TTC which are outlined in their Consultation Paper released on 26 February 2019. The outcomes of this report have not yet been released publicly.

Given the involvement of the Board to date on the TTC, it is our view that the Board should play a significant role in any proposed changes to public transparency disclosures required to be made by large corporates and the ATO and that any process be consultative.

With respect to the proposals canvassed in the Consultation Paper, we provide the following comments:

5.1. Public Reporting of Tax Information on a Country by Country (CbC) basis

- Full CbC reporting is provided to the ATO, and many entities voluntarily disclose the amount of tax they pay in the jurisdictions they operate on their tax transparency reports.
- Public release of 'high level data' without an explanation of how those amounts are calculated or the narrative explaining the lifecycle of entities and/or reasons for fluctuations on taxes paid will not improve community awareness on the arrangements of MNEs operating in Australia but rather

likely confuse the wider community on the tax status of MNEs. This has already been seen through the release of the three tax figures published by the ATO, without explanations, nearly 12 months after taxpayers publish their tax transparency and financial reports. There is little understanding of why entities do not pay tax, such as due to the existence and utilisation of tax losses, so the disclosure of the amount of taxes paid in any jurisdiction does not provide clarity and leads to the incorrect assumption that the absence of taxes being paid means an entity has engaged in BEPS activity.

- Consideration should also be given to compliance costs already incurred in the preparation of CbC reports that are lodged with the ATO. A significant amount of internal time is required to compile the information for various entities. This is then generally reviewed by external consultants as well to ensure there are no errors or omissions and in accordance with taxpayers' governance requirements. If in addition to this, taxpayers will then be required to prepare a different set of CbC information for public release, with explaining commentary, since the policy objective of the measure is to improve community awareness around the arrangements of large MNEs operating in Australia, we foresee significant additional compliance costs would be incurred.

- The Global Reporting Initiative (**GRI**) standard is very detailed and was developed and implemented over many years. It is not appropriate to mandate Australian corporations to adopt the GRI standard as a first step. Alternatively, entities should be encouraged to voluntarily report the information included in the GRI standard as part of their tax transparency reporting, noting that some already do.

- With respect to which entities should be required to report for CbC purposes, the measure should be limited to significant global entities required to report for CbC reporting purposes and have General Purpose Financial Statement reporting obligations.

- With the forthcoming introduction of the OECD Pillars One and Two, the introduction of limited public CbC reporting requirements, if implemented, should be deferred until after the year commencing on or after 1 July 2024.

5.2. Mandating the Voluntary Tax Transparency Code

- Taxpayers are better placed to voluntarily disclose their own tax information. That allows them to provide a narrative that explains the details behind tax numbers over the existence of the entity

and the specific economic cycle to which they relate. Being mandated to report specific tax numbers to be compared with entities in different industries and at difference lifecycles will not assist in better informing the public debate on MNE tax compliance.

- In addition, compliance costs are likely to be significant as a mandatory code will necessarily require figures and information disclosed to be verified, increasing not only the cost but also the timing for the finalisation of reports with no increase in transparency.

5.3. Mandatory reporting of material tax risk to shareholders

- Domestic and international accounting standards dealing with uncertain tax positions already exist requiring taxpayers to disclose tax risk to shareholders in their financial reports as well as to raise provisions to deal with certain tax risks. These standards are taken very seriously by auditors who are required to sign off on tax provision calculations and raise any concerns with the entities and their boards. The requirement for a further separate disclosure makes no sense and will provide no more information to shareholders. The accounting standards requirements are robust enough to ensure shareholders are informed of arising tax risks.

5.4. Requiring government tenderers to disclose their country of tax domicile

- We do not have any specific comments on this proposal.

6. Conclusion and further contact

We very much appreciate the opportunity to provide this submission on the Federal Government's important multinational tax integrity and enhanced transparency proposals.

Infrastructure Partnerships Australia looks forward to further assisting the Independent Review. If you require additional detail or information please do not hesitate to contact Mollie Matich, Director, Policy and Research, on 02 9152 6000 or mollie.matich@infrastructure.org.au.

Yours sincerely

Adrian Dwyer
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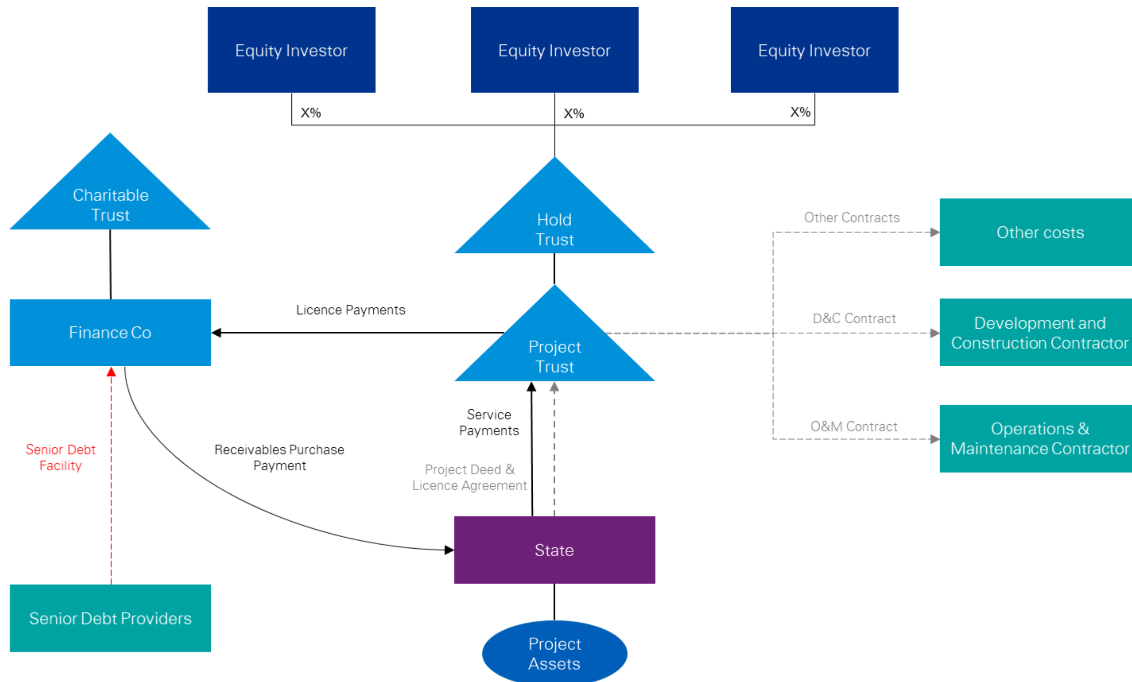
Infrastructure Partnerships Australia

Attached/Appendix

Appendix 1

Example 1- Typical PPP Securitised Licence Structure



A typical PPP securitised licence transaction structure is outlined in the diagram above, where Finance Co is used to raise the required project financing for the PPP project.

In the above example, Finance Co satisfies the exemption from thin capitalisation under Section 820-39 ITAA 1997 and confirmed by the ATO in TD 2014/18. In addition, Finance Co would also be able to rely on the ALDT.

If amendments to Section 820-39 or the ALDT is contemplated, it will be important to ensure that the Australian implementation of the fixed ratio rule only seeks to limit the **net** interest expense of Finance Co (as is currently indicated in the Treasury Consultation Paper – this is also consistent with OECD guidance and the overseas implementation of the rules in countries such as the UK).

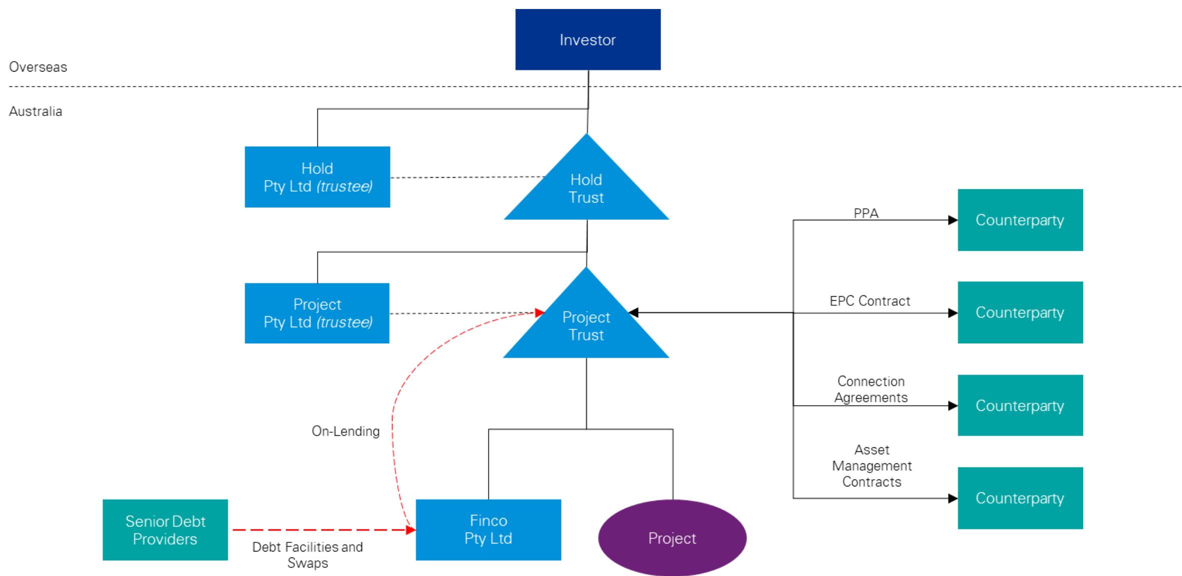
- This is because Finance Co would typically be 100 per cent debt funded and would on-pay all the debt it borrows onto the State to purchase the receivables. As such, Finance Co would normally be expected to have a **net** interest expense of $Nil (because its interest expenses would be fully offset by its securitisation income – this assumes the new rules treat securitisation income as "interest" income) such that there should be no restriction of interest deductions for tax purposes under the fixed ratio rule.

- If the fixed ratio rule was to purely restrict **gross** interest expenses this would have a significant negative impact on the tax profile of Finance Co. It would essentially bring all its interest income to be subject to tax without allowing for any deductions for interest expenses. This is because Finance Co would be expected to have an EBITDA of $Nil given that all its income and expenses effectively relate to interest payments.

In respect of Project Trust, depending on whether the PPP project is a "lump sum" or "progressive" securitisation transaction, the debt in Project Trust could vary significantly. In a progressive securitisation transaction, Project Trust would have a small amount of debt compared to Finance Co's borrowings. In a "lump sum" securitisation, Finance Co on-lends funds from the Senior Lenders to Project Trust for the construction phase, thus resulting in significant interest expense.

In a "lump sum" securitisation transaction, Project Trust typically relies on the ALDT. Please refer to our comments in Example 2 on the impact of Project Trust if the ALDT is no longer available.

Example 2 – Renewable Energy Transaction Structure



A typical renewable energy transaction structure is outlined in the diagram above. While we consider the comments provided in Example 1 with respect to Finance Co would equally apply to a scenario where Finance Co has borrowed and on-lent on back to back terms to Project Trust, we note the ATO has sought to limit the application of Section 820-39 such that it is only available to PPP securitised licence structures.

Under the current thin capitalisation provisions, Project Trust would typically rely on the ALDT on the basis Finance Co has borrowed from senior lenders and on-lent on back to back terms. Project Trust would not be able to rely on the exemption under Section 820-39.

If amendments to the ALDT are contemplated, we note the following (which applies to PPPs and renewable transactions):

- As outlined in section 2, many social and economic infrastructure projects have gearing ratios which far exceed the proposed fixed ratio rule, based on 30 per cent of EBITDA. This is particularly, relevant during the construction phase of the asset where income is typically minimal and therefore EBITDA would be expected to be negative.

- To illustrate how the safe harbour rules could impact a typical renewable energy project, we have assumed the following simplified facts:

1. Project Trust holds an asset worth $100 million

2. The asset provides an income yield of five per cent

3. Operating expenses are 20 per cent of income, and

4. Debts are borrowed at an interest rate of 4.5 per cent.

Based on the above parameters, we have estimated the position during the operating phase of the asset under the proposed rules for LVRs of 60 per cent, 70 per cent and 80 per cent.

LVR	**60%**	**70%**	**80%**
Income	$5,000,000	$5,000,000	$5,000,000
Operating expenses	$1,000,000	$1,000,000	$1,000,000
Interest expenses	$2,700,000	$3,150,000	$3,600,000
Profit	**$1,300,000**	**$850,000**	**$400,000**
EBITDA	$4,000,000	$4,000,000	$4,000,000
Maximum interest allowed under proposed changes	$1,200,000	$1,200,000	$1,200,000
Interest Denied	**$1,500,000**	**$1,950,000**	**$2,400,000**

As can be seen from the relatively simple above example, in the absence of the ALDT being available, the investors in Project Trust could be significantly adversely impact by the proposed rules.

An even greater adverse impact would arise in respect of the construction phase where the EBITDA for the years in question would likely be Nil or negative such that interest deductions would be denied in full.

Even if interest denial carry-forward rules were introduced, similar to other countries, given the highly geared nature of infrastructure project it is likely that there would never be sufficient capacity to “reactivate” the carried forward interest denial in future years when the project enters the operations phase (as illustrated by the above example).

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