Privatisation and Infrastructure – ATO Tax Framework

2 February 2017

In brief

On 31 January 2017, the Commissioner of Taxation released the long awaited updated draft of the "Privatisation and Infrastructure – Australian Federal Tax Framework" (Framework Document) with four chapters, consisting of:

- Chapter 1 – Construction of social infrastructure using the 'securitised licence' PPP model
- Chapter 2 – Privatisations of Government businesses into stapled structures
- Chapter 3 – Other infrastructure-related issues
- Chapter 4 – Areas of ATO compliance focus

The purpose of the Framework Document is to provide general guidance on the Australian Taxation Office's (ATO) position on a range of infrastructure related tax issues. The document does not bind the Commissioner to a particular view as expressed in the Framework Document, however ATO officers are expected to follow the guidelines provided. There has been consultation and another heavy round of consultation is expected on particular aspects, including negative control, stapled structures, upstream gearing, gifted assets, expense allocation and valuation/pricing issues.

In detail

Chapter 1 – Construction of social infrastructure using the 'securitised licence' PPP model

Chapter 1 essentially acknowledges that social availability based public private partnerships (PPPs) which are structured as debt securitisation arrangements where the operator is a trust will generally be accepted by the ATO. This chapter has been updated and essentially endorses lump sum or progressive debt securitisations in a particular form. There are, however, flags suggesting that equity securitisations and aggressive debt securitisation approaches will be heavily scrutinised.

Chapter 2 – Privatisations of Government businesses into stapled structures

Chapter 2 only applies to land-rich Government business privatisations into a stapled structure that follows the specific guidance and tax treatment on a range of matters set out in this chapter. A stapled structure comprises of a tax flow through property trust to hold the land, land interests and improvements to derive rental income; and an operating entity that holds the business contracts. The

ATO views the segregated activities of each side of the stapled structure as constituting a single unified business.

The ATO will apply compliance resources to privatisations and other businesses into a stapled structure that depart from its preferred approach on a number of key issues. The Framework Document refers to Taxpayer Alert 2017/1 which is intended to apply separately to stapled structures outside the context of privatisations. The key areas dealt with include:

Purchase Price allocation between the Asset Trust and Operating Trust – The ATO considers that a market valuation of the individual assets be conducted as it is critical that each of the tangible and intangible assets should be subject to its own fair and reasonable valuation for tax allocation purposes. Approaches that allocate firstly to tangible assets and the surplus to intangibles are discredited.

Approach to the pricing of the cross-staple lease – The pricing of the cross staple lease should reflect an appropriate return on capital made by each of the Asset Trust and Operating Trust. The ATO expects that the rent should be priced at the combined net present value of the Asset Trust and Operating Trust being allocated between the parties in the same proportions as each entity's contribution to the purchase price.

Levels of gearing of each side of the staple – the ATO expects the level of gearing into the Asset Trust and the Operating Trust would be broadly the same. For example, the ATO considers the scenario where the Asset Trust was geared at 40% and the Operating Trust was geared at 99% to be a high risk.

Application of Division 6C to the Asset Trust – Rent from land – The ATO has concerns regarding situations where the Asset Trust may not meet the Division 6C of the ITAA 1936 requirements of "investing in land" and could be a trading trust or control a trading business.

Tracing for the purposes of Division 6C – The ATO confirms that in a simple trustee-beneficiary relationship, the unitholder has a beneficial interest in the specific assets of the trust estate. In other cases where the relationship may not be as clear, for example with certain off-shore pension schemes, taxpayers are encouraged to approach the ATO.

Application of Part IVA – The ATO will review privatisations into stapled structures which contains features that depart from those stated in Chapter 2. This could lead to Part IVA applying to the transaction in its entirety.

Cross-staple loan variation – The ATO views that the existence of a cross-staple loan raises a number of issues:

- The deductibility of interest payments made by the Operating Trust;
- The justification for the margin charged on the cross-staple loan;
- Whether the cross-staple loan gives rise to unequal levels of gearing between each side of the staple;
- Interest withholding tax treatment on income from cross-staple on-lending –The ATO views that a reasonable methodology of apportioning the Asset Trust's expenses against income would differentiate between the heads of income on a direct and indirect basis. For example, the Asset Trust's gross interest expenses should first be applied against gross interest income from a cross-staple loan. This would typically mean that there will be no net interest income to which investors and non-resident investors would be presently entitled to (this approach is likely to attract a lot of attention).

Upstream feeder-level structures - The ATO reiterates that it considers the use of investor level upstream debt to fund an infrastructure investment with equity could be considered a high compliance risk to the ATO. Other ATO concerns include the use of MITs and whether the Division 6C concept of control applies. The ATO is likely to allocate compliance resources to test whether there is control through conduct and/or informal understandings where an investor has a stake of 20% or more. Where an investor holds 30% or more, the ATO will definitely apply compliance resources.

Restructuring and exiting of an investment – The ATO has concerns if taxpayers purport to treat a particular asset as not being real property for the purposes of Division 855, but land for the purpose of Division 6C (notwithstanding the different definition of real property/land and fixtures involved). The ATO will regard this treatment as high risk from a compliance perspective and apply compliance resources.

Chapter 3 – Other infrastructure-related issues

Chapter 3 covers other infrastructure tax issues which are broader than stapled structures and privatisations.

Government grants – Generally government grants are treated as assessable income under section 6-5 or 15-10.

Gifted assets – The ATO uses two examples covering gifted assets to present its view on the relevant tax treatment. In the example of a gift of a wharf, the value of the wharf will be assessable to the lessor at the end of the lease. The gift of an expanded network asset to the owner (i.e. through legislation) for no consideration will be assessable income to the recipient. For the party who constructed or gifted the asset, deductions may be available in certain circumstances but would generally be treated as capital in nature.

Control for the purpose of Division 6C – The ATO reaffirms (if not strengthens) its previously held views on its expansive reading of "trading business control" for the purposes of Division 6C /MIT rules. In particular, the ATO confirms its view that shared minority investor veto rights over operational matters like budgets/capex will constitute control. The ATO provides specific examples of particular director/ investor rights amounting, in their view, to control for the purposes of Division 6C. A further five specific examples using different investment structures and rights are used to explain the ATO's concepts of "control".

Chapter 4 – Areas of ATO compliance focus

The current version of Chapter 4 has undergone some updates since its initial draft released in February 2016. The chapter highlights the areas of concern and will be the subject of focus by ATO compliance teams.

Abuse of PPP structures – The ATO outlines three specific arrangements which the ATO regards as being high risk, including an equity securitisation structure.

Illegitimate use of staple structures – The ATO reconfirms that the guidance in Chapter 2 on stapled structures is specific to privatisations by way of a long-term lease. For other types of stapled structure privatisations and those not of the type described in Chapter 2, the ATO will apply compliance resources to these structures. Taxpayers should refer to Taxpayer Alert 2017/1 for further details.

Fracturing of control interests – The ATO highlights three examples of an investor fracturing their controlling stakes. One of these examples includes an investor holding their investment through multiple investment vehicles to potentially avoid the definition of "control" for Division 6C purposes, to gain MIT status and to avoid the particular entity from being an "associate entity" for the investor under the thin capitalisation rules. The ATO considers the fracturing of control interests will give rise to a high

compliance risk.

Satisfaction of MIT requirements – The ATO has highlighted the issue of whether MITS or withholding MITs actually satisfy the MIT requirements, in particular the investment management activities aspects.

Interposition of a Finance Co owned by Charitable Trust – The ATO has concerns with certain arrangements where associate issuers and lenders interpose a finance company that is owned by a charitable trust in order to achieve section 128F requirements.

PwC view

- The ATO's approach in providing a draft Framework Document on how it will apply its tax compliance resources is welcomed as it facilitates consultation and transparency on many difficult and uncertain issues.

- A majority of the issues raised in the Framework Document were subject to a consultation process. In many cases the technical position has been updated, but there are obvious areas of concern where significant disagreement/uncertainly exists between industry and the ATO, including:
    - trading business negative control and shared minority investor rights;
    - valuation methodology for purchase price allocation;
    - approaches to gearing/upstream gearing;
    - allocation of expenses to classes of income;
    - use of stapled structures.

  Many of the ATO views are untested with outcomes expressed that lack technical detail.

- It is unclear as to whether the guidance contained in the Framework Document will be applied to existing structures and their financing or whether it will apply prospectively to new structures established. The next round of consultation on these issues will be critical to give investment certainty to investors.

- In order to create certainty in privatisations, the ATO has provided guidance on the "dos and don'ts" when using stapled structures in the context of Government privatisations. Within Chapter 2, the ATO is generally accepting and comfortable with the use of stapled structures, albeit conditional on numerous prescriptive rules being adhered to on areas including valuations, cross-staple instruments, gearing levels, and upstream gearing. These matters are extensively debated during bidding processes and are critical to optimising bid pricing. Departures can lead to FIRB scrutiny and expectations of heightened compliance.

- In contrast, Chapter 4 creates uncertainty as the ATO refers to Taxpayer Alert 2017/1 as the guidance on stapled structures outside of privatisations. Note that the Taxpayer Alert was not subject to public consultation. The basis for limiting the ATO's views on certain stapled structures to privatisations only is not explained.

- The reluctance of the ATO to shift their view on negative control and shared minority protective rights in a trading control context is disappointing. This will be a key issue in further consultation.

- The ATO has toughened its approach in many areas relating to infrastructure investment, and this will lead to increased compliance risk, tax audits, disputes and negotiation of rulings and comfort letters. Tax is still a key risk for long term deals given the propensity for tax law and tax administration changes. For investors, there will be trade-offs between bid price competitiveness and getting a low ATO risk rating.

The takeaway

There is much to digest in the Framework Document and we suggest clients remain active in the consultation process as the key uncertain areas are progressed, administration and guidance is updated and transitional approaches are developed.

Let's talk

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