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Taxing infrastructure: Reforming the tax act

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TAXING INFRASTRUCTURE: REFORMING THE TAX ACT

The way infrastructure projects are taxed can have a profound effect on the costs of privately provided infrastructure assets and services. A Bill currently being drafted might solve some of the problems explains Jim Ferguson from the Victorian Department of Treasury and Finance.

The existing tax law, known as the leasing provisions (section 51 AD and Division 16 D), has been in place for approximately twenty years. It is generally believed that the origins of these tax provisions can be found in a tax aggressive leveraged financing deal that the NSW Wran Government entered in the early 1980s (Eraring Power Station).

The leasing provisions constitute specific anti-avoidance tax law. The Commonwealth Government of the day was concerned with revenue leakage, that is transactions that transferred tax deductions which could not otherwise be accessed by tax exempt parties. The Commonwealth view was that the property in question may be financed wholly or predominantly by non-recourse or limited recourse debt. But whilst the lessor party is at risk for only a relatively small part of the funds used to acquire the property, the lessor party would (otherwise) be able to claim capital allowances on the full value of the property (and share the rewards with the tax exempt party).

The central issue with s. 51 AD has always been identifying which party is the real end user or has control of the assets. Division 16 D was added to cover non-leveraged arrangements that tax exempts might enter for the same purpose, i.e. to access tax benefits not available if the project was undertaken internally.

In effect, the Commonwealth considered that its tax base subsidised the lease payments made by tax exempts to lessors. The effect of the leasing provisions was to reduce the potential value of the net profits from investment in infrastructure.

Whilst the original concerns were valid, eventually it became accepted that one set of problems was replaced with another.

Some of the issues that have emerged over the years include:

- For tax purposes, the definition of leasing is extremely broad and includes virtually any assignment of the rights to use property. There is no tax mischief in many public–private deals.
- Section 51 AD became a deal breaker when it applied, i.e. too punitive (much more so than D. 16 D)
- Even though the interpretation of the leasing tax law was softened, laws require modification when they become dated. The tax exempts have changed the way they interact with the private sector and, in particular, modern service arrangements involve a quantum increase in the ‘at risk’ status of providers. Clearly, today’s PPPs and the like are not mere financing arrangements.

This area of tax law was re-examined as part of the John Ralph Review of Business Taxation (RBT). The final report of the RBT (July 1999) recommended that s 51 AD be abolished and that D 16 D be revised. Over the last five years, the Commonwealth Treasury has been developing a replacement Bill, but at the time of writing, the Treasury has yet to gain popular support for its proposals. As a result, there is no certainty about the final direction of reform, or its timing. Stakeholders are unhappy with this scenario. Genuine uncertainty imposes dead-weight costs.

TAX REFORM - STAKEHOLDER’S OBJECTIVES

The major tax exempts (state, territory and local governments) have a material stake in the outcome of infrastructure tax reform. Firstly, there is an economic regulatory effect: the provision of infrastructure plays a major role in economic growth. A more facilitative regime would encourage investment (and vice versa). Many stakeholders could benefit from the growth dividend that would flow out of increased infrastructure spending.

Secondly, through participation in public private partnerships (PPPs) and similar arrangements, the tax exempts may be a direct party to transactions which come within the ambit of both the leasing provisions and the proposed replacement law (Division 250).

Industry and the tax exempts have formed an alliance to lobby the Commonwealth on infrastructure tax reform. The common objectives of the majority of the stakeholders are to:

- achieve an approximately revenue neutral outcome
- support the drafting of user friendly replacement tax law - in a self assessment system, clarity of intent, certainty of outcome, and low compliance/ transactions costs are highly desirable attributes
- encourage a long run view, consistent with the Ralph RBT which recommended generational change.

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THE COMMONWEALTH GOVERNMENT'S POLICY AGENDA

The version of the tax Bill that was publicly released in 2003 indicated that D. 250 is intended to deny, or reduce certain tax deductions (capital allowances) that would otherwise be available to a taxpayer in relation to an asset that is put to a tax preferred use (in certain circumstances).

Concerned with how this headline principle would actually be implemented, the main industry body (AusCID) secured the following policy advice from the Government on 9 Feb 2004.

- The proposed changes are intended to encourage appropriate private sector investment and risk sharing in infrastructure/property projects involving tax exempt entities.
- The proposed reforms aim to restrict tax timing benefits for asset financing arrangements between taxable entities and tax exempt entities by altering, for tax purposes, the timing of the recognition of costs and financial benefits provided for the tax preferred use of the assets;
- The reforms will be comprehensive and the tax treatment of transactions will be 'more coherent, neutral and certain'.
- Whilst there will be 'swings and roundabouts', the reforms have been designed neither to raise additional revenue nor to provide a tax concession. Further, there is no intention to broaden the scope of s. 51 AD or D. 16 D.
- It is unlikely that most charities, clubs, universities and religious organisations currently engage in relevant asset financing arrangements.

Stakeholders consider that the intended outcomes of the Bill should have been documented from the start. Negotiations on the efficacy of the Bill are now able to continue on a more informed basis. As a result, the tax Bill is undergoing change. The following outline relates to the publicly available version of the Bill (which has since been revised, but not materially as regards the parts of the Bill that are of major concern to the States and Territories).

STRUCTURE OF THE NEW BILL

The Bill is crafted in three parts:

1. the main amendments (see below)
2. consequential amendments (largely to s. 51 AD and D. 16 D of the 1936 Act and to Divisions 40 and 43 of the 1977 Income Tax Assessment Act. Divisions 40 and 43 are the capital allowance rules that govern depreciation deductions on plant and structures)
3. a section on application (transitional arrangements).

Essentially, the Bill opens with the specification of when the Division applies, and provides some gateway tests that selectively carve out a number of arrangements from the scope of D. 250.

If an arrangement is subject to D. 250, a series of (risk-based) tests are then proposed to draw a conclusion on the asset ownership question, i.e. which party is the in substance economic owner of the assets. If the tax payer party is judged to be the asset owner, then D 250 does not apply (but the rest of the Tax Act potentially does). If the tax exempt party is determined to be the owner, D. 250 treats the arrangement in a conceptually similar way to the current tax treatment specified under D. 16 D.

TAX OUTCOMES

The various drafts of the infrastructure tax Bill continue the general trend with tax law over the last decade towards:

- complex law that requires expert interpretation
- increased uncertainty and lack of predictability (including multiple provisions for regulations, and discretionary powers for the ATO) and
- the necessity for rulings.

For any specific project there are number of possible results under D. 250.

- The arrangement does not involve the tax preferred use of assets.
  Outcome: the arrangement is not tested against Div 250.
- The arrangement involves the provision of financial benefits from the tax exempt to the taxpayer in relation to the tax preferred use of assets, but it escapes D. 250 because of the gateway tests, e.g. short-term arrangement (less than 12 months); the contract value is almost exclusively services (90 per cent or more) and so on.
  Outcome: the arrangement is not tested against D. 250 because it poses no threat to Commonwealth revenues.
- The arrangement is a relevant arrangement and is tested for risk transfer. The outcome could be:
  - The taxpayer party is assessed to be the holder of the assets and has the predominant interest in the property
    Outcome: D. 250 clearance.
  - The taxpayer party is assessed to be the holder of the assets and have the predominant interest in the property and takes deductions which are subsequently dis-allowed under Part IV A.
  - The tax exempt party is determined to be the holder of the assets and have the predominant interest in the property.
    Outcome: D. 250 failure - sale and loan treatment.

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- The taxpayer party may elect to have the Division apply.

When Div 250 is failed:

- depreciation deductions are denied and
- the relevant financial benefit payments received by the taxpayer from the tax exempt party are subject to notional loan treatment (along the lines of D. 16 D taxation) but
  - the relevant income stream is 'Financial Benefits', not expected 'lease' payments
  - calculation of notional interest is more complex than under D. 16 D.
  - taxation of terminal values under D. 250 can be punitive.

PREFERRED OUTCOMES

The draft Bill has a number of positive features which the tax exempts endorse. For a start, the removal of s. 51 AD (as recommended by the Ralph RBT) is a major step in the right direction.

The change away from control tests to risk-based assessments of asset ownership is more objective and also welcome. Further, not all projects will be adversely affected by D. 250. On reasonable assumptions, the modelling of D. 250 that was commissioned by the states and territories revealed only minor differential financial impacts for a number of projects that would have cleared s. 51 AD but been caught by D. 16 D.

However, the tax exempts are unable to support the Bill in its current form. There are major negatives for many stakeholders such as a wider casting of the tax net; a bring forward of tax revenues through the taxation of unrealised and unfunded gains, and a broader definition of the payment stream to be subject to tax assessment under D. 250 compared with D. 16 D. As a result, the states and territories contend that the short term effect of D. 250 would be a transfer of revenue from the tax exempts to the Commonwealth. In addition, the Bill is complex and the maths required of taxpayers will probably necessitate assistance from expert advisors, surely raising compliance costs.

There remain significant policy and/or interpretational differences between most stakeholders and the Commonwealth regarding the scope and direction of infrastructure tax reform. In order not to lose the value embedded in the reform project over the last five years, stakeholders might be willing to continue negotiations on the Bill with a view to further improving its content.

Last year, the states and territories proposed a two-stage process, starting with honouring the commitment to remove s. 51 AD and modify D. 16D, and by this means, gain better stakeholder buy-in and reduce the pressure on the project team to produce a Bill that is acceptable to all parties. The Commonwealth rejected this sequential pathway, labelling it a piecemeal approach, but at the time of writing, the Bill is still being revised and presumably a federal election is close enough to significantly reduce the chances of the Bill becoming law in 2004.

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