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Committee Secretary
Senate Economics References Committee
PO Box 6100
Parliament House
Canberra ACT 2600

19 January 2015

Dear Dr Dermody

Submission to Senate Economics References Committee Inquiry into Corporate Tax Avoidance and Minimisation

We refer to your email dated 27 October 2014 inviting Aurizon to make a submission to the Senate Economics References Committee Inquiry into Corporate Tax Avoidance and Minimisation.

As requested, we have outlined below information in relation to Aurizon's tax position. In particular, we have made reference to the low effective tax rate reported in the Tax Justice Network ("TJN") Report.

Aurizon Holdings Limited – Background and corporate information

Aurizon Holdings Limited ("Aurizon") (formerly QR National Limited) listed as a public company on the Australian Securities Exchange on 22 November 2010. Prior to this Aurizon was wholly owned by the Queensland Government.

Aurizon is Australia's largest rail freight operator and owns and operates the Central Queensland Coal Railway Network. Aurizon also provides intermodal transport services, a range of specialist services in rail design, engineering, construction, management and maintenance, and offers large-scale supply chain solutions to a diverse range of customers Australia-wide.

Aurizon's operations and assets are essentially entirely based in Australia. Whilst Aurizon currently has a small number of very minor overseas operations in South East Asia and Africa, over 99.9% of Aurizon's revenue and assets are represented by its

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Australian based operations. Aurizon funds its operations through its Australian resident subsidiaries using corporate bank debt and corporate bonds.

Aurizon's Tax Profile

Aurizon entered the Federal income tax regime on 22 November 2010 following privatisation and listing. Prior to this Aurizon was part of the National Tax Equivalent Regime (NTER) and was exempt from paying Federal income tax in Australia. Aurizon and its wholly owned Australian subsidiaries formed a tax consolidated group on 22 November 2010. This is standard practice for Australian corporate groups.

Since privatisation Aurizon has fully complied with Australia's Federal income tax law, and fully co-operated with the Australian Taxation Office (ATO). As a result of Aurizon's co-operative approach with the ATO (including during ATO reviews of Aurizon's tax position) and its simple and predominately domestic business, Aurizon has been rated as "low risk" (the lowest possible risk rating) by the ATO for income tax purposes.

As Aurizon's operations are almost entirely based in Australia, foreign tax rules and the interaction between Australian and foreign tax rules are inconsequential to Aurizon's tax profile.

Tax Justice Network Report

The TJN has recently reported that Aurizon's average "effective tax rate" for the period ended 30 June 2013 was 2%. The average effective tax rate as reported by the TJN is misleading as it does not have regard to the numerous issues that affected Aurizon's tax position in the three year period covered by the TJN report for Aurizon (i.e. the 2011 financial year to 2013 financial year). In particular, Aurizon's low effective tax rate for this period arises as a result of Aurizon recently entering the federal tax regime, specific tax adjustments applicable to Aurizon as a result of its privatisation and as a result of ordinary tax adjustments that arise for an Australian business that has a large fixed asset base.

In particular, the TJN report calculates the effective tax rate for an income year based on the actual cash tax paid in that year (rather than the tax that will be paid to the ATO in respect of the income year). The actual cash tax paid in an income year is the balance of the unpaid tax liability for the <u>prior year</u>, plus an estimate of the tax liability for the current year based on the <u>prior year</u> tax return. Accordingly, the low effective tax rate for Aurizon reported by the TJN has been heavily influenced by the fact that Aurizon only recently

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entered the Federal tax regime (i.e. on 22 November 2010) and had no PAYG instalment obligations until 18 months after the start of the income year in which the company first became tax payable.

A more detailed explanation of the effective tax rate reported by the TJN is provided in the attached Appendices.

Further Information

Should you have any questions in relation to the above, please do not hesitate to contact Peter Nearhos.

Kind Regards

Peter Nearhos	Keith Neate
Aurizon Holdings Group	Aurizon Holdings Group
Manager Group Tax & Public Officer	EVP & CFO

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APPENDIX A

Tax Justice Network Report – Detailed

As mentioned previously, the TJN recently reported that Aurizon's average "effective tax rate" for the period ended 30 June 2013 was 2%. Broadly, we understand that this was calculated by taking Aurizon's average "income taxes paid" per Aurizon's statutory cash flow statement for the 2011 to 2013 financial years and dividing this by the average of Aurizon's reported profit before tax over the same period. Note, the period applicable to Aurizon was only the 2011 to 2013 financial years as prior to that Aurizon was not subject to Federal income tax. This consequently gives rise to numerous issues and is a misleading indication as to Aurizon's tax profile. In particular, the key issues with the information presented by the TJN report as applicable to Aurizon are as follows:

1. The cash tax reported in the statutory cash flow for a financial year misrepresents the actual tax paid by Aurizon to the ATO in respect of that financial year. This is because the income taxes paid in the cash flow statement for a financial year comprise Pay As You Go income tax instalments paid during (e.g. quarterly) the income year (which are broadly based on the prior year tax liability) and the final income tax payment for the <u>previous</u> financial year. The impact of this cash tax payment timing is particularly relevant to Aurizon given its recent entry into the Federal tax regime.

2. The report bases its calculation off the Group's accounting net profit before tax. There are numerous reasons why the taxable income of an entity can (through a proper application of Australian income tax law) differ significantly from the accounting net profit before tax. This is because Australian tax law principles of income and deduction often differ from accounting concepts of income and expense. In this respect, there are significant fixed asset related ordinary tax timing differences between tax and accounting impacting Aurizon in the period covered. Please refer to Appendix B for further details.

3. In addition to the ordinary tax timing differences, there are a number of specific factors relevant to Aurizon over the period covered that resulted in a reduction in taxable income compared to reported net profit before tax. In particular, the operation of the tax privatisation and tax consolidation legislation (which results in differences between accounting and tax concepts) that arose on privatisation of Aurizon. Further details regarding the operation of these tax privatisation and consolidation rules is provided in Appendix B.

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Aurizon's tax history & effective tax rate explanation

An overview of Aurizon's Federal income tax history for the period covered by the TJN report and an explanation as to the low effective tax rate is outlined below.

- As PAYG instalments are based on a company's prior year tax liability and as Aurizon was tax exempt prior to 22 November 2010, Aurizon was not required to make any PAYG instalments during 2011. This resulted in nil Federal PAYG instalments for 2011 income year and a nil final income tax payment in respect of the previous (2010) year. This essentially resulted in nil tax payable for the 2011 financial year for the purposes of the TJN report.

- Due to the application of the tax privatisation and tax consolidation rules (which applied on listing of Aurizon on 22 November 2010) and ordinary tax timing adjustments (refer Appendix B for further details), Aurizon was in a significant tax loss position for the 2011 income year (Aurizon's first year of privatisation). Aurizon's 2011 Federal income tax return has been reviewed by the ATO, Aurizon's external auditors and Aurizon's external tax advisors.

- As a result of the tax loss position in 2011, Aurizon was not required to make PAYG instalments during the year ended 30 June 2012 or a final tax payment in respect of the 2011 income year. This resulted in nil cash tax payments for the 2012 financial year for the purposes of the TJN report.

- Aurizon utilized all carry forward tax losses from 2011 in the income year ended 30 June 2012 and had a small income tax liability in respect of the income year ended 30 June 2012. This income tax liability was impacted by the tax consolidation, tax privatisation and other ordinary tax adjustments. Further, the deduction of the 2011 tax loss in 2012 is a tax adjustment only and does not affect accounting net profit before tax. The 2012 financial year tax liability was paid to the ATO in December 2012 (i.e. in the 2013 financial year) and resulted in a small amount of tax payable in 2013 for the purposes of the TJN report.

- Following lodgment of Aurizon's 2012 tax return in December 2012, Aurizon commenced paying quarterly PAYG instalments. In this respect, only the March 2013 PAYG instalment was paid in the 2013 financial year as Aurizon was only required to pay PAYG instalments following lodgment of its first tax payable tax return (i.e. Aurizon 2012 tax return) and the June 2013 quarter PAYG instalment was paid

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in July 2013 (i.e. the 2014 income year). This means (other than the 2012 final tax payment – refer above) only the March 2013 quarter cash tax payment was recorded for the 2013 year for the purposes of the TJN report.

- Aurizon paid the balance of its 2013 income tax liability in the 2014 income year (i.e. through its June 2013 quarter instalment paid in July 2013 and its final tax payment paid in December 2013). This represented the payment of the significant majority of the tax payable in respect of the 2013 income year. These payments were not captured in the TJN report as the report did not extend to 2014.

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APPENDIX B

Summary of tax laws relating to key tax adjustments for Aurizon

Privatisation Rules

Division 57 (contained in Schedule 2D) of the *Income Tax Assessment Act 1936* and Division 58 of the *Income Tax Assessment Act 1997* apply where an entity ceases to be a tax exempt entity (for example, a Government owned entity) and becomes subject to the Federal income tax regime. The purpose of the privatisation rules is to ensure only income, deductions, gains and losses that relate to the period after the entity enters the Federal income tax regime are taken into account in determining the tax position of the entity.

Some further details regarding the implications of the rules are as follows:

Income & Deductions

Broadly, under general principles, income is subject to tax in the period in which it is derived and deductions are claimable in the period in which the outgoings are incurred. This is modified under Division 57, which provides that:

- Income is deemed to be derived at the time the underlying services, goods or act giving rise to the income is undertaken. In particular, certain income received by Aurizon after privatisation for services rendered by Aurizon before privatisation are deemed to have been derived before privatisation and are therefore <u>not</u> subject to Federal income tax.

  For example, Charges received by Aurizon from Customers post-privatisation which related to unused above rail capacity made available to customers in the pre-privatisation period was treated as non-assessable to Aurizon under Division 57. This means the accounting income recorded in that year in respect of these amounts was not assessable for income tax purposes.

- Outgoings are deemed to be incurred at the time the underlying services, goods or act giving rise to the outgoing is undertaken. For example, outgoings paid by Aurizon after privatisation for goods or services received before privatisation are deemed to have been incurred before privatisation and accordingly, are not deductible under the Federal tax regime.

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- Accrued leave entitlements, bad debts and superannuation are deemed to be not deductible to the extent these items were accrued at the time of privatisation.

The application of these rules will generally give rise to different tax outcomes than would otherwise arise under ordinary tax timing principles and will often result in the tax treatment of certain items varying significantly from the accounting treatment.

Assets & Liabilities

Very broadly, Division 57 provides that the privatised entity is deemed to have disposed of its assets and liabilities immediately before the privatisation and to have immediately reacquired them on privatisation for market value.

Division 58 sets out specific rules that apply in calculating the limit on the tax cost of an asset post privatisation which impacts the entity's ability to claim tax depreciation post privatisation. In particular, the tax cost of the entity's depreciating assets at privatisation is recalculated as if the assets had been depreciated under the Federal tax regime from acquisition. This ensures the entity does not claim tax depreciation deductions in excess of that which it would otherwise be entitled to claim had the entity been required to comply with the Federal income tax rules while the entity was tax exempt.

Accordingly, Division 57 and Division 58 (as well as the tax consolidation rules – refer below) resulted in the resetting of the tax base of the Aurizon group's assets and liabilities upon privatisation. The resulting difference between the accounting and tax base of the Aurizon group's assets affects the ongoing tax timing of income and deductions recognised by Aurizon and will often result in the tax treatment of certain items varying from the accounting treatment.

Tax Consolidation Rules

Under the tax consolidation regime, members of a tax consolidated group are treated as a single entity for income tax purposes. Each entity is treated as though it is a separate division of the tax consolidated group. Transactions between entities that are part of the tax consolidated group are effectively ignored for income tax purposes. While tax consolidation is optional, generally Australian corporate groups will elect to tax consolidate due to the substantial administrative and compliance savings which are achieved by tax consolidation.

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Under the tax consolidation rules, the formation of a tax consolidated group results in a deemed acquisition by the head entity of the group of all the underlying assets held by each joining subsidiary at the time of consolidation. This is undertaken by Allocable Cost Amount ("ACA") calculations to determine the value that is then spread across the assets of all subsidiary members to reset the tax values of these assets.

Aurizon undertook the ACA calculations in accordance with the tax legislation and (in conjunction with the application of Divisions 57 and 58) reset the tax cost of the assets held by the Company upon privatisation and tax consolidation.

This tax cost base resetting again gave rise to differences between the accounting and tax base of assets which resulted in ongoing different accounting and tax outcomes for Aurizon.

For example, under the tax consolidation rules Aurizon was able to recognise a tax cost in respect of certain "rights to future income" (i.e. valuable contracts) it held at that time. Aurizon is claiming a tax depreciation deduction for these assets over the term of the contract (up to a maximum of 10 years). This is the case even though neither of these assets, nor depreciation expense in respect of these assets, is recognised for accounting purposes.

Ordinary Tax Timing Adjustments

Aurizon is a capital-intensive business, with over 85% of its $11 billion asset base comprised of property, plant and equipment (PP&E). As a result, a significant portion of the difference between Aurizon's accounting and tax outcome is as a result of the different treatment between accounting and tax of fixed asset related costs.

Australian tax law and Australian accounting standards have different rules in respect of the timing of recognition of income and costs. This arises because of the conflicting objectives between accounting and tax. The accounting rules seek to match the recognition of outgoings to the revenue to which they relate; whereas tax rules seek to acknowledge costs at the point they are incurred and compensate business more readily

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for the economic cost of any business investment made as a means of encouraging investment in productive business assets.

The two key issues that give rise to the majority of the differences between Aurizon's accounting pre-tax profit and taxable income in respect of fixed assets in any given financial year are as follows:

- **Depreciation rates** – For accounting purposes Aurizon adopts a straight line method for depreciating PP&E. This is permitted by Australian accounting standards and is common practice for Australian companies. However, under the Australian tax rules taxpayers are able to choose to accelerate their tax depreciation claim using a diminishing value method, which Aurizon applies. Where the taxpayer chooses to use the diminishing value method, the taxpayer's depreciation claim will be higher than accounting straight line depreciation in the early years of the life of the asset and then lower than the accounting depreciation in the later years of the life of the asset. The diminishing value method for tax recognises that new assets can depreciate faster in the early years of the asset's life and slower in the later years and therefore compensates business for the lost value sooner.

- **Capitalised Expenditure** – The Australian accounting standards have specific rules regarding when certain expenditure can be capitalised into the cost of an accounting asset (and depreciated) for accounting purposes. However, for income tax purposes, certain expenditure which is capitalised for accounting purposes may be deducted upfront (or expensed) for tax purposes. This difference in treatment again reflects the different objectives of the tax rules and accounting rules. The recognition of the deduction for tax purposes acknowledges that the economic cost has been incurred as opposed to accounting principles which seek to align the costs to the potential future revenue return associated with the expenditure.

  For example, interest paid on debt used by Aurizon to fund the construction of rail infrastructure is capitalised into an asset for accounting purposes and depreciated over the life of the rail infrastructure. That is, the interest cost is recognised as accounting depreciation over the life of the asset to align the interest cost with the revenue derived from the constructed asset. However for tax purposes, the interest is immediately deductible when incurred. This means that the cost of the interest incurred is recognised much sooner for tax purposes than it is recognised for accounting purposes.

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As a result of the above significant fixed asset tax timing adjustments (in addition to other tax timing adjustments) there is a consistent and ongoing difference between the accounting and tax treatment of Aurizon's fixed asset related costs. These are significant given Aurizon's large fixed asset base.