INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

26 October 2018

Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2000

Via email: economics.sen@aph.gov.au

Dear Committee Secretary,

RE: Submission on the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* and related Bills

1. INTRODUCTION

We are pleased to make this submission to the Senate Economics Legislation Committee on the provisions set out in the following bills (referred to collectively as "the Bills"):

- *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018*
- *Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2018; and*
- *Income Tax Rates Amendment (Sovereign Entities) Bill 2018*

The new measures are complex and require a number of changes to current practices and processes from an operational, reporting and investment management perspective for domestic and foreign investors. For a more comprehensive understanding of our input into the design of the policy package and the subsequent drafting of the Bills, we refer the Committee to our previous submissions to Treasury, including:

- Submission on the Stapled Structures Consultation Paper, April 2017
- Submission on the Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018 Exposure Draft and Explanatory Memorandum, May 2018
- Submission on the Stapled Structures Integrity Measures Proposal Paper, July 2018
- Submission on the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* Exposure Draft and Explanatory Memorandum, August 2018

The measures outlined in the Bills will have material consequences for infrastructure investment in Australia. Accordingly, our submission seeks to explain the importance of stapled structures in infrastructure projects and the impact of the proposed measures on Australian infrastructure investment.

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2. STAPLED STRUCTURES IN AUSTRALIAN INFRASTRUCTURE

The success of importing capital into Australian infrastructure has its roots in the introduction of stapled structures as acceptable investment vehicles in the late 1980s, and the introduction of the Managed Investment Trust (MIT) regime.

The initial heavy capital investment and associated debt financing required for infrastructure investments leads to tax losses being generated or recouped for the initial years. However, once a project is up and running, there can be cash available for distribution that exceeds any accounting or tax profits. In a company, which is subject to the Corporations Act 2001 requirements around paying dividends, capital returns et cetera, the accounting profits are paid out as unfranked dividends with the risk of trapped franking credits within the company at the end of project life when tax profits are higher than accounting profits.

A stapled structure comprises an operating entity and an asset trust. A trust, which is not subject to the same Corporations Act 2001 requirements as a company, can pay out surplus cash as tax deferred distributions in the early years to investors, who are then taxed on their income accordingly. A stapled structure can also allow the ATO to collect tax earlier than would be the case under a corporate structure.

Stapled structures also permit project financiers to lend against pre-tax cash flows, because tax is paid at the investor level rather than the project level. This enhances gearing levels and enables cheaper project debt to replace more expensive project equity and hence optimises a project's cost of capital.

Many infrastructure ownership transactions are structured in this way. As an investment vehicle, stapled structures have allowed capital to flow into investment opportunities and support the development of infrastructure projects in Australia. Changes to the tax treatment of the structure will undoubtably affect future appetite for investing in Australian infrastructure.

2.1 Managed Investment Trust (MIT) in infrastructure investment

The introduction of the MIT regime allowed Australia to further strengthen its international competitiveness. The original policy intent of the MIT regime explicitly stated the regime would attract foreign investors with a tax outcome that was certain and generous compared to the Australian corporate tax rate.

In the past 10 years the MIT withholding tax rate has fluctuated considerably. Notably, in 2012 the MIT withholding tax rate increased from 7.5 per cent to 15 per cent. The new measures in the Bills restrict eligibility to access the concessional 15 per cent tax rate. Instead, income derived by a MIT from new infrastructure investments will now be treated as "non-concessional MIT income" and taxed at the prevailing corporate tax rate (currently 30 per cent), with limited exceptions.

We welcome the exception to greenfield nationally significant economic infrastructure projects, which will be eligible to access the concessional 15 per cent MIT rate for a 15-year period, if approved by the Treasurer. However, we submit that the benefit of the concession may be small considering such projects normally incur or utilise tax losses for a significant initial period post completion due to large upfront capital expenditure, interest deductions during construction phase and depreciation deductions and possible ramp-ups in the generation of income.

We also welcome the carve out for affordable housing from the changes, however we express concern that the Bill removes MIT concessions for student accommodation.

A twofold increase to the MIT withholding tax rate, from 15 per cent to the corporate tax rate of 30 per cent (one of the highest in the OECD), will materially impact the ability of Australia's managed funds industry to attract funds from other markets. For example, the Australian Double Taxation Agreement (DTA) with Japan also provided a withholding tax rate of 15 per cent for managed funds, to foster cross-border investment. Japan's investment in Australia ranges from transport and energy to telecommunications and more.

Ultimately, the increase in the MIT tax rate means the tax settings for foreign investors are neither globally competitive nor levelled with Australian superannuation funds (which are subject to a maximum 15 per cent tax rate).

It is worth noting that according the OECD's report on tax developments across OECD economies, the average corporate tax rate fell from 32 per cent in 2000 to 25 per cent 2015.[1] This does not include the United States reducing its corporate tax rate from 35 per cent to 21 per cent in 2017 and the United Kingdom reducing its headline corporate tax rate to 17 per cent by 2020, citing the reduction will provide "the right conditions for business investment and growth".[2]

Therefore, if non-concessional MIT income will be taxed at the corporate tax rate, we submit that reform is needed to Australia's corporate tax rate to ensure Australia remains a globally competitive market.

Without competitive tax rates and well-established legislative frameworks, which support infrastructure investment, investors will see Australia as having a high pre-tax return hurdle on opportunities. As a result, there is a risk that capital can move to other markets offering more attractive after-tax investments.

3. IMPACT OF THE NEW MEASURES ON INFRASTRUCTURE INVESTORS

Over the past ten years, Australia has attracted and retained capital by enabling investors to competitively price infrastructure assets, based on confidence in the regulatory and legislative environments. This has been particularly evident by the participation of foreign investment in Australia's recent state government asset recycling transactions – as part of successful consortia as well as under-bidding consortia.

However, the unexpected review of the use of stapled structures and a prolonged period of policy and regulatory uncertainty have caused legitimate concern and uncertainty in the infrastructure investment market.

[1] OECD, *Tax Policy Reforms in the OECD 2016*, September 2016
[2] HM Revenue & Customs, *Policy Paper: Corporate Tax to 17% in 2020*, 16 March 2016

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Investors assess the attractiveness of an investment on an after-tax basis. This means that if the effective tax rate is comparatively high, or there are disparities in the tax rate, it will directly and adversely impact potential investment returns.

As a net capital importer, it is important that any changes to Australia's tax policy settings avoid adverse impacts on attracting foreign direct and indirect investment into infrastructure. Any changes to the settings should also place greater importance, not less, on the need for foreign investment to create a pool of sufficient 'dry powder' to create competition in the market and deliver the required pipeline of infrastructure projects at the best price for the community.

For each of the last four years, Infrastructure Partnerships Australia has conducted an annual survey of domestic and international infrastructure investors to understand Australia's investment environment in a global context, and how this is changing over time.

We have attached the 2018 *Australian Infrastructure Investment Report* for your reference.

This year, the report showed that Australia's value proposition to investors is being eroded by policy and regulatory uncertainty. Notably, concerns over political risk, sovereign risk and taxation benefits saw material increases compared to previous years. Last year, investors pointed to the Federal Government's review of stapled structures as the cause for the 30-percentage point increase in taxation as a challenge to investment, compared to 2016. This year, there was minimal relief following draft legislation for the package providing some direction.

This demonstrates that uncertainty in taxation and similar regulatory environments has very real impacts on investors' considerations. Investors require certainty, and while we accept that the Government needs to preserve its revenue base by closing any perceived revenue leakages, it should not do so in ways that could serve to frustrate the Government's broader productivity objectives, including much-needed investment in infrastructure development.

The increased scrutiny of stapled structures and tax concessions that were available to foreign investors, is part of a broader change in Australia's approach to inbound investment in infrastructure. The acceleration of asset recycling programs over recent years, coupled with an active secondary infrastructure deals market, has resulted in greater scrutiny of foreign investment by Australian policymakers and regulators, and less certainty for investors.

4. CONCLUSION

The measures set out in the Bills are suboptimal, complex and impact infrastructure investors across both greenfield and brownfield projects.

We remain concerned that the proposed measures will affect future investments in infrastructure development, including flow on effects on asset values and the subsequent appetite of states to recycle their infrastructure assets.

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However, if the new policy measures underlining the Bill are going to stand, we urge Parliament to punctually pass the legislation in order to return Australia to a stable and predictable tax setting, which provides much-needed legislative certainty and direction for investors.

We hope our comments are helpful to the Committee in its inquiry.

Yours sincerely,

[redacted]

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