Greenwoods & Freehills

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New Tax Measures for Property and Infrastructure Projects

On 16 August 2007, the Government introduced into Parliament the Tax Laws Amendment (2007 Measures No. 5) Bill 2007 ("**the Bill**"). It contains new measures addressing the tax consequences of property and infrastructure projects that involve both private sector and tax exempt or non-resident participants and terminates the operation of the current draconian provisions.

The Bill represents the conclusion of a long and difficult tax reform project which involved significant consultation with industry. There has already been one false start in 2003, but it now seems that, even though the Bill has been referred to the Senate Economics Committee, the measures will proceed to legislation without significant modification.

When triggered, the principal effect of the measures in the Bill will be to re-cast leases, licences and similar arrangements as the making of a loan, with consequential effects on income and deductions, including the deductions for capital allowances that the private sector participant would otherwise be entitled to claim. These consequences are triggered only for the private sector entity which provides the use of the asset; the position of the tax exempt or non-resident participants is unaffected by these measures.

The new measures will, for the most part, be relevant for transaction entered into on and after 1 July 2007.

1. Background

The focus of the Bill is on the tax consequences for private sector participants which own assets (e.g., commercial property and other infrastructure assets) that are used by tax exempt bodies, typically Government agencies, or non-residents. Common examples would include commercial property leased to a Government agency, privately owned toll roads and tunnels, rail networks, port facilities, power generation plants, pipelines, prisons and so on. The principal provisions of the current law which affect these kinds of projects – s. 51AD and Division 16D of the *Income Tax Assessment Act 1936* (Cth) ("**ITAA 36**") – can operate to deny or reduce deductions for capital allowances (usually deductions for depreciation and capital works, that is, building allowance), and in some cases deductions for the financing and other costs that would otherwise be available. Currently, there is significant and usually costly structuring to avoid the operation of s. 51AD in relation to infrastructure projects in view of its potentially draconian impact.

In a speech in August 2002, then Assistant Treasurer Senator Coonan agreed that the current law was "no longer appropriate" and that amendments would be made to replace the existing provisions by mid-2003.

In June 2003, the Assistant Treasurer released an Exposure Draft of these provisions, the New Business Tax System (Tax Preferred Entities Asset Financing) Bill 2003. That Bill proposed a new Division in the *Income Tax Assessment Act 1997* (Cth) ("**ITAA 97**") to replace the existing law. The Bill was subject to significant criticism at the time, and was quietly shelved.

In September 2005, the Assistant Treasurer Mr Brough announced that the project would be revived and the new Bill just released is the conclusion of that work.

2. Inclusions

The new provisions will apply to a taxpayer if there is a "tax-preferred use" of an asset – that is, a tax preferred entity is likely to use for more than 12 months an asset that the taxpayer owns (and for which the taxpayer claims deductions for capital allowances), where the taxpayer does not have the "predominant economic interest" in the asset. The various elements of that description are then elaborated in detail in the Bill:

- A tax preferred entity is defined to include a tax exempt entity, an Australian or foreign Government agency and a non-resident.
- Tax preferred use of the taxpayer's asset will occur if, in general terms:
  - a tax preferred entity leases the asset, uses the asset under some other arrangement or is in a position to "effectively control" the use of the asset, or there is an arrangement under which the output from the asset is being provided to or produced for the tax preferred entity, and
  - the end-user of the asset is a tax preferred entity, or the asset is being used offshore by a non-resident. (This aspect of the test creates particular problems where the rule has to be applied to a controlled foreign company owned by an Australian shareholder.)

In this respect, the tests resemble current law in Division 16D ITAA 1936 which is triggered by reference to use or effective control.

- The regime is defined to operate for each individual "asset" and, for this purpose, the Bill severs improvements and fixtures from the land on which they are built. This can have important ramifications as various tests are in consequence applied separately to each individual asset.
- The notion of "predominant economic interest" in an asset is defined in six different ways in the Bill. In summary, the taxpayer will lack the predominant economic interest in the asset if:
  - the asset was financed with excess limited recourse debt – that is, if limited recourse debt was used to finance the acquisition or construction cost of the asset, and that debt exceeds 80% of the cost of an asset used by a resident, or 55% of the cost of an asset used by a non-resident;
  - the asset is likely to be acquired by the tax preferred end user for a price other than its market value at that time;

- the arrangement will last for at least 75% of the effective life of the asset (or 30 years) and is non-cancellable;
- the tax preferred end user guarantees the residual value of the asset;
- the arrangement with the tax preferred end user amounts to a debt interest under the debt / equity tests in the ITAA 97; or
- the present value of all the amounts that the tax preferred end user is likely to pay under the arrangement exceeds 70% of the market value of the asset.

It is important to note that these tests are intended to be continuously applied to an arrangement; subject to very limited exceptions, this is not a "set-and-forget" test which needs only to be undertaken once when an arrangement is established.

3. Exclusions

The Bill contains a number of exceptions to these rules, including five express exceptions and a number of other obscure ones.

First, there is an exception for short term arrangements – the rules do not apply unless the arrangement is likely to last more than 12 months. The length of an arrangement is to be determined on entering the arrangement and is, broadly, the period during which the tax preferred entity uses or is likely to use the asset under the arrangement. Where a tax preferred user continues to use an asset after a 12-month term expires, the arrangement is re-tested from that date to determine whether the new arrangement also qualifies for the exception.

Secondly, there are two separate sets of exceptions for short term and low value transactions.

The first of these exceptions provides that the provisions will not apply to an arrangement unless tax preferred entities are expected to pay at least $5m to the taxpayer in respect of all assets made available under the arrangement. There are no further qualifications to the first exception.

The second is a group of three related, more generous, but highly qualified exceptions which are also targeted at short term or low value transactions ("**the conditional exceptions**"). Again, the conditional exceptions are directed to short term transactions, transactions which will generate low returns to the private sector provider, or transactions involving the provision of low cost assets. There are separate thresholds for each exception depending on whether the asset involved is real property or some other kind of asset:

- for arrangements involving real property, the rules will not apply if –
  - the real estate is leased for a likely term of 5 years or less;
  - the tax preferred end user will likely pay $50m or less to the taxpayer; or

- the value of all real property being leased to the tax preferred entity is $40m or less;

Again, for the purpose of these exceptions, the length of an arrangement is to be determined on entering the arrangement and depends upon how long the tax preferred entity is likely to use the asset under the arrangement. So, for example, a 3 year lease of real estate with an option for a further 3 year term is prima facie still within this exception, as the length of an arrangement will generally be determined on the basis that the option to extend will *not* be exercised. However, it may be excluded if it is reasonably likely that the option to renew will be exercised by the user, typically because of some term of the arrangement which would trigger adverse consequences for the user if it fails to renew. And again, if the tax preferred user continues to use an asset after a 5 year or 3 year arrangement expires, the arrangement is re-tested from that date to determine whether the new arrangement also qualifies for the exception.

The conditional exceptions are, however, subject to important limitations. A taxpayer cannot rely on any of the exceptions if, *inter alia*:

- the arrangement is a debt interest under the debt / equity rules;
- a tax preferred entity or non-resident has a right to buy the asset at the end of the arrangement for a price other than market value;
- in certain cases, the accounting standards would classify the arrangement as giving rise an asset or a liability that should be disclosed in the taxpayer's balance sheet; or
- in certain cases, the assets in question are so specialised that they could not realistically be sold or leased to any one other than a tax preferred end user.

Thirdly, these rules do not apply to small business entities (annual turnover under $2m) which provide assets to tax preferred end users.

The fourth exception is intended to eliminate arrangements where there is no tax advantage for the taxpayer from making the asset available in this manner (which would typically mean there is no significant acceleration of deductions under the capital allowance regime). This fourth exception permits the taxpayer to compare, in present value terms, the tax result that would occur apart from the new rules with the tax result that would occur if the new rules applied. If applying the new rules would generate a smaller amount of net assessable income, the taxpayer need not apply the new rules.

One final point to note involves arrangements which provide for a tax preferred end user (typically a government agency) to assume temporary control of an asset for reasons of public safety, environmental protection or ensuring the supply of an essential service (often referred to as "step-in rights"). These temporary exercise of step-in rights will not result in a tax preferred entity having control of the asset.

4. Effects of triggering new rules

As was noted above, when the new rules are triggered, the principal effect is to re-cast leases, licences and similar arrangements as the making of a loan, with consequential effects on income and deductions, including deductions for capital allowances that the private sector participant would otherwise be entitled to claim. Generally, the new rules are similar to the current Division 16D ITAA 1936, albeit with more extensive exceptions.

These effects can be triggered from the establishment of the arrangement or during the life of an arrangement.

One consequence of triggering these rules is that the taxpayer will be denied deductions for some or all of its "capital allowances." This term refers principally to deductions for depreciation or capital works. This provision assumes that the taxpayer is entitled to claim deductions for depreciation or capital works – that is, that the arrangement with the tax preferred entity has not made that entity the holder of the depreciating asset or building for the purposes of those rules.

Where an asset is put to mixed use and only part of the use is disqualified, the taxpayer may be able to apportion the capital allowances and retain part of its entitlement.

The taxpayer is required to re-cast the arrangement as involving the making of a loan. Just how this is done depends on whether the taxpayer has been denied all or just some of the deductions for capital allowances:

- If the taxpayer has been denied all of its deductions for capital allowances, the amount of the loan will usually be the adjustable value of the depreciating asset or the undeducted construction expenditure for a building. The payments made by the tax preferred entity that would have been treated as rent (or equivalent payments) by the taxpayer, are instead re-cast as being blended repayments of principal of the loan and interest. The effect of this is that the excess of the payments made by the tax preferred end user over the amount deemed to be lent is made assessable to the taxpayer, and the surplus is included in its assessable income under a compounding accrual calculation. The methodology prescribed for this calculation mirrors the rules proposed for the taxation of financial arrangements regime.
- If the taxpayer has been denied only part of its deductions for capital allowances, the amount of the loan will be the denied proportion of the adjustable value of the depreciating asset or the undeducted construction expenditure for a building. A portion of the rental payments made by the tax preferred entity will be re-cast as principal and interest, and the excess over the amount deemed to be lent will be assessable to the taxpayer.

The amount that will be subject to deemed loan treatment excludes any amounts to be paid by the tax preferred entity that represents something other than payment for the use of the asset. The Explanatory Memorandum to the Bill gives as an example payments by the tax preferred entity for

services provided by the taxpayer in connection with arranging the use of the asset.

5. Transition

The transition to these rules is somewhat complicated as two different transitions are in play – the commencement of the new regime and the cessation of s. 51AD ITAA 1936.

Once the Bill is enacted, the new regime will apply to arrangements where the asset is provided to the tax preferred end user on or after 1 July 2007, unless that happens under a binding arrangement made before 1 July 2007. Section 51AD and Division 16D will not apply to arrangements starting after that date, including, in the case of s. 51AD, sale and leaseback transactions.

However, the new regime can also apply where the asset is made available after 1 July 2007, but under binding arrangements entered into before 1 July 2007. Taxpayers can elect to have the new regime apply to their arrangement if they would have been subject to s. 51AD or Division 16D, or if they changed an existing arrangement so that it became subject to s. 51AD or Division 16D.

With regard to s. 51AD, there is a special transitional provision which can terminate the operation of this section in relation to tax preferred end use from 1 July 2007, even though the arrangement was in place on that date. The provision appears to be an attempt to honour the Government's promise in 2002 that s. 51AD would be withdrawn. The transitional rule switches off s. 51AD from 1 July 2007, even though the arrangement was in place as at 1 July 2007, provided that a tax-preferred use of the asset commenced on or after 1 July 2003. According to the Explanatory Memorandum to the Bill, this will allow taxpayers to "remove contingent equity arrangements entered into for the purpose of avoiding the application of s. 51AD." It should be noted that this only applies to the operation of s. 51AD in relation to tax referred end use and not sale and leaseback transactions.

6. Some observations about the changes from current law

The new Bill represents a significant improvement to many of the difficulties apparent in the current law.

First, the *de minimis* exemptions for short term and low value transactions will confine the new regime to major projects and remove transactions where the scope for tax deferral is modest at best.

Secondly, as was mentioned above, many of these tests are applied in respect of each asset. That means, for example, when it comes to determining effective life, market value, how the construction or acquisition was financed or the length of an arrangement, these tests are to be applied to each asset individually, severed from surrounding assets. Some tests,

however, are applied to all assets provided under an arrangement – for example, the thresholds in some of the short term or low value exceptions are based on the value, or amount to be received in respect of, all the assets to be provided under the arrangement. This is obviously intended to aggregate values for transactions involving multiple assets with low values such as fleet leases of motor vehicles or rolling stock.

Thirdly, the new regime does not automatically include all sale and leaseback transactions within its scope. Current law views these transactions as inherently suspicious; the new regime does not. So, a sale and leaseback between two resident private sector participants will no longer put in jeopardy the capital allowances of the owner.

Fourthly, the significance attached to the use of non-recourse debt is diminished. Taxpayers can now finance the construction or acquisition of an asset to be used onshore with up to 80% limited recourse debt before they are treated as lacking the predominant economic interest in an asset. Section 51AD is triggered if more than 50% limited recourse debt is used.

Fifthly, the new regime puts in jeopardy only deductions claimed for depreciation, building allowance and other capital allowances. Other deductions such as interest or repairs which can be affected by s. 51AD are no longer affected by these rules.

Sixthly, there will be a number of difficult issues involved in performing the calculation of both the application of thresholds and in determining the assessable income where the provision applies.

Finally, the "all or nothing" outcome from s. 51AD has thankfully been removed. No-one will lament its demise.

For further information, please contact:

Paul King

paul.king@gf.com.au

61 2 9225 5972

Josh Cardwell

josh.cardwell@gf.com.au

61 2 9225 5887

Chris Colley

chris.colley@gf.com.au

61 2 9225 5918

Greenwoods & Freehills

Tim Neilson

tim.neilson@gf.com.au

61 3 9288 1054

Adrian O'Shannessy

adrian.o'shannesy@gf.com.au

61 3 9288 1723

www.gf.com.au

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited

ABN 60 003 146 852

Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Facsimile (02) 9221 6516 Telephone (02) 9225 5955

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