



Australian Government

The Treasury

Infrastructure Taxation Incentive Proposal

Regulation Impact Statement

Table of Contents

Background	3
Problem	3
Objectives of government action	5
Options that may achieve the objective	5
<i>New Tax Treatment Option 1 – Loss maintenance</i>	<i>7</i>
<i>New Tax Treatment Option 2 – Flow through shares</i>	<i>7</i>
<i>New Tax Treatment Option 3 – Infrastructure subsidy</i>	<i>8</i>
Consultation	9
Implementation and review	9
Conclusion	10

Background

1. Well-targeted investment in physical infrastructure can play an important role in the economy by facilitating other productive activities. For example, port infrastructure allows Australian production to be moved around the country or exported, as well as providing a means for inputs to reach producers.
2. However, governments' abilities to finance new infrastructure are constrained by competing demands on public finances within the overarching constraints of desired budget outcomes.
3. Consequently, progress in addressing infrastructure bottlenecks will depend significantly on private financing being attracted to projects. Private financing depends on the expected commercial return from the project being sufficient relative to the risks involved.
4. In recent years there have been increased opportunities for private investment in infrastructure, in particular where the private sector can anticipate an acceptable return on its investment (eg. airports and ports).
5. Because private financing depends on the expected commercial return from the project being sufficient relative to the risks involved, it is important the government creates an environment conducive to well targeted infrastructure investment. In particular, this includes ensuring impediments — whether they are tax, regulatory, or market imperfections — do not prevent or distort private investment in infrastructure where it would otherwise have taken place.
6. Infrastructure projects are typically long term, highly risky investments, that can often have a long lead times between when expenditure is incurred and when a project starts earning income. One way that infrastructure projects typically deal with these risks is to allow different entities that specialise in different aspects of infrastructure (eg construction, operation, maintenance) to deliver different stages of a project. However under current tax arrangements there is a risk that, if there is a substantial ownership change in the project and a change in business operation, then the new owners may be unable to access previous years' losses.
7. The private return on investment in infrastructure can also be reduced if the tax system does not adequately recognise costs. Under current arrangements the tax value of expenditures is reduced by the delay in being able to use them as tax deductions against project income, because of inflation and the time value of money.

Problem

8. Consultation with industry has identified the risk of trapped losses as being significant in some cases, raising the project financing costs and hence reducing infrastructure investment. While the tax system already contains many provisions that reduce the risk of losses being trapped or to prevent significant delays in their usage — for example, consolidated groups can offset losses from one part of the group against income from another, while certain deductions for research and development expenditure are immediately refundable — such arrangements are of limited use for infrastructure projects due to the way they are structured and the types of expenditure they incur. As infrastructure projects often have significant lead times between when the investment is made and when income is earned, this can result in project losses being trapped or only being used after a considerable lag. Where losses are trapped or there is

considerable lag between when they are incurred and used, the project's required rate of return (hurdle rate) increases. When a project's hurdle rate of return is higher than it otherwise would have been, the project may not proceed.

9. The problem can also be illustrated as one of relative effective tax rates between alternative investments within the economy. For example, most major mining projects will see the costs written off against current income as they are incurred (or the capital is depreciated). In this situation there is no risk of trapped losses and hence the value of the losses is not reduced by any delay in being able to utilise them. For a stand-alone infrastructure project, losses may not be able to be used or may only be used after a considerable lag. The effect is a higher effective tax rate on the infrastructure project than the mining project.
10. In its submission to the Australia's Future Tax System (AFTS) Review Panel in October 2008, Infrastructure Partnerships Australia (IPA) identified the problem this way:

Restrictions on the use of tax losses in the infrastructure context: *The long life of infrastructure imposes considerable risk on the likely returns for new investment. The extent to which Australia's tax system restricts access to early stage tax losses in infrastructure projects is a major problem or inefficiency in the tax treatment of major public infrastructure projects.*

Early stage tax losses in infrastructure projects are generated from the typically large capital allowance and interest expenses deductions involved in major infrastructure development and, also, the delay involved in these projects commencing to produce income.

In some cases, investors may wait until an infrastructure project commences to produce income in order to utilise those tax losses, but in most cases, it is more efficient to use them as soon as possible, maximising their value. For instance, interest costs incurred during the construction period are usually deductible during that period even though the project in question may have no revenue (i.e. the interest costs are treated as a loss). Such a loss can normally be carried forward and progressively offset against profits during the operational phase of a project.

The ability to use carried forward losses depends on continuity of ownership and the same business test. Should a change in majority ownership in the entity occur early in the life of the project before those losses are fully offset against profits, those losses cannot be deducted by the new owner against future project profits. Instead, in these circumstances, profits from the project are arguably taxed on an illusory basis during the operational phase because the tax treatment of the project's profits fails to take into account the significant sunk costs incurred at the outset of the project (i.e. interest incurred during construction).

IPA contends these restrictions imposed on the ability of taxpayers to use carried forward losses is a disincentive to private investment in assets with a higher risk profile, such as infrastructure assets.¹

11. In its Report to the Treasurer, the AFTS Review Panel provided the following comments on the broader issue of risk taking and the treatment of losses:

¹ Infrastructure Partnerships Australia, *Submission to Australia's Future Tax System Review Panel*, October 2008, pages 13 to 14

The tax system treats gains and losses differently. The current tax system limits the refundability of losses, while all gains are taxed as they are realised. This reduces incentives to undertake risky investments, as denying full loss offset reduces the expected return from, and therefore increases effective tax rates on, risky investments.

Where losses are not fully refunded or where gains and losses are taxed at different rates, as under a progressive tax rate scale, these asymmetries will tend to discourage risk taking including entrepreneurial activity. Restrictions on loss utilisation may also lead to pressure for concessions to attract investors to investments that are disadvantaged as a result of the restrictions. If such concessions are targeted towards specific types of investments, they risk further biasing investment allocation...

...However, despite its theoretical benefit, full loss offset is rarely seen in practice.

In the same way that profits are highly mobile and can be shifted between countries in response to high statutory tax rates, full refundability could attract losses into a country at a substantial cost to revenue — without necessarily improving the climate for investment. While loss restrictions are an imperfect substitute for effective integrity provisions, they limit the benefits of tax avoidance schemes. They also limit the benefits arising from any income mismeasurements, such as immediate deductions for capital expenditure and accelerated capital allowance arrangements.

Loss restrictions, such as continuity of ownership tests, also prevent losses from being transferred to new investors who may value them more highly because of differences in tax rates. Further, loss restrictions may limit the extent of a bias in favour of debt financing by companies and, in respect of trusts, may reduce the scope to exploit differences in the tax rates of trust beneficiaries.

Principle

The treatment of business losses should reduce biases against risk taking by treating income and losses symmetrically. This must be balanced against problems arising from the mismeasurement of losses from difficulties in measuring economic income, artificial loss creation schemes or from other forms of tax avoidance.²

Objectives of government action

12. To remove barriers to efficient private investment in public infrastructure of national significance caused by the operation of the tax system consistent with the Government's fiscal strategy.

Options that may achieve the objective

13. The identified problems suggest two broad approaches.
14. One approach would be to specifically address the problem of not being able to immediately use potential tax deductions relating to project expenditures.

² Commonwealth of Australia, *Australia's Future Tax System Review – Report to the Treasurer: Part Two Detailed Analysis volume 1 of 2*, December 2009, pages 174 to 175

15. The other approach would be to provide tax allowances or explicit subsidies that effectively reduce the hurdle rate of return required for a project to proceed — reducing the impact of the distortion arising from the current restrictions on loss utilisation. Although this approach would not directly address the distortion, it could provide a benefit that offsets its impact.
16. These approaches are overlapping, in that increasing the real value of tax deductions may improve the effective return from the project, while tax allowances and explicit subsidies could provide a benefit that may offset the impact of the current loss restrictions.
17. Direct Commonwealth Government subsidies to projects would not be consistent with the objective.
18. Within these two broad approaches there is also a question around what projects and what quantum of investment should receive the new tax treatment. To manage the potential cost to revenue and ensure that the highest value projects are supported it is proposed that measure focus on projects of national significance up to \$25 billion of capital investment for 5 years (2012-13 to 2016-17).
19. Given this constraint a number of factors are important in order to maximise value for money, including that:
 - the absolute size of the net gain to the community from the projects is of national significance;
 - the benefit to the community from the new tax provision is maximised by choosing between competing projects;
 - projects have appropriate corporate governance arrangements in place; and
 - the project is available to multiple users and benefits the broader community.
20. In the absence of a cap, one option would be to let infrastructure projects self assess against such criteria. However, to manage the potential cost to revenue while ensuring that the highest value projects are supported, it is proposed a decision maker be established to deem certain projects as Designated Infrastructure Projects (DIPs).
21. A clear and objective process for selecting DIPs will be important for the initiative to meet its objective.
22. To ensure that only nationally significant projects are considered a pre-condition would be that they must be listed on Infrastructure Australia's (IA) National Priority List of projects considered 'Ready to Proceed' or 'Threshold'. In addition to meeting this pre-condition a decision maker and set of criteria will be established to decide whether a project should be a granted DIP status for the purpose of the new tax treatment.
23. Governance arrangements for the decision maker and more detailed criteria will be developed through further consultation with industry and other stakeholders. Issues likely to be canvassed in that process include:
 - the relationship between the decision maker and Infrastructure Australia (in particular their ability to share information);

- the process of appointing a decision maker and what skills and qualifications they should have; and
- the specificity of the selection criteria (for example, should the criteria include a 'hurdle' rate of return to the economy as a whole).

New Tax Treatment Option 1 – Loss maintenance

24. This option directly targets the concerns that early stage tax deductions (which in the first instance feed into carry forward losses) might not ever be used due to changes of ownership, or if used will have declined in value due to inflation and the time value of money.
25. Under this option, DIPs would enjoy maintenance of the value of carry forward losses and increased flexibility in utilising those losses.
 - Before being applied to the entity's income for an income year, any prior year losses would be uplifted at the government bond rate.
 - Losses attributable to the DIP would be exempted from the continuity of ownership test (COT) and same business test (SBT). That is, any uplifted losses would still be deductible against future income if the entity experienced a change in ownership or business.
26. Although consultation will be undertaken on the design and implementation of the proposal, the simplest approach would be to require the DIP to be held by a separate entity, which would work out its income and deductions (ie, calculate its losses) under the ordinary income tax law, subject to any special rules that may be required. This would avoid the need to identify which part of the assessable income and allowable deductions for an entity (worked out under the ordinary income tax law) are directly attributable to the DIP for an income year.
27. The entity would (in principle) work out its income and deductions — and hence any eligible losses — under the current income tax law. Any exceptions or variations to the ordinary rules would be reflected in the enabling legislation, not subject to the decision maker's discretion.
28. Loss integrity rules other than the COT and SBT would still be applied. In addition, specific integrity rules may be required to ensure that the amounts taken into account are at arm's length.
29. Overall, this option has the potential to reduce the weighted average cost of capital for eligible projects and hence, relative to the status quo, more projects should go ahead. Compliance costs will be reduced by the removal of the COT and SBT, although there would be a cost in meeting other integrity rules and seeking DIP status. However, these costs are likely to be small relative to the size of the DIP and the sophisticated nature of the players involved. Since this option eliminates the risk that losses are trapped and maintains their value until they can be utilised, the end result is that the project will pay the intended rate of tax on its profits, which represents an appropriate cost to revenue.

New Tax Treatment Option 2 – Flow through shares

30. This option would allow tax losses from DIPs to flow through to Australian resident investors.
31. Allowing investors direct access to losses (to be used immediately to offset income from other sources) will effectively increase potential private (after tax) returns of eligible projects and hence make them more attractive to investors.

32. By bringing forward, rather than merely ensuring access to and preserving the value of potential deductions, this option would also have a significant, near-term revenue impact. Since the marginal tax rates of potential investors cannot be predicted with any real accuracy, the fiscal cost of a flow through shares scheme is also highly uncertain.
33. This option would also require strong integrity rules to prevent projects from becoming vehicles for tax avoidance. Such integrity rules are likely to make compliance costs high, particularly as some of the compliance is likely to fall on smaller investors.
34. The AFTS Review examined a flow through shares scheme for mining exploration. The Review found that such a scheme would be complicated and therefore likely to result in high administration and compliance costs. The Review also noted it would not assist in attracting investment from non-resident investors.
35. Overall, a flow through shares scheme would be expected to have a positive impact on private investment in infrastructure relative to the status quo. However, a flow through shares scheme would impose an onerous compliance burden on business and investors as well as having a significant, but highly uncertain, impact on revenue.

New Tax Treatment Option 3 – Infrastructure subsidy

36. This option would provide a ‘bonus tax deduction’ to eligible projects to increase the potential private returns and hence make them more attractive to investors.
37. The entity conducting a DIP would be able to claim a bonus deduction of the lesser of actual project expenditure and approved project expenditure. Approved project expenditure could be less than the expected actual project expenditure, reflecting the national priority the decision-maker attributes to the project.
38. In general terms, expenditure would need to be directly attributable to the DIP to be eligible for the investment allowance. Generally, eligible expenditure would be limited to capital expenditure for which a deduction is available under the income tax law. However, financing costs, such as interest payments, would be excluded.
39. The investment allowance would have no impact on deductions for expenditures incurred or on the timing or amount of capital allowance deductions for depreciating assets, the timing and amount of deductions for capital works, or on any balancing adjustments when such assets are sold, scrapped or abandoned.
40. It is expected that the bonus deduction would be claimable on completion of project milestones (such as when sections of the infrastructure come into public use) specified in the instrument conferring DIP status on the project. The relevant project milestones would be specified in the instrument approving the project as a DIP. There would be a mechanism for amending project milestones in light of unforeseen events and developments.
41. Overall, providing a subsidy that reduces the weighted average cost of capital for eligible projects should, relative to the status quo, mean more projects go ahead. Compliance costs would arise from meeting integrity rules and seeking DIP status. However, these costs would be relatively small compared to the size of the DIP and the sophistication of the players involved. Because this approach does not directly address the distortion arising from the current restrictions on loss utilisation it has a higher cost to revenue.

Consultation

42. On the broad issue of restrictions on the use of tax losses, the AFTS Review undertook extensive consultation to develop the principle that 'the treatment of business losses should reduce biases against risk taking by treating income and losses symmetrically. This must be balanced against problems arising from the mismeasurement of losses from difficulties in measuring economic income, artificial loss creation schemes or from other forms of tax avoidance.'
43. In the context of infrastructure, confidential consultation with selected industry stakeholders was undertaken in March and April of 2011 on the three options that were identified as potentially capable of meeting the objective of removing barriers to efficient private investment in public infrastructure of national significance caused by the operation of the tax system consistent with the Government's fiscal strategy.
44. This consultation suggested that industry's preference was for a flow through shares scheme that would allow tax losses from DIPs to flow through to Australian resident investors. Some stakeholders considered that if this was not possible, then their preference was for a combination of option 1 and option 3 that would deliver both certainty of losses and a subsidy for DIPs.
45. Eliminating uncertainty around the ability to utilise future losses (i.e. removing the COT and SBT) was considered valuable. If implemented correctly, participants considered this had the potential to reduce the weighted average cost of capital for eligible projects. That is, the losses option would more clearly reduce the risks of investing in selected projects.
46. While uplifting losses or an investment allowance was also considered desirable, some participants expected these benefits to be competed away through the bidding process for a project, and others highlighted that without certainty around access to future losses, uplifts or allowances were of limited value.
47. Consultations reinforced that tax structures involved in infrastructure projects are often complex and that ongoing consultation during the development and implementation of the tax measure will be crucial.

Implementation and review

48. Implementation will proceed in a number of stages.
49. A consultation paper will be issued shortly after the measure is announced in the 2011-12 Budget.
50. A period of between four and six weeks will be provided for interested members of the public to make a submission on the consultation paper. Meetings with key stakeholders may also occur during the consultation period.
51. Responses to the consultation paper will inform further policy decisions by the Government (on issues like the decision maker and selection criteria) and the preparation of draft legislation. Subject to Government's overall drafting priorities, the draft legislation could be exposed for public comment by the end of 2011.

52. As with the consultation paper, interested members of the public would have between four and six weeks to make a submission on the exposure draft legislation. Meetings with key stakeholders may occur during the consultation period.
53. Responses to the draft legislation will determine how quickly the legislation could then be finalised for introduction in the Parliament. However, the implementation process would be undertaken with a view to the legislation being introduced in the first half of 2012.
54. It is expected that a post-implementation review of the measure would be conducted once the legislation has been in place for at least two years. This would provide an opportunity to review both the implementation process and the preliminary evidence on the efficacy of the legislation and the effectiveness of the measure.

Conclusion

55. Based on an assessment of the costs and benefits of each option, the 'loss maintenance' approach appears most like to deliver a net benefit to the Australian economy. In the current budgetary environment, it is appropriate to place a cap on the quantum of capital investment that is supported by the incentive. The decision maker will effectively be asked to construct a portfolio of infrastructure projects that will deliver the maximum possible benefits for the nation as a whole. In this way, the incentive will be focussed on ensuring that private investment in public infrastructure of national significance is not deterred by impediments in the tax system.