### University of New South Wales

University of New South Wales Faculty of Law Research Series 2010

*Year* 2010

Paper 36

## Tax Efficient Infrastructure Financing: Reducing Funding Costs

Gordon D Mackenzie\*

\*University of New South Wales

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#### Abstract

The way that the Australian tax system taxes infrastructure projects means that the tax losses that are created from the early stage expenses in a project are not used by the project sponsor until some time in the future. That means that the net present value of those losses is less than the rate of tax paid on the project income when it commences, and that increases the cost of funding these types of projects. The market has developed several ways for overcoming this loss in value but these are complex and expensive. The Australian Government has announced that it may fix the problem. This paper offers five alternate ways that the Government should consider, including copying that which is done in Canada, as a mean of fixing the problem.

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#### ABSTRACT

The way that the Australian tax system taxes infrastructure projects means that the tax losses that are created from the early stage expenses in a project are not used by the project sponsor until some time in the future. That means that the net present value of those losses is less than the rate of tax paid on the project income when it commences, and that increases the cost of funding these types of projects. The market has developed several ways for overcoming this loss in value but these are complex and expensive. The Australian Government has announced that it may fix the problem. This paper offers five alternate ways that the Government should consider, including copying that which is

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Key words: infrastructure financing, tax efficiency, reduce funding costs

#### Introduction

Infrastructure in Australia is under strain from a number of influences. First, the existing limited infrastructure is unable to keep pace with economic growth and, secondly, from the demand for health and welfare infrastructure because of an ageing population. In addition, there is now demand for renewable energy infrastructure to meet changing social attitudes to non-renewable energy infrastructure.

Yet, except in very limited circumstances there are no special rules for the taxation of infrastructure under Australian taxation law such that the taxation of infrastructure assets is governed by the general taxation rules that apply to similar types of assets.

Under that system, infrastructure is adversely affected by the asymmetrical way that early stage tax losses from the project are taxed. Early stage tax losses in infrastructure projects are generated from the typically large capital allowance and interest expense deductions when the project asset is being built and, also, the delay in those projects commencing to produce income. The delay in use of the tax losses means that the net present value of the losses is less than their face value. That tax inefficiency increases the cost of funding for the project.

Project sponsors have developed arrangements that are compliant with the existing Australian tax law and that have the effect of obtaining early access to the tax losses,

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thereby mitigating this tax inefficiency. However, these add additional expense and complexity to the project financing structure.

The present Australian government has indicated that it may move to resolve this tax inefficiency, although it is yet to say specify how that will be achieved.

This paper starts by discussing the reason for and the cost of deferral of tax losses in infrastructure projects and the market based arrangements that are currently used by Australian investors to utilise those losses. Finally, it discusses the advantages and disadvantages of five options for resolving this tax inefficiency including one based on the Canadian tax system, as a means of informing the Australian Government should it decide to proceed to cure this problem.

#### Tax efficiency and early stage tax losses in infrastructure projects

Infrastructure projects usually have one or more of the following characteristics:

- 1. Large elaborate projects
- 2. Long operational life (that is a long pay back period)
- 3. Economies of scale
- 4. High sunk costs
- 5. Lumpy investment

## 6. Provide 'essential' services

- 7. Networked delivery system
- 8. Public good, with neither rival nor excludable consumption features.

It is particularly the features in 2, 4 and 5 that create the tax inefficiency. The large upfront capital expenditure on project assets gives rise to tax deductions for the project sponsor in respect of interest costs and capital allowances. However, because income from the project assets is delayed, the tax losses in the project sponsors' holding vehicle generated by those deductions are then carried forward until the project commences to generate income, at which time they will be utilised. This delay in the use of the tax losses can be up to four years, resulting in them losing value.

This loss in value can be exacerbated where a project is owned by a special purpose vehicle (SPV). A SPV is used for a number of non- tax reasons including quarantining business risks of the project from other business activities of the project sponsors and quarantining credit risk from any debt funding associated with the project. Importantly, it can isolate the tax losses from other income earning activity of the project sponsor, exacerbating their delayed use.

Because of the delay, the net present value of the tax deduction for the tax losses is less than the tax rate payable on income from the project asset. Depending on the nature of the project assets, as that will have a bearing on the rate of the capital allowance deductions, the cost of the deferral could increase the effective tax rate of the project sponsor by 2.4 to 3.5 percentage points and, consequently, the cost of funding.

#### Market mechanisms for reducing the cost of deferral

The market has developed financing structures that can make the tax losses available earlier than otherwise would have been the case.

With respect to equity investors, the early stage tax losses generated in an SPV can be immediately grouped for taxation purposes with other tax paying entities in the corporate group of the project sponsor using the tax consolidation rules.

In other cases the type of SPV chosen will be made to facilitate investors obtaining immediate value for these losses. For example, the project asset may be owned by a unit trust, the units in which are sold to retail and institutional investors, who ultimately fund the asset's acquisition. A unit trust is, in effect, able to pass the value of those tax losses to those investors by distributing income that is not assessable income to them because it is sheltered by those tax losses. Those distributions reduce the cost base of the units to the investor for tax purposes and when those units are disposed of, or the distributions exceed the initial cost of the unit, the investors will be assessed on a capital gain based on the cost of the unit reduced by those distributions. Nevertheless, the distributions that are sheltered by the tax losses facilitates a deferral of tax and, more importantly, it means that investors utilise the value of the tax losses earlier than otherwise would have been the

case.

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Care needs to be taken where the SPV holding the asset is a unit trust because of tax rules that could cause the unit trust to be taxed as a company, rather than as a trust. This risk is avoided if the unit trust comes within one of the exemptions from application of these rules and any part of the project that is not within that exemption is then carried on in a separate vehicle, usually a company, to protect the unit trust's tax status as a trust. Investors can then take an interest in both vehicles (units in the unit trust and shares in the company) and those interests can be stapled if the project's securities are listed.

Nevertheless, this fix of the problem is not ideal from a number of perspectives. First, it adds complexity and expense to the project structure and, secondly, it can create financial stress in the project vehicle, as it may need to revalue assets and borrow against that new valuation to fund the cash distributions, in the absence of income from the project asset.

Lenders can access the tax losses, where the asset was financed with borrowed funds, by the tax deductions for the initial capital allowances being transferred to the lender by way of a finance lease. The lender can then share the value of those deductions with the project sponsor by reducing the rental payments and, thereby, reducing their cost of funds. The generic name for this a "tax benefit transfer" or a "tax preference transfer" transaction and is disliked by the Australian tax authority precisely because it advances the use of the capital allowance deductions.

The Australian tax authorities' dislike of these structures adds to the tax risk of the project sponsor, as well as adding another layer of cost and complexity in the structure

itself and only being effective for the capital allowance deductions and not the interest expenses.

#### Five options for resolving the tax inefficiency

In this part of the paper, for the purpose of informing the Australia Government should it proceed to resolve this tax inefficiency, five options for resolving this tax inefficiency are discussed, together with their advantages and disadvantages.

The first option is for tax losses to be carried back and offset against prior years income of the project vehicle. However, this solution is not practical because, in the general case of infrastructure projects, where the assets is held in a special purpose vehicle, there is no prior year income against with which to offset the losses.

The second option is for losses be carried forward by the project vehicle and interest paid by government on the value of those losses carried forward until the project turns tax positive. This solution, in effect, is similar to government refunding the value of the losses, which is then invested in an interest paying security with government.

An advantage of this is that it is less susceptible to tax avoidance and evasion by project sponsors because the interest payment is tied to the project asset. A disadvantage is that it implicitly assumes that the project will continue until it becomes income earning. It also has another problem, which is deciding the interest rate that is to be paid on the losses. The corporate tax rate would seem the most obvious to choose. However, it does not seem an appropriate rate given that most infrastructure investors are tax preferred superannuation funds and individuals, whose tax rate is less than the corporate rate.

The third option is for an immediate refund of the value of the losses to the project vehicle, and a variant of this is a refund of the value of the losses to the project vehicle together with a form of reverse imputation to shareholders.

With respect to a refund of the value of the tax loss, there is, again, an issue about what tax rate should be used to calculate the value of the refund and similar problems in choosing that rate apply as in the second solution.

A reverse imputation system means that the value of the tax loss is attributed to the shareholders in the project owning vehicle, together with the value of any refund for the losses that that vehicle received. The result is that the investor would then account for the loss at their effective tax rate.

The fourth option is to allow the losses to be transferred by the project vehicle to anyone who could use them. Broadly, this is equivalent to a market being created for the tax losses. Clearly, this would be unacceptable to government because of the potential for tax avoidance and evasion.

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The final option is based on an initiative that has been used very successfully to stimulate the mining industry in Canada, generically named 'Flow Through Shares'. Broadly, the project vehicle that incurs the expenditure that generates the tax losses, forgoes any tax deduction for those losses and, instead, the shareholder in that vehicle is allowed a tax credit at the corporate rate for the tax losses incurred by the company. This has been proposed for brownfield exploration expenditure of Australian mining and petroleum companies to stimulate activity, but could equally apply to tax losses of infrastructure projects.

The advantage of this option is that it is modelled on Australia's imputation credit system, which are well known and understood, thereby reducing complexity and expense. In addition, it is has proven very successful in attracting funding to the exploration sector in Canada, since its introduction, necessarily meaning that it is attractive to investors.

Further research is now warranted to prioritise the utility of each of these five options.

#### Conclusion

The increased funding cost of infrastructure projects caused by the deferral of the use of early stage tax losses is now well understood and quantified. The mechanisms used by the market to mitigate this increased funding cost are complex and expensive. Should the Australian Government proceed with its announcement that it will consider a legislative fix to this tax inefficiency, five options are available from which to choose the optimal. • B Sc LLb (Mon) LLM (Syd) Grad Dip Securities Analysis FTIA F Fin, Senior Lecturer, Atax Faculty of Law UNSW

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