



Australian Energy Regulator

Implications of ownership structures on tax paid by regulated entities

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McGrathNicol



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Disclaimer

This Report has been prepared for the Australian Energy Regulator (“AER”) in accordance with the Order for Services for the provision of a report on the corporate structures of the gas and electricity networks the AER regulates.

In accordance with our usual practice, McGrathNicol expressly disclaims all responsibility to any person or entity other than the AER for any reliance on the content of this Report.

The information in this report may not include all possible or relevant information in relation to the matter we have been instructed to review. Whilst every effort has been made to ensure the information contained in this report is accurate, McGrathNicol accepts no responsibility if the information ultimately turns out to be incorrect or not applicable. We note that, in issuing the report, McGrathNicol is not certifying we have identified all relevant information. We have sought to identify relevant information but provide no assurance that all such information has been identified.

We note that McGrathNicol are not taxation or legal experts. Accordingly, the contents of this report should not be construed as taxation or legal advice and we are not able to comment on potential changes to Australian Corporations Law or Australian Tax Law that may arise due to current reviews.

The documents used to support our findings have been identified throughout the report.

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1 Executive summary

1.1 Background and scope

The AER's Consumer Challenge Panel ("CCP") has made a submission to the AER questioning whether the regulated tax allowance provided by the AER properly reflects the likely tax paid by the benchmark efficient entity.

The Australian Energy Regulator ("AER") is currently undertaking a detailed review into the tax allowance and the tax paid by regulated electricity and gas businesses ("regulated businesses"). To assist this review, the AER sought a high level review from McGrathNicol on how the various corporate ownership structures of the gas and electricity businesses the AER regulates may impact on the actual tax paid by the regulated entities.

In accordance with our Order for Services with the AER, McGrathNicol was engaged to undertake a review that:

- provides an overview of the corporate ownership structures of the gas and electricity network businesses that the AER regulates;
- provides a summary and discussion / comment on the patterns of observations on:
 - The level of publicly available information on actual tax paid;
 - The type of entity structures identified, such as stapled structures;
 - The existence of trust vehicles within the group structure;
 - If the group or related entities pay income tax equivalents;
 - If deferred tax assets are utilised by the business or group;
 - Whether tax paid is consistent with the corporate tax rate;
 - The existence of carried forward tax losses; and
 - The existence of intra group loans;
- discusses any current reviews into this issue and potential changes to Australian Corporations Law or Australian Tax Law that may result from any such review;
- discusses what implications the structures may have on the actual tax paid by the regulated entity and where this might cause actual tax paid to materially differ from the regulated tax allowance; and
- provides general advice on what information is required to assess the material drivers of the difference between actual tax paid and the regulated tax allowance in the next stage of the review. This should include a recommendation on whether the AER should seek additional expert tax advice, and (if required) comments on the scope of that advice.

Analysis in respect of the above elements was to be based on information available up to 30 June 2017.

The review has been undertaken using publicly available information and information provided to McGrathNicol by the AER. It is important to note that we are Chartered Accountants with expertise in reviewing financial statements for group entities, but we are not taxation or legal experts. Accordingly, in this report we do not provide taxation or legal advice.

1.2 Overview of ownership structures

We identified the following ownership structures for the 32 regulated businesses reviewed:

- Nine appear to be part of an Australian owned group;
- 17 appear to be foreign controlled; and
- Six appear to be owned by a State / Territory government.

From our review of available corporate and financial information for the regulated businesses (and parent entities where applicable), we make the following observations regarding structure / taxation approach issues that may impact on the tax payable by a regulated business:

	Number of regulated businesses this applies to	Unclear from information available
Utilise a stapled structure	6 (19%)	26 (81%)
Use trusts in the corporate structure	9 (28%)	23 (72%)
Utilise carried forward losses (either the regulated business or a parent entity)	11 (34%)	21 (66%)
Tax payable is impacted by deferred tax (for either the regulated business or a parent entity)	22 (69%)	10 (31%)
Intragroup loans identified	12 (38%)	20 (62%)

In addition to the above, based on a review of income statements set out in the regulated businesses' Regulatory Information Notices ("RINs"), we found that:

- the statutory income tax expense appeared to be reasonably consistent with the Australian company tax rate of 30% (which is also the regulated tax allowance) in all three years reviewed for six of the 32 regulated businesses;
- the statutory income tax expense appeared to be reasonably consistent with the Australian company tax rate of 30% in one or two years, but not all three years reviewed for 10 of the 32 regulated businesses;
- the statutory income tax expense appeared to be inconsistent with the Australian company tax rate of 30% in all three years reviewed for nine of the 32 regulated businesses (noting that three regulated businesses reported zero statutory income tax expense in all three years); and
- there was insufficient information available to determine consistency of statutory income tax expense for seven of the 32 regulated businesses (where RIN income statements were not available for review).

1.3 Challenges comparing statutory income tax expense to the regulated tax allowance

Our review of the tax information disclosed by regulated businesses highlights that for a significant number of businesses there is likely to be difference between tax actually paid and the regulated tax allowance.

There are a number of reasons why this may occur, including:

- Ownership structures that result in tax payable being passed through to other entities or owners;
- Tax consolidation arrangements which result in tax being paid by other entities in the corporate group;
- Application of deferred tax;
- Utilisation of carried forward tax losses; and
- Differences between statutory income tax expense determined in accordance with the regulated businesses accounting policies and procedures (as reflected in the RINs) and tax actually payable in accordance with ATO requirements and taxation legislation.

As a result of the above, it may be reasonable for the tax paid by a regulated business to fluctuate significantly from one year to another.

Whilst the intention of this McGrathNicol review is only to provide general background information and guidance on implications of ownership structures on tax paid, it is clear that there are a number of challenges comparing tax paid to the regulated tax allowance. These challenges include:

- Lack of available information – this includes regulated businesses not reporting tax paid in their RIN income statements (potentially due to difficulty allocating tax to the regulated businesses where it part of a group with other operating entities), and RIN information capturing statutory income tax expense in accordance with the

accounting policies and procedures used to prepare its audited statutory accounts, but not actual tax paid to the ATO;

- The tax position of a businesses can very complex, and require specific taxation expertise to understand;
- Whilst audited financial statements often provide detailed taxation notes explaining the tax position, as a number of the regulated businesses do not prepare audited financial statements for the regulated entity (as they are part of a larger group), this detailed information is not available for the regulated business; and
- Use of tax consolidated groups - which make it difficult to extract the tax payable by a regulated business from other entities in the tax consolidated group.

1.4 Further action the AER may wish to consider

Noting the challenges set out above, there appears to be opportunity for the AER to obtain a better understanding of the tax paid by the regulated businesses by:

- Requesting additional information from the regulated businesses regarding the tax paid directly by the business (or indirectly by a related business); and
- Engaging a taxation expert to undertake a comprehensive review of the tax paid by the regulated businesses.

1.5 Recent reviews of tax implications of corporate structures

Based on information available publicly at 30 June 2017, we conducted a high level review of relevant information sources (including reviews and announcements by the ATO and other Government departments, federal budget announcements and court orders and judgements) to identify relevant regulatory reviews or other reforms that were recently conducted, including potential changes to Australian Corporations Law and Australian Tax Laws.

The following matters were identified based on our review of relevant information sources:

- ATO review of fragmenting businesses to re-characterise trading income as passive income;
- ATO treatment of privatisation of infrastructure;
- Australian Government multinational anti-avoidance law changes;
- Australian Government foreign investment regime;
- Australian Government Treasury Stapled Structured Consultation Paper;
- Corporate tax rate changes;
- Recent cases and ATO rulings in respect of Spark Infrastructure, AusNet, and other relevant matters; and
- The recent privatisation or sale transactions of TransGrid, AusGrid and Endeavour Energy.

Although we are not taxation or legal experts, we highlight that the above matters may have broad implications for electricity and gas businesses regulated by the AER. For example:

- The ATO and Australian Government Treasury's recent review activities targeting stapled structures may increase the risk that regulated businesses utilising these structures will be subject to tax rulings or that certain deductions may be disallowed. To mitigate this risk, regulated businesses that utilise these structures may adopt structures which are less easily identifiable to minimise their tax burden. Based on the information we have available, some of the regulated businesses we have reviewed may be impacted.
- The Australian Government established the Critical Infrastructure Centre to proactively address risks of foreign ownership of critical infrastructure. We highlight that a number of regulated businesses have foreign parent entities and/or shareholders and therefore may be impacted by this regime.
- The Australian Government intends to reduce the corporate tax rate from 30% to 25%. This reduction will apply at different rates depending on an entity's annual turnover. We note that while the regulated businesses we reviewed are sufficiently large that it is unlikely they will benefit substantially from these concessions, this taxation reform may incentivise regulated businesses to utilise fragmented corporate structures to bring turnover under the relevant thresholds and therefore take advantage of reduced corporate tax rates.

Please refer to section 4, in which we have provided further information in respect of recent regulatory reviews and other reforms and their implications for regulated network businesses.

2 Background and scope

2.1 Introduction

The AER is responsible for the regulation of energy markets and networks under national energy market legislation and rules. Its functions include:

- monitoring wholesale electricity and gas markets to ensure energy businesses comply with the legislation and rules, and taking enforcement action where necessary;
- setting the amount of revenue that electricity and gas network businesses (“regulated businesses”) can recover from customers for using networks (electricity poles and wires and gas pipelines) that transport energy;
- regulating retail energy markets in Queensland, New South Wales, South Australia, Tasmania (electricity only) and the ACT;
- operating the Energy Made Easy website, which provides a retail price comparator and other information for energy consumers; and
- publishing information on energy markets, including the annual “State of the Energy Market” report, to assist participants and the wider community.

The AER is reviewing the corporate ownership structures of the gas and electricity network businesses it regulates and the implications of these structures on tax paid.

2.2 Background

A number of consumer groups and individuals have raised concerns with the AER regarding the level of profitability of the regulated businesses. A consistent argument from consumer groups has been that the building block framework may overcompensate regulated businesses and enable them to earn super profits, or returns above what would be expected given the risk to the businesses. The AER’s Consumer Challenge Panel (“CCP”) has made a submission to the AER questioning whether the tax allowance provided by the AER properly reflects the likely tax paid by the benchmark efficient entity.

The AER is currently conducting a detailed review into the tax allowance and the tax paid by regulated businesses. To assist this review, the AER sought a high level review from McGrathNicol on how the various corporate ownership structures of the gas and electricity businesses the AER regulates may impact on the actual tax paid by the regulated entities.

McGrathNicol are not taxation experts. However, the AER approached McGrathNicol to undertake this review due to our familiarity with the ownership structures and financial reporting of regulated businesses, and access to documentation gathered through our recent engagement with the AER to undertake a scoping study into profitability measures for regulated businesses.

2.3 Scope

In accordance with our Order for Services with the AER, McGrathNicol was engaged to undertake a review that:

- provides an overview of the corporate ownership structures of the gas and electricity regulated businesses that the AER regulates;
- provides a summary and discussion / comment on the patterns of observations on:
 - The level of publicly available information on actual tax paid;
 - The type of entity structures identified, such as stapled structures;
 - The existence of trust vehicles within the group structure;
 - If the group or related entities pay income tax equivalents;
 - If deferred tax assets are utilised by the business or group;
 - Whether tax paid is consistent with the corporate tax rate;
 - The existence of carried forward tax losses; and
 - The existence of intra group loans;

- discusses any current reviews into this issue and potential changes to Australian Corporations Law or Australian Tax Law that may result from any such review;
- discusses what implications the structures may have on the actual tax paid by the regulated entity and where this might cause actual tax paid to materially differ from the regulated tax allowance; and
- provides general advice on what information is required to assess the material drivers of the difference between actual tax paid and the regulated tax allowance in the next stage of the review. This should include a recommendation on whether the AER should seek additional expert tax advice, and (if required) comments on the scope of that advice.

Analysis in respect of the above elements was required to be based on information available up to 30 June 2017. The review has been undertaken using publicly available information and information obtained from the AER.

2.4 Limitations

In respect of this report, it is important to note the following:

- We are Chartered Accountants with expertise in reviewing financial statements for group entities, but we are not taxation experts. Accordingly, we do not provide taxation advice in this report.
- We are not taxation or legal experts, and as a result we are not able to comment on potential changes to Australian Corporations Law or Australian Tax Law that may arise due to current reviews that have been outlined in Section 4 of this report.

2.5 Sources of information

In preparing this report, we have relied on the following sources of information:

- Information provided by the AER;
- Information that is publicly available, including:
 - Information on the AER's website;
 - Information on the Australian Taxation Office's ("ATO") website;
 - Company websites for regulated entities and their related entities;
 - Australian Stock Exchange announcements; and
 - Case legislation.

3 Overview of corporate ownership structures of the gas and electricity network businesses and implications on tax paid

3.1 Available information

The information available to us to undertake this review is detailed at section 2.5 above, and includes both publicly available information and confidential information provided by the businesses to the AER.

Information available for our review included:

- RIN income statements for 25 of the regulated businesses, noting that for the period reviewed some gas transmission businesses were not required to provide a RIN income statement to the AER;
- Audited financial statements (for at least one financial year ended in 2014, 2015 or 2016) for 17 of the regulated businesses; and
- At least some parent or group audited financial information for 20 of the regulated businesses.

Limitations in respect of the available information include:

- Whilst the RIN financial information required to be prepared by some regulated businesses includes an income statement, we found that often information is only populated to the Net Profit before Tax level, with no disclosure of tax payable by the regulated business. This may be due to difficulty allocating tax to the regulated businesses where it part of a group with other operating entities;
- Where tax information is disclosed, typically the RIN information does not include information explaining how this tax information has been generated (and if applicable, what assumptions have been made in estimating figures); and
- A number of regulated businesses are not reporting entities and do not prepare financial statements. Accordingly, whilst audited financial statements often provide detailed taxation notes explaining the tax position, as a number of the regulated businesses do not prepare audited financial statements (as they are part of a larger group), this detailed information is not available for a number of the regulated business.

Our comments in Sections 3.2 to 3.11 are based on our review of the information available to us for the 2014 to 2016 financial years for the businesses.

3.2 Ownership structures identified

We identified the following ownership structures for the 32 regulated businesses reviewed:

Number of regulated businesses that appear to be stand-alone, non-Government owned entities.	0 (0%)
Number of regulated businesses that appear to be part of an Australian owned group	9 (28%)
Number of regulated businesses that appear to be majority foreign owned.	17 (53%)
Number of regulated businesses that appear to be majority owned by a state / territory government, and pay income tax equivalents.	6 (19%)
Total	32 (100%)

3.3 Tax consolidated groups

From our review we found that a number of regulated businesses are part of tax consolidated groups for tax purposes.

The group allocation method is primarily used where a tax consolidated group prepares a tax return directly on a consolidated basis.

The separate taxpayer within group method of tax consolidation allocates tax to members of a tax-consolidated group using a separate tax calculation for each entity in the group. Entities can choose whether deferred taxes are calculated with reference to the carrying amount of assets in the each member's separate financial statements, or the consolidated figures. This method also requires adjustment for transactions occurring between members of the consolidated group that do not give rise to tax.

The standalone taxpayer approach allocates the consolidated current and deferred taxes to members of the tax-consolidated group as if each member entity in the group were a taxpayer in its own right. Under this method, transactions between members of the tax-consolidated group are subject to tax. This means that each member is allocated tax which would reflect the notional tax payable if the entity were not a member of a tax-consolidated group.

The grouping of entities for tax purposes can have a significant impact on the tax payable by a regulated business. Depending on the approach, it can make it harder to discern the tax payable by the individual regulated business.

In the table below, we have provided a summary of the tax consolidation methods that appear to be used by the regulated businesses.

Number of regulated businesses that appear to use the group allocation method.	7 (22%)
Number of regulated businesses that appear to use the separate taxpayer within group method of tax consolidation.	7 (22%)
Number of regulated businesses that appear to use the standalone taxpayer approach.	9 (28%)
Number of regulated businesses where it is unclear from the information available what approach to tax consolidation is used.	9 (28%)
Total	32 (100%)

3.4 Stapled structures

A stapled security structure consists of two or more securities which are contractually bound together and are not able to be separately traded. Typically, a company and a trust or a debt and equity investment may be stapled.

We identified two main types of stapled structures utilised within regulated entities:

- stapled structures where the company rents assets from the trust and rent payments are claimed as a deduction ("Leasing Stapled Structures"), reducing the tax payable; and
- stapled structures where the company borrows money from the trust and interest payments are claimed as a deduction ("Loan Stapled Structures"), reducing the tax payable.

Based on review of available information:

Number of regulated businesses that appear to utilise stapled structures	6 (19%)
Number of regulated businesses that do not appear to utilise stapled structures	26 (81%)
Total	32 (100%)

3.5 Trusts

A trust is a structure where an obligation is imposed on a person or other entity to hold property for the benefit of beneficiaries.

Trusts may be considered to be a structure associated with favourable taxation benefits. This is because tax is not actually paid by the trust itself, but the income is passed through to the beneficiaries of the trust. Whether tax is actually payable on the income will often depend on the circumstances of the beneficiary (including where it is domiciled, whether it is able to utilise carried forward tax losses, or apply any distributed profits to current year losses).

Based on review of available information:

Number of regulated businesses that appear to use trusts in their corporate structure	9 (28%)
Number of regulated businesses that do not appear to use trusts in their corporate structure	23 (72%)
Total	32 (100%)

3.6 Deferred tax

Deferred tax assets or liabilities arise as a result of the treatment of temporary differences between accounting and taxation carrying amounts. A deferred tax liability indicates that, in the future, the entity will pay more income tax resulting from a transaction that occurred in the current year, particularly revaluation of assets and adjustments for foreign currency movements. A deferred tax asset indicates that, in the future, the entity will be able to receive a tax deduction as a result of a transaction that occurred in the current year.

Certain structures may be put in place to take advantage of deferred tax provisions. Given the complexity around deferred tax, specific investigations may be required to be undertaken in relation to the underlying transactions giving rise to the deferred tax position.

Deferred tax positions may ultimately unwind and the tax may become payable.

Based on review of available information:

Number of regulated businesses (including parent entities) that appear to have reduced tax payable through use of deferred tax positions	22 (69%)
Number of regulated businesses where it is unclear from the information available whether deferred tax positions have been utilised by the regulated businesses and / or their parent entities	10 (31%)
Total	32 (100%)

3.7 Carried forward losses

When required conditions are met, entities are able to apply group carried forward losses from prior years to reduce tax payable in the current year.

Where regulated entities have large balances of carried forward losses which have been applied to current year profits for multiple consecutive years, the ATO may investigate the source of these losses and whether they comply with the rules regarding use of carried forward tax losses, including the continuity of business and continuity of ownership tests.

Based on review of available information:

Number of regulated businesses (including parent entities) that appear to have utilised carried forward tax losses in any of the past three financial years (to the business' 2016 year end).	11 (34%)
Number of regulated businesses where it is unclear from the information available whether carried forward tax losses have been utilised by the regulated business or its parent entities.	21 (66%)
Total	32 (100%)

3.8 Intragroup loans

Interest rates on intragroup loans may not always reflect market rates that arms-length third parties would agree to when considering allowances paid. It appears that the ATO is actively investigating what level of interest deductions are allowable as discussed in section 4.8 below.

When intragroup loans fall outside tax consolidated groups, interest deductions for loans within the group can be used as a method of reallocating profits between entities which are subject to different taxation treatments or rates.

Based on review of available information:

Number of regulated businesses that appear to have intragroup loans	12 (38%)
Number of regulated businesses where it is unclear from the information provided whether there is intergroup loans between the regulated business and related entities	20 (63%)
Total	32 (100%)

3.9 Tax paid compared to the regulated tax allowance

From the financial information available we sought to identify tax payable by regulated businesses.

In the table below we have set out the results of our review of the consistency of statutory income tax expense with the corporate tax rate of 30%, based on the income statement in RIN information submitted to the AER by the regulated businesses. The income statements in the RIN are required to be prepared in accordance with the accounting policies and procedures used to prepare the regulated businesses' audited statutory accounts.

Number of regulated businesses that appeared to record statutory income tax expense that was reasonably consistent ¹ with the corporate tax rate in each of the three years reviewed.	6 (19%)
Number of regulated businesses that appeared to record statutory income tax expense that was reasonably consistent with the corporate tax rate in one or two of the years reviewed, but not all three.	10 (31%)
Number of regulated businesses that did not appear to record statutory income tax expense that was reasonably consistent with the corporate tax rate for any of the three years reviewed.	9 (28%)
Number of regulated businesses for which there was insufficient information to assess whether the recorded statutory income tax expense was reasonably consistent with the corporate tax rate (RIN income statements not available).	7 (22%)
Total	32 (100%)

It is noted that tax payable for accounting purposes may not be consistent with tax actually paid. Whilst audited financial statements were available for some of the regulated businesses, the financial statements highlight that the tax payable as per the statement of financial performance generally does not simply agree to the actual tax paid in the following year as per the statement of cash flows. There are a number of differences between statutory accounting and tax reporting (including useful lives for assets which impact depreciation expense for accounting and tax purposes). Accordingly, it is unlikely that accounting tax payable for a year will equal the actual amount of tax that will need to be paid.

We also reviewed financial information available for the parent entities of the regulated businesses. From this review we note that:

- Audited financial statements showing net profit before tax and income tax expense was available for some but not all parent entities;
- For a number of parent entities the percentage rate of tax payable fluctuates significantly between years; and
- There are a number of adjustments impacting on the tax payable for accounting and tax purposes, that mean it is rarely as simple as applying the corporate tax rate to the net profit before tax to determine tax payable for the regulated businesses and their parent entities.

3.10 Challenges in comparing tax paid to the regulated tax allowance

It is our understanding that the regulated tax allowance in the AER's building block framework² is consistent with the Australian company tax rate of 30% (which applied for 2014 to 2016 financial years, covering the period over which financial information for the regulated businesses was reviewed).

¹ For the purposes of this review, reasonably consistent was considered to be within 5% of the corporate tax rate of 30% (i.e. 25% to 35%).

² Based on the AER's Consumer guide to Victorian electricity distribution pricing review, 2016-20 (May 2015), the building block model is a tool used by the AER to set the annual revenue allowance of a regulated business by spreading the capital expenditure of a business

Our review of the tax information disclosed by regulated businesses in their financial information (refer to Section 3.9 above), highlights that for a significant number of businesses there is likely to be a difference between tax actually paid and the regulated tax allowance.

As discussed above, there are a number of reasons why this may occur, including:

- Ownership structures that result in tax payable being passed through to other entities or owners;
- Tax consolidation arrangements which result in tax being paid by other entities in the corporate group;
- Differences between tax payable determined in accordance with accounting standards and tax actually payable in accordance with ATO requirements and taxation legislation;
- Application of deferred tax assets; and
- Utilisation of carried forward tax losses.

As a result of the above, it may be reasonable for the tax paid by a regulated business to fluctuate significantly from one year to another.

Whilst the intention of this McGrathNicol review is only to provide general background information and guidance on implications of ownership structures on tax paid, it is clear that there are a number of challenges comparing tax paid to the regulated tax allowance. These challenges include:

- Lack of available information – this includes regulated businesses not reporting tax expense in their RIN income statements (potentially due to difficulty allocating tax to the regulated businesses where it part of a group with other operating entities), and RIN information capturing tax expense in accordance with the accounting policies and procedures used to prepare the regulated businesses' audited statutory accounts, but not actual tax paid to the ATO;
- The tax position of a businesses can very complex, and require specific taxation expertise to understand;
- Whilst audited financial statements often provide detailed taxation notes explaining the tax position, as a number the regulated businesses do not prepare their own audited financial statements (as they are part of a larger group), this detailed information is not available for the regulated business; and
- Use of tax consolidated groups - which make it difficult to extract the tax paid by a regulated business from other entities in the tax consolidated group.

3.11 Further action that could be considered to better understand the tax paid by the regulated businesses

Noting the challenges set out at Section 3.10 above, there appears to be opportunity for the AER to obtain a better understanding of the tax paid by the regulated businesses by:

- Requesting additional information from the regulated businesses regarding the tax paid directly by the business (or indirectly by a related business); and
- Engaging a taxation expert to undertake a more comprehensive review of the tax paid by the regulated businesses.

Undertaking the above may assist the AER in informing its review of the appropriateness of the regulated tax allowance.

over time. The building block model ensures that the regulated business is able to pay back its lenders, with interest, and provide its investors with a reasonable rate of return on their investment (given the relative risk of the business compared to other investments).

4 Current reviews of tax implications of corporate ownership structures

4.1 Overview

Based on information available publicly at 30 June 2017, we conducted a high level review to identify relevant regulatory reviews or other reforms that were recently conducted, including potential changes to Australian Corporations Law and Australian Tax Laws. We have sought to provide information below on the impacts this is likely to have on the regulated businesses. We have used the following sources to identify this information:

- recent reviews and other activity undertaken by the ATO;
- recent reviews and announcements from other Government departments;
- federal budget announcements; and
- court orders and judgements.

As discussed in the limitations section, we note that we are not taxation or legal experts.

4.2 ATO review of fragmenting businesses to re-characterise trading income as passive income

4.2.1 Background

On 31 January 2017 the ATO issued Taxpayer Alert TA2017/1³. This alert advised that the ATO is reviewing arrangements which attempt to artificially separate an integrated business operation to re-characterise trading income into passive income. This has the effect of diverting income from a corporation to a flow-through trust in order to avoid paying tax at the corporate tax rate.

The review largely focused on situations where there are stapled structures or other trust relationships where the corporate entity is claiming deductions for payments to the related party trust.

Where the ATO identifies structures meeting the categories outlined in Section 4.2.2 below, the ATO is engaging with taxpayers to explore the arrangements and ensure they do not seek to avoid the payment of corporate tax.

4.2.2 Structures impacted

The ATO have advised that the arrangements under review include:

- Finance staple – where equity advanced to the operating entity by the trust is characterised as debt and deductions are claimed for the interest repayments;
- Synthetic equity staple – the operating entity pays an amount equivalent to turnover or profit to the asset trust and claims a deduction for this amount;
- Royalty staple – the operating entity pays royalties to the asset trust for use of its assets and claims a tax deduction for these payments. Distributions from the trust to non-resident investors are subject to royalty withholding tax at capped rates under treaties where applicable; and
- Rental staple – assets owned by the trust are leased to the operating entity at terms that an arms-length party would not usually enter into.

4.2.3 Potential impacts on regulated businesses

We consider that the ATO's review of these structures is likely to have the following impacts:

- regulated businesses may be discouraged from utilising the above structures due to potential ATO scrutiny;
- regulated businesses utilising these structures run a risk of being subject to tax rulings disallowing tax deductions; and
- regulated businesses may develop new structures to minimise tax payments which are less easily identifiable.

From the information we have available, it is not clear whether any of the regulated businesses have a structure that might be of concern to the ATO.

³ <https://www.ato.gov.au/law/view/document?DocID=TPA/TA20171/NAT/ATO/00001>

4.3 ATO treatment of privatisation of infrastructure

4.3.1 Background

The Privatisation and Infrastructure – Australian Federal Tax Framework (January 2017 draft) (“the Framework”) outlines situations where the ATO will not apply the resources of the ATO’s compliance team to review stapled structures formed when privatising a government business (i.e. situations where the ATO is satisfied the structure is not likely to lead to tax avoidance activity).

This document provides a “road map” for setting up structures when privatising infrastructure businesses and how tax should be paid. The suggested structure involves an operating trust and an asset holding trust.

4.3.2 Structures not impacted

The ATO have advised the following privatisation structures will not be the focus of compliance reviews provided they utilise the prescribed structures and tax treatments:

- land rich government businesses being privatised;
- a long term lease of government assets granted to a consortium in exchange for a lease premium;
- disposal of non-land assets to a consortium for consideration;
- assets acquired above are used to run the privatised business; and
- in some cases, agreeing to upgrade or expand the assets during the lease.

The ATO prescribes that the stapled structure should be treated as a single unified business for tax purposes.

4.3.3 Potential impacts on regulated businesses

The Framework provides an example structure for infrastructure businesses to use when pursuing the privatisation process and outlines a number of structures which create potential concerns/focus for the ATO. It is unclear whether the ATO will focus on the use of these structures for new businesses only or also include reviews of existing businesses.

Regulated businesses utilising structures that the ATO has concerns with may be more likely to be engaging in tax minimisation activity. From the information we have available, it appears that some of the regulated businesses which use stapled structures we have reviewed may fall into these categories, however further information would be required to confirm this.

4.4 Australian Government multinational anti-avoidance law changes

On 9 May 2017, as part of the 2017-2018 federal budget announcements, the federal government announced it would enhance the multinational anti-avoidance law so that it applies to:

- corporate structures that involve the interposition of partnerships with foreign resident partners;
- trusts that have foreign resident trustees; and
- foreign trusts that temporarily have central management and control in Australia⁴.

This will negate the use of foreign trusts and partnerships in corporate structures to circumvent the multinational anti-avoidance law.

The legislation for these changes has not yet been released. However, should it become law, there may be a number of foreign-owned regulated businesses impacted.

⁴ <http://budget.gov.au/2017-18/content/bp2/html/ p.39>

4.5 Australian Government foreign investment regime

As part of the 2017-2018 federal budget announcements, the Australian Government announced it would undertake further work to streamline and enhance the foreign investment regulatory framework to reduce complexities and regulatory burdens.⁵

The Critical Infrastructure Centre has also been established to proactively address risks of foreign ownership of critical infrastructure.

A number of regulated businesses have foreign parent entities and/or shareholders and therefore may be impacted by the regime.

4.6 Australian Government Treasury Stapled Structures Consultation Paper

The Australian Government Treasury sought stakeholder views on policy options to address issues that arise in relation to stapled structures. Submissions closed on 20 April 2017 but had not yet been published at 30 June 2017⁶.

It is considered likely that any reform will remove some of the tax advantages of stapled arrangements. Some of the options raised in the paper include:

- disallowing certain deductions for cross-staple payments;
- taxing the recipient of cross staple payments at the corporate tax rate; and
- treating stapled entities as a consolidated tax group.

This may reduce the benefits of stapled structures for those regulated businesses with stapled arrangements.

4.7 Corporate tax rate changes

4.7.1 Background

The federal government announced in its 2016-17 budget that it intends to reduce the corporate tax rate in stages from 30 to 25 percent⁷. These reductions will apply at different rates depending on the entity's annual turnover.

4.7.2 Structures impacted

In structures where the operating entity is a corporate entity this will reduce the tax payable. Lower corporate tax rates will apply to corporate tax groups with smaller turnovers, however most of the providers are sufficiently large that they will not benefit substantially from these concessions.

4.7.3 Potential impacts on regulated businesses

This reform will:

- reduce the corporate tax payable, slightly reducing the benefit of tax avoidance activities. This reduced rate remains higher than the tax paid in certain tax minimisation structures and is unlikely to deter this practice; and
- provide an incentive for smaller businesses and potentially the utilisation of fragmented corporate structures (where not treated as a consolidated tax group) to bring turnover under the relevant thresholds to take advantage of reduced corporate tax rates.

If the corporate tax rate changes, the AER may need to revise the tax allowance component of the building block framework.

4.8 Recent cases and ATO rulings

4.8.1 Spark Infrastructure

The ATO and Spark Infrastructure reached a settlement agreement with the ATO in June 2015 regarding the deductibility of interest on subordinated loans to Victoria Power Networks ("VPN") and SA Power Networks ("SAPN") (which it held 49% interest in). The key aspects of the settlement are:

⁵ <http://budget.gov.au/2017-18/content/bp2/html/ p.32>

⁶ <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2017/Stapled-Structures>

⁷ <https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Reducing-the-corporate-tax-rate/>

- the ATO refunded approximately \$39 million of payments made by VPN;
- VPN to cancel deductions and losses of \$187 million for prior tax years;
- Spark Infrastructure will cancel \$82 million in net losses distributed to it by SAPN for prior tax years;
- Deductible interest rates have been agreed with the ATO for the 2015 to 2017 income years and will be negotiated with the ATO for subsequent income years; and
- no penalties were imposed.⁸

4.8.2 AusNet

In 2015 AusNet lost a preliminary decision and subsequent appeal in relation to whether certain statutory charges in the amount of \$177 million were deductible expenses or payments of a capital nature. These charges were held to be payments of a capital nature. This led to an \$89.7 million liability comprising \$54 million primary tax plus \$35.7 million interest.⁹

4.8.3 Other relevant cases

We have set out in the table below recent cases that do not involve regulated businesses, but involve taxation implications of corporate structures.

Table 4: Other relevant cases identified

Matter	Issue	Outcome
Orica Ltd v Commissioner of Taxation [2015] FCA 1399	Schemes involving deductions for interest payments in Australia offset against pre-existing US tax losses.	IVAA anti-avoidance rules and shortfall penalties upheld.
Chevron Australia Holdings v Commissioner of Taxation [2017] FCAFC 62	The ATO raised a transfer pricing assessment in relation to Chevron's pricing for related party loans at interest rates significantly higher than the cost of capital was challenged by the ATO. Chevron sought to challenge this assessment.	The assessment was upheld as Chevron was unable to demonstrate the rates were what an arms-length rate would have been.
Channel Pastoral Holdings v Commissioner of Taxation [2015] FCAFC 57	Clarification of the interaction between Pt IVA of the Income Tax Assessment Act 1936 and the tax consolidation provisions was sought in relation to a scheme which involved an entity which, joined a tax consolidated group as a subsidiary member.	The Court held the Commissioner could apply Part IVA to the scheme by including an amount in the assessable income of the subsidiary member.

4.8.4 Summary of findings

The recent cases above highlight the ATO's current focus on schemes to avoid paying income tax. Each of the cases above resulted in an increase in the amount payable to the ATO.

4.9 Privatisation/sale transactions

4.9.1 TransGrid

In November 2015, the NSW Government announced a 99 year lease of 100% of TransGrid to NSW Electricity Networks, comprised of a consortium of investors.

4.9.2 AusGrid

In October 2016 the NSW Government leased 50.4% of Ausgrid to a consortium of investors. The government will retain a 49.6% interest in the assets.

⁸ www.asx.com.au/asxpdf/20150619/pdf/42z8r866tg9sgw.pdf

⁹ AusNet Transmission Group Pty Ltd v Federal Commissioner of Taxation [2015] HCA 25; ASX & SGX-ST Release re AusNet appeal - ATO Dispute S.163AA (5 August 2015); AusNet Services Statutory Annual Report 2015 p. 118.

4.9.3 Endeavour Energy

On 14 June 2017 a consortium of long-term investors purchased a 50.4% interest in a 99 year lease of Endeavour Energy.

The remaining 49.6% is leased by the State of New South Wales.

4.9.4 Potential implications of recent privatisation/sale transactions

Our understanding is that the privatised businesses will no longer pay income tax equivalents, but the businesses may be required to pay Australian company tax.

Limited information is currently publicly available regarding the structures implemented as part of the above leases. The structures implemented will become clearer as annual reports and other financial information post the lease become available.

APPENDIX A: List of electricity and gas regulated businesses

Regulated business	Sector	Segment
ActewAGL Distribution Partnership	Electricity	Distribution
AusGrid	Electricity	Distribution
AusNet Electricity Services Pty Ltd (Distribution)	Electricity	Distribution
AusNet Services (Transmission) Ltd	Electricity	Transmission
CitiPower Pty Ltd	Electricity	Distribution
Directlink	Electricity	Distribution
ElectraNet Pty Ltd	Electricity	Transmission
Endeavour Energy	Electricity	Distribution
Energex Limited	Electricity	Distribution
Ergon Energy	Electricity	Distribution
Essential Energy	Electricity	Distribution
Jemena Electricity Networks (Vic) Ltd	Electricity	Distribution
Murraylink Transmission Company Pty Ltd	Electricity	Distribution
Powercor Australia Ltd	Electricity	Distribution
Powerlink	Electricity	Transmission
SA Power Networks	Electricity	Distribution
Tasmanian Networks Pty Ltd	Electricity	Transmission
Tasmanian Networks Pty Ltd	Electricity	Distribution
Transgrid	Electricity	Transmission
United Energy Distribution Pty Ltd	Electricity	Distribution
ActewAGL Distribution Partnership	Gas	Distribution
APA GasNet Australia (Operations) Pty Ltd	Gas	Transmission
APT Pipelines (NT) Pty Ltd	Gas	Transmission
AusNet Gas Services Pty Ltd	Gas	Distribution
Australian Gas Networks (Albury) Ltd	Gas	Distribution
Australian Gas Networks Ltd (SA)	Gas	Distribution
Australian Gas Networks (Vic) Pty Ltd	Gas	Distribution
Central Ranges Pipeline Pty Ltd	Gas	Distribution
Central Ranges Pipeline Pty Ltd	Gas	Transmission
Jemena Gas Networks (NSW) Ltd	Gas	Distribution
Multinet Gas Distribution Partnership	Gas	Distribution
APT Petroleum Pipelines Pty Ltd	Gas	Transmission