Australian Government
Australian Taxation Office

ATO NOTE

10 April 2018

To: Warwick Anderson, Australian Energy Regulator

Subject:	Indicative comparative analysis of the AER electricity distribution tax allowance and tax payable

Key Points

We reviewed the tax allowance data published by the Australian Energy Regulator ('AER') and the income tax return data lodged by electricity distribution businesses that the AER regulates over a four year period from 2013 to 2016.

The electricity distribution businesses we reviewed were either state owned National Tax Equivalent Regime ('NTER entities') entities or private and public owned entities ('taxpaying entities').

In general, our analysis indicates that:

- the aggregate AER tax allowance provided to taxpaying entities consistently overstated the actual tax payable by those entities; and
- the aggregate AER tax allowance provided to NTER entities consistently understated the 'notional' tax payable by those entities.

Over the four year review period the AER provided the taxpaying entities with a substantial tax allowance. However, the aggregate tax paid by these entities per their tax returns was significantly less than the tax allowance they received under the notional AER tax allowance rules.[1]

Our analysis indicates that there are several key drivers for this difference. The material drivers are as follows:

> the entity structure adopted meaning that tax may be payable at an investor level not the entity level (and potentially subject to concessional treatment at the investor level);

> deductions for interest expenses;

> available tax losses; and

> deductions for depreciation.

It should be noted that we made some assumptions and exclusions in undertaking this comparative analysis due to limitations in the data available. Where entities conduct a mixed business, or operate within a consolidated group, we have either apportioned the data on a reasonable basis where possible to attempt to isolate the electricity distribution business or excluded the entity from the aggregated amounts if the electricity distribution business could not be apportioned.

In relation to NTER entities, we suspect the reason their notional tax payable under the NTER regime is higher than their AER tax allowance is because these entities typically have more conservative tax positions. For example, they are less likely to claim accelerated R&D deductions, or have related party international dealings (as they are only permitted to borrow from State Treasury Corporations).

[1] Noting the potential for tax positions to be adjusted, i.e. the potential for amended tax assessments.

Entity structure

The AER's post-tax revenue model ('PTRM') assumes the electricity distribution business is being carried on by a company subject to a 30% corporate tax rate.

We have observed that the following entity structures are being utilised by the taxpaying entities:

- 'Stapled structures', comprising of a flow-through 'asset' trust that is stapled together with an 'operating' trust or company. The effect of these structures is that the profits that are generated in the asset trust are not taxed in the hands of trust, rather they flow through to the owners of the stapled entity and may be concessionally taxed at that level; [2]
- Company structures;
- Partnership structures. Partnership entities are not themselves taxed, with the profits of the partnership flowing untaxed to the partners. The taxation of those profits will depend on the taxation profile of the partner. Partners may not be subject to a 30% tax rate on the profits received, e.g. because they are a domestic or foreign superannuation fund, a sovereign wealth fund or located in a low tax jurisdiction.

Interest expense

An interest expense allowance is built in the AER's tax allowance calculation. In calculating the interest expense amount the AER assume the electricity distribution businesses maintain constant gearing level of 60%, with the level of debt based on business' Regulated Asset Base (RAB) and the applicable interest rate remaining constant for each pricing determination period.

Our preliminary analysis indicates that some taxpaying entities reviewed have an average gearing level above the AER's assumed gearing level. This leads to higher tax deductions being claimed for interest expenditure than the AER builds into its calculation.

In aggregate, the interest expense deduction claimed for tax purposes by the taxpaying entities reviewed appears to be larger than the interest expense allowance in the AER's regulatory models.

Available tax losses

The AER inputs carried forward losses reported to it by the electricity distribution businesses into the tax allowance model at the beginning of each five year regulatory period.

Over the review period there were several taxpaying entities that had significant tax losses carried forward that do not appear to be reflected in the AER tax allowance calculations for these entities.

Our analysis indicates that at the end of the 2016 income year, these taxpaying entities in aggregate had substantial carried forward tax loss balances available to be deducted from future assessable income in future years. We have observed that these significant tax losses have generally accumulated over several income years.

Deductions for depreciation

A depreciation expense allowance is built in the AER's tax allowance calculation. The tax depreciation deductions claimed by a number of taxpaying entities reviewed appear to be consistently higher than the AER depreciation allowance.

Our analysis suggests that possible reasons for this discrepancy are:

- The AER uses a straight line depreciation calculation whereas the taxpaying entities will typically use the diminishing value method – this method delivers higher depreciation deductions earlier in the write-off period for the asset.
- The AER uses the Commissioner's effective life determinations to calculate its depreciation allowance. Taxpaying entities often exercise their option to 'self-assess' shorter effective lives – this method delivers higher deductions for the asset over a shorter period.

[2] We note the Government's recent announcement in respect of stapled structures: see Morrison S (Treasurer), Levelling the playing field for Australian investors: Taxation of Stapled Structures, media release, Canberra 27 March 2018

- We surmise that taxpaying entities are also using the 'low-value pool' mechanism to write-off a large amount of component assets – this method enables the capital cost of those assets to be written off over several years rather than the effective lives associated with the larger composite asset.

Other factors

There are a number of other tax technical factors that we consider are likely to be driving a difference between the AER tax allowance and actual tax paid, however these factors appear to be not material in terms of their quantum.

Relevant Background

We are only able to provide limited information to you as information that is 'protected', that is, disclosed or obtained under or for the purposes of a taxation law, that relates to the affairs of an entity and that identifies, or is reasonably capable of identifying the entity cannot be divulged by the ATO to the AER.

We trust that this preliminary analysis provides a high-level comparison that helps inform the matters under review by the AER