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AER Tax Review 2018

Expert Advice

Australian Energy Regulator

26 October 2018

pwc

Ben Stonehouse
Australian Energy Regulator
Level 20, 175 Pitt St
Sydney NSW 2000

26 October 2018

Dear Ben

AER Tax Review 2018 - Expert Advice

Enclosed is the report (**Report**) of Vaughan Lindfield and Michael Davidson.

Purpose of the Report

This Report has been prepared at the request of the Australian Energy Regulator (**AER**) in accordance with our order of services with a commencement date of 9 July 2018 (**Order of Services**) and our procedures were limited to those described in that Order of Services. Specifically, and in accordance with the Order of Services, we have been engaged to:

- Determine if there is a discrepancy between the AER's tax allowance for regulated energy networks and the actual tax payments made by those energy networks;
- Assuming there is a discrepancy, identify the drivers of the tax differences; and
- Based on the identified discrepancies, recommend any changes to the AER approach to determining the estimated cost of taxation for regulatory determinations which will provide better alignment between actual tax practices and the regulatory tax approach.

Information relied upon

Our Report is based on publicly available information and specific information provided by businesses regulated by the AER in response to a voluntary request for tax information issued by the AER. We have summarised the level of participation by the Network Service Providers (**NSPs**) in responding to the AER's voluntary requests for information in Appendix D and elsewhere in the Report to the extent it was appropriate to qualify our observations. Other than as set out in this Report, we have not conducted an audit or other verification of any information supplied to us. We have assumed that the information supplied to us is accurately stated.

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Yours sincerely

Vaughan Lindfield
Partner

Michael Davidson
Partner

Contents

1	Introduction		1
	1.1	Background	1
	1.2	Scope of work	5
	1.3	Declaration regarding conflicts of interest	6
	1.4	Information reliance	6
	1.5	Qualifications	9
	1.6	Reliance on this report	9
	1.7	Assistance by colleagues	9
	1.8	Conduct of this engagement	10
2	Key observations and recommendations		11
	2.1	Tax differential	11
	2.2	Key drivers	15
3	Detailed analysis		24
	3.1	Difference between actual tax paid and the regulatory provision for tax costs	24
	3.2	Holding structures	38
	3.3	Capital expenditure and depreciation deductions	59
	3.4	Comparisons: International case studies	95
	3.5	Regulatory activity	101
	3.6	Other considerations	106
Appendix A	Glossary		112
Appendix B	Curricula Vitae		115
Appendix C	Pro forma voluntary information request and RIN		118
Appendix D	Summary of responses received		133
Appendix E	Depreciating Asset		134
Appendix F	Tax Loss Integrity Rules		138

1 Introduction

We, Vaughan Lindfield and Michael Davidson, are partners of PricewaterhouseCoopers working in the tax practice. Our curricula vitae are set out at Appendix B.

1.1 Background

The AER is the independent regulator for Australia's national energy market. The AER regulates electricity networks and natural gas pipelines by, amongst other things, setting the maximum amount of revenue they can earn.

The estimate of expected tax payments is one component taken into consideration in setting the revenue allowances for regulated electricity and gas networks (together, **energy networks**). These allowances are set using a "building block" approach where total revenue is the sum of four components:

- return on capital (to compensate investors for the opportunity cost of funds invested in the business);
- return of capital (depreciation, to return the initial investment to investors over time);
- operating expenditure (opex, to cover the day-to-day costs of maintaining the network and running the business); and
- notional cost of corporate taxation (after reducing the estimated cost of taxation by Gamma, being the value of imputation credits assumed to be received by shareholders).

The AER determines the expected cost of corporate tax in accordance with the relevant rules—that is, the National Electricity Rules (**NER**) and National Gas Rules (**NGR**). Broadly, the revenue allowance system is an incentive framework, so the energy networks retain the benefit (or detriment) where costs are lower (or higher) than expected. Changing the approach to estimating tax for regulated energy networks could therefore change the total revenue allowance for these businesses.

The AER is undertaking a review of its approach to estimating the tax allowance in regulatory determinations. The review was prompted by concerns raised by the ATO that there is a discrepancy between the AER's regulatory forecast of tax costs for energy networks, and actual tax payments made by these regulated energy networks.

In summary:

- On 10 April 2018, the ATO issued a note to the AER in relation to the "Indicative comparative analysis of the AER electricity distribution tax allowance and tax payable" (**ATO Note**).
- On 15 May 2018, the AER publicly initiated a review into the appropriateness of the regulatory tax approach by releasing an Issues Paper which provided an overview of the current regulatory tax approach, discussed the quantum of tax allowances provided to the Network Service Providers (**NSPs**) over the past 5 years, and summarised the findings from the ATO Note (**AER Issues Paper**).
- On 28 June 2018, the AER released its initial report entitled "review of regulatory tax approach" (**AER Initial Report**).
- Following release of the AER Initial Report, the AER also released two expert reports it had commissioned as part of its review:

- An expert report by Dr Martin Lally, Capital Financial Consultants Ltd (**Martin Lally Report**); and

- An expert report by McGrathNicol on how the various corporate ownership structures of the gas and electricity businesses that the AER regulates may impact on the actual tax paid by the regulated entities (**McGrathNicol Report**).

A summary of the key issues covered in each of the above publications is set out below.

1.1.1 ATO Note

The ATO Note broadly states that:

- The ATO reviewed the tax allowance data published by the 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. These businesses were either State owned National Tax Equivalent Regime (**NTER**) entities, or private and publicly owned taxpaying entities.

- The ATO analysis indicated 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.

- The ATO noted that it was limited in the advice it could provide due to tax privacy laws.

- The material drivers for this difference as identified by the ATO preliminary analysis were:

  - the entity structure adopted;

  - deductions for interest expenses;

  - available tax losses; and

  - deductions for depreciation.

- In undertaking its analysis, certain assumptions and exclusions were made by the ATO due to limitations in the data available. Specifically, where entities conduct a mixed business or operate within a consolidated group, the data was apportioned on a reasonable basis, where possible, to attempt to isolate the electricity distribution business, or where apportionment was not possible the entity was excluded from aggregate amounts.

1.1.2 AER Issues Paper

The AER Issues Paper provided an overview of:

- The current regulatory approach to determining the estimated cost of taxation and the tax allowance for the purpose of the tax building block;

- The quantum of the estimated cost of taxation and tax allowance provided to the NSPs over the past five years, split between State government owned networks and privately owned networks;

- Existing observations regarding the actual tax payments made by the NSPs, having regard to the ATO Note, and certain other publicly available information (noting the significant limitations applicable to the publicly available information); and

- The potential drivers for the discrepancy between the estimated cost of taxation and the actual tax paid by the NSPs having regard to the ATO Note and the AER's own assessment of the potential drivers.

The AER Issues Paper asked for submissions relating to information which the AER should gather for the purpose of its review into the regulatory tax approach, and the potential drivers for any discrepancy between the estimated cost of taxation and the actual tax paid by the NSPs.

1.1.3 Martin Lally Report

The AER commissioned Dr Martin Lally to provide an expert report on "Tax Payments versus the AER's Allowances for Regulated Businesses". The Martin Lally Report dated 16 June 2018 was released following the release of the AER Initial Report.

The Martin Lally Report:

1. Identifies the following three alternatives to the current approach:

    a. setting the regulatory tax allowance in accordance with actual taxes paid ("complete pass through");

    b. reducing the regulatory tax allowance to match actual taxes paid when this is less than the current allowance ("capping"); and

    c. identifying specific activities that reduce tax payments, quantifying their impact and reducing tax allowances accordingly ("targeting").

2. Dismisses the "complete pass through" approach as it could result in higher prices for consumers if the actual tax payments exceed the level allowed under the current tax allowance regime, and would encourage firms to undertake actions that raise their corporate tax payments.

3. Recommends against "capping" on the basis that it implicitly and wrongly attributes all tax shortfalls to tax minimisation behaviour.

4. Recommends against targeting tax minimisation activities as this would replicate the efforts of the ATO, be administratively complex, require the AER to monitor all ATO actions in this area, and in the case of trusts would require estimates of personal tax parameters that would be very difficult to obtain.

5. Recommends against adjusting each firm's tax allowance to reflect its actual gearing level as this would discourage potentially efficient behaviour (i.e. adopting optimal leverage for the specific firm).

6. Recommends against adjusting the AER's tax allowance for carry-forward tax losses on the basis that these tax losses arise either as a consequence of unregulated activities which are outside the remit of the AER, or as a result of tax minimisation activities which for the reasons stated in item 5 should not be targeted by the AER.

7. Recommends the AER adopt the diminishing value (**DV**) method to determining depreciation for the purposes of setting the tax allowance (rather than the straight line method currently applied) for all energy networks.

8. Concludes the merits in the AER changing its approach to effective lives of depreciating assets are weak for the reasons stated in respect of other tax minimisation activities (see item 5 above) and on the basis that it would impose a significant administrative burden to the AER.

9. Suggests that the low-value pool mechanism can likely be ignored by the AER as it is unlikely to result in any material reduction to the tax allowance, but recommends that the AER verify that most of the assets of an energy network do not cost less than $1,000.

10. Recommends that the tax allowance be adjusted to recognise uplifts to the tax values of assets on a firm-specific basis as this does not target any tax minimisation activities, would not discourage any efficient behaviour and the administrative effort would likely be small (assuming energy networks would be required to inform the AER of uplifts).

11. Recommends no change be made to the determination of the tax allowance of government-owned businesses (other than the switch to the DV method for depreciation – see item 7 above) as there are no efficiencies to incorporate.

1.1.4 McGrathNicol Report

The McGrathNicol Report notes:

- For the 32 regulated businesses reviewed, the ownership structures of those businesses included the use of stapled structures, the use of trusts in the corporate structure, utilisation of carried forward tax losses, tax payable being impacted by deferred tax and the presence of intragroup loans.

- There are a number of challenges in comparing the statutory income tax expense to the regulated tax allowance, including the lack of available information, the complexity of tax positions and the need for specific taxation expertise, and the lack of audited financial statements, or specific tax numbers, where regulated businesses form part of a larger group.

- There is an opportunity for the AER to obtain a better understanding of the tax paid by requesting additional information regarding the tax paid directly by the regulated business, and engaging a taxation expert to undertake a comprehensive review of the tax paid by the regulated businesses.

- The ATO and the Australian Government have recently undertaken a number of reviews and reforms which may have broad implications for the energy networks regulated by the AER.

- The review performed was limited in that McGrathNicol are not tax experts and have not sought to provide tax advice as part of their review.

1.1.5 AER Initial Report

The AER released an initial report on its review of the approach to estimating tax for regulated energy networks on 28 June 2018. The initial report summarises and responds to stakeholder submissions received in response to the issues paper released in May 2018.

The AER Initial Report:

- Confirmed the lack of publicly available information in relation to actual tax payments and noted that the AER would use its information gathering powers to request this information from the energy networks.

- Noted that many stakeholder submissions cautioned against changing from the current benchmark approach to an approach based on actual tax paid (i.e. a “tax pass-through

approach") as it could lead to increased consumer charges over time, and could also create windfall gains/losses at the point of transition and an incentive to shift tax between unregulated and regulated components of each business.

1.2 Scope of work

This report has been prepared to provide the AER with expert taxation advice to assist in reviewing its approach to estimating the tax allowance in regulatory determinations.

Specifically, and in accordance with the Order of Services, we have been engaged to:

1 Determine if there is a discrepancy between the AER's tax allowance for regulated energy networks and the actual tax payments made by those energy networks

2 Assuming there is a discrepancy identified in response to item 1, identify the drivers of the tax differences

3 Based on the drivers identified in response to item 2, recommend any changes to the AER's approach in determining the estimated cost of taxation to the NSPs which will provide better alignment between actual tax practices and the regulatory tax approach

As noted above, this Report serves only to provide our views on these questions based on publicly available information and the voluntary information provided by the NSPs. We will issue an Addendum to this Report to capture any additional observations as a consequence of the additional information provided by the NSPs in response to the formal RINs. In particular our Addendum will confirm whether any of the additional information received in response to the RINs impacts on our observations or recommendations in this Report. Further, our Addendum will also consider additional finance related matters which have not been considered to date given the limited time available.

The scope of our review and recommendations is limited to consideration of the actual tax practices of the NSPs and the application of this to the forecast cost of taxation included in the tax building block applied by the AER. In particular, our observations are limited to identifying the extent of, and reasons for, key differences between the calculation of the forecast cost of taxation for regulatory purposes and the actual tax outcomes for the NSPs based on the information we have been provided. Based on this, we have then recommended whether changes to the benchmark efficient entity approach in forecasting the cost of taxation could practically achieve a better alignment between the forecast and actual costs of taxation relating to the operation of the regulated business operations.

Our review does not have regard to matters of policy or the network tariff more broadly and we have not been asked to make any comment on the appropriateness or otherwise of the calculation of any other components of the regulated compensation for NSPs. In line with this, the following matters have been excluded from the scope of our review:

- calculation and application of Gamma;
- policy matters relating to the application of the tax allowance to State Owned Enterprises (including NTER entities) in the same manner as privately owned utility owners given State Owned Enterprises are not subject to Federal tax; and
- any policy matters relating to the adoption of a complete pass through of actual taxes paid which does not have regard to the application of the tax legislation. In this regard, our review is limited to considering the changes that should be made to the calculation of the forecast cost of taxation for regulatory purposes to better align the outcome with the actual tax practices of the NSPs having regard to the regulated operations.

1.3 Declaration regarding conflicts of interest

PwC is Australia's largest professional services firm and provides material taxation, financial and consulting services to the NSPs which are subject to this review across various lines of service.

Due to the specialised nature of the corporate and income tax matters relevant to this review, the tax experts have significant experience in advising businesses, investors and the public sector in respect of the ownership and operation of electricity and gas network assets.

In accepting the engagement to assist the AER on this matter, we have undertaken an assessment of any potential conflicts arising, and applied safeguards where relevant to ensure an independent assessment of the matters can be achieved. In particular,

- Vaughan Lindfield, is based in Western Australia (which does not include any network assets which are regulated by the AER) and does not, or has not, advised any of the NSPs which are subject to this review, or their investors; and

- Michael Davidson is based in New South Wales. Michael has previously provided tax advice to Spark Infrastructure and APA. In addition, he has historically been involved in the annual audit of TransGrid's financial statements from a tax perspective. Accordingly, Michael has not been involved in the review or assessment of any information relating to Spark Infrastructure, APA or TransGrid.

1.4 Information reliance

1.4.1 Information reviewed

In summary, certain information was requested from NSPs by the AER for the purposes of our investigations. These requests for information were made in the form of voluntary information requests and formal RINs.

The formal RINs were issued by the AER on 9 October 2018 with the deadline for the NSPs to respond being 26 October 2018 (being the date of this Report). Accordingly, in preparing this Report, we have only relied on information provided by the NSPs in response to the voluntary information requests and publicly available information. The RIN responses will be considered once received with comments included in a subsequent Addendum to this Report where necessary.

A copy of the voluntary information requests and RINs issued by the AER are included in **Appendix C**. The AER requested that core tax information be provided on a voluntary basis, since it was reasonable to believe that this core information was held by NSPs and available to be provided. The voluntary information requests were broadly limited to information regarding:

- group structures;

- lodged income tax returns;

- treatment of capital expenditure (**Capex**) (including providing detailed tax fixed asset registers); and

- ATO interactions.

We have denoted the extent to which responses have been provided by the NSPs to the voluntary request for information issued by the AER in a table included at **Appendix D**.

In addition to the information reviewed, we have also undertaken a high level investigation of tax regulatory practices in foreign jurisdictions to determine whether there are any different approaches to determining the tax allowance for regulatory purposes and whether any insights could be established that may suggest or influence a change in approach to the existing benchmark efficient entity model.

1.4.2 Limitations

No independent verification of information

We have not conducted an audit or other verification of any information supplied to us. We have assumed that the information supplied to us is accurately stated, true and accurate.

We do not warrant the accuracy or reliability of any of the information supplied.

The opinions set out in this Report may alter if the information subsequently supplied in response to the RINs is inconsistent with the information received for the purpose of this Report.

Restrictions on available information

Notwithstanding the AER's information gathering powers, we note the following restrictions in respect of the information that was made available to us for the conduct of our review:

- As at the date of this Report, very limited information had been received from the energy networks in response to the formal RINs issued by the AER – see comments on "Timeframe" below. As such, our review was based solely on information provided by the energy networks in response to the voluntary information requests issued by the AER and publicly available information pertaining to the identification of upstream investors in certain flow through ownership structures.

- Where an energy network is held in a flow through vehicle (i.e. a trust or partnership), Australian tax is paid at the investor level (rather than the entity level). In issuing the voluntary information requests and the formal RINs, the AER sent the relevant notices to the NSPs only and did not issue separate information requests to the upstream investors in those flow through entities. Accordingly, the NSPs in these circumstances were asked to provide certain information in respect of their upstream investors on a best endeavours basis. However, the information provided in response to the voluntary request for information in respect of upstream investors was extremely limited. In this regard, we did not receive any information on the actual tax paid by investors in flow through vehicles and our observations on the tax payable at the investor level are based on our expertise having regard to the general tax operation of these ownership structures.

- Further, where a participating equity interest in a "flow through" entity is owned by foreign investors, we have been advised that the AER has not sought information under the RINs in respect of any foreign taxes paid by these upstream foreign investors (including their ability to obtain a tax credit for any Australian taxes paid). Whilst the incurrence of foreign taxes by upstream foreign investors, including their ability to obtain tax credits for any Australian tax, is not directly relevant to the calculation of the existing regulatory forecast cost of taxation in its current form, this aspect may need to be revisited to the extent the approach to determining the forecast cost of taxation is amended to an actual tax pass through approach.

- Some of the energy networks regulated by the AER are part of a broader business (that includes unregulated businesses) owned by a single entity or a consolidated group. Where an election to form an income tax consolidated group had been made, information regarding the regulated business as a stand-alone business was generally limited.

- Other limitations in respect of the information we have relied upon for the purposes of our investigation include the following:

  – Not all NSP's responded to the voluntary requests for information, so as a consequence the data population we have reviewed is incomplete as it does not represent all regulated network assets – refer to **Appendix D** for a summary of responses received.

  – Certain information provided by the NSPs was not disaggregated as between regulated and unregulated activities. This was not unexpected given the limited time available to the NSPs to provide responses to the voluntary requests for information issued by the AER.

  – Some of the information provided in response to the voluntary requests for information was also incomplete, or lacked sufficient details to be relied upon. Again, this was not unexpected given the limited timeframe available for the NSPs to provide responses to the voluntary request for information.

  – The NSPs that held the more recently privatised assets had no access to the tax data of the NTER entities that previously owned these assets and appropriately clarified this limitation in the data they could provide for the purposes of this investigation. We consider this to be reasonable in the circumstances.

We have provided a detailed assessment of the information received and any relevant limitations in each section of our Report to give context to our findings.

Confidentiality

Information provided by the NSPs on a voluntary basis for the purpose of our review have generally been subject to declarations of confidentiality, such that it cannot be replicated in this Report. Rather, our findings have been aggregated or sanitised such that confidentiality is maintained as required.

The NSPs have been given the opportunity to review certain disclosures in a draft version of this Report prior to its release in final form to provide comments regarding any concerns regarding the confidentiality of information disclosed.

Timeframe

It is noted that the time frame for the conduct of this review was initially envisaged to be 2 months, which provided for the issue of RINs by the AER, and the receipt of responses to the RINs from the energy networks.

Due to the time limitations and in response to stakeholder concerns, the information request process was split by the AER firstly into a voluntary information request phase and then subsequently the issue of the formal RINs. The formal RINs were only issued on 9 October 2018, with the due date for responses being 26 October 2018 (the date of this Report). Accordingly, this Report only has regard to information provided by the NSPs on a voluntary basis. Once the RIN information is received, we will consider the impact on our findings in this Report and address this in a later Addendum to our Report.

The responses to the voluntary information requests were received over a period of weeks, with the first responses submitted to the AER on 27 August 2018, and the latest responses provided to the AER on 27 September 2018. Given the high level nature of the voluntary information requests (as compared to the RIN), and the limited timeframe for our review, we have been unable to undertake detailed tax reconciliations of the historical tax arrangements of the NSPs including:

- Reconciling the historical tax losses carried forward to identify the components driving the generation of those losses; and

- Reconciling the written down value of depreciable assets to the written down value of assets in the regulatory Tax Asset Base (**TAB**),

which would both be very substantial exercises in and of themselves.

Accordingly, it was necessary to rely on judgment and expertise to determine key areas of focus for data analysis. In this regard, a heavy focus was placed on the tax practices of NSPs with respect to expenditure recoverable by NSPs under the regulatory building blocks (and therefore taken into account in determining the forecast tax cost) to determine any misalignment in tax treatment of those items based on the actual tax practices of the NSPs. This is important to ensure the analysis of any discrepancies between actual tax paid and the estimated cost of tax for regulatory purposes has regard to which items fall inside and outside of the regulatory ring-fence. Specifically, the forecast cost of taxation should only take into account the regulated income and expenditure, and not income or expenditure that is not taken into account in the regulatory framework.

Changes to conclusions in this report are subject to responses to formal RINs

Given the limitations identified above, it is possible that information received by the AER in response to the formal RINs after the date of this Report may further inform our observations and recommendations. As noted above, we will issue an Addendum to this Report once the additional information is provided by the NSPs. The Addendum will also address our findings in respect to finance related matters which have not been considered to date given the limited time frame.

1.5 Qualifications

This Report has been based on the relevant taxation legislation, applicable case law and published ATO rulings, determinations and statements of administrative practice at the date of this Report. The opinions in this Report may alter if there is a change to the legislation, or a change of interpretation of the legislation by the courts or the ATO, after the date of this Report. We are not responsible for updating this Report for changes in the law or its interpretation.

If this Report is to be relied upon in the future or in any other context other than this specific engagement, it is important you ask us to review this Report as our original opinions may no longer be applicable or appropriate in such circumstances.

1.6 Reliance on this report

This Report has been prepared, and may be relied on, solely for the purposes of this engagement. This Report has been prepared specifically for the AER. Neither we nor PwC accept responsibility to anyone other than the AER if they use the Report for some other purpose.

Neither we nor PwC assume any responsibility for liability for any losses suffered as a result of the circulation, publication, reproduction or other use of this Report contrary to the Order of Services.

1.7 Assistance by colleagues

In order to arrive at our observations and recommendations on this matter, we have selected colleagues to assist us. Our colleagues carried out the work that we decided they should perform. We have reviewed their work and original documents to the extent we considered necessary to form our opinions. The opinions expressed in this Report are ours.

1.8 Conduct of this engagement

We have been instructed that the Report is to be prepared in a form which satisfies the requirements of the guidelines for expert witnesses in proceedings in the Federal Court of Australia. These guidelines are set out in Federal Court of Australia's Expert Evidence Practice Note (GPN-EXPT).

We confirm that the Report is prepared in a form which is consistent with the Practice Note, subject to the qualifications stated in this Report. Documents used to support our findings have been identified throughout the Report. We have made all inquiries which we believe are desirable and appropriate for the purpose of responding to the AER's request, but provide no assurance that all such information has been identified. No matters of significance that we regard as relevant to our opinion have, to our knowledge, been withheld.

2 Key observations and recommendations

2.1 Tax differential

Observation

Based on the information we have reviewed and noting the limitations set out in section 1.4.2 above, we have confirmed that there is generally a discrepancy between actual tax paid by the NSPs and the estimated cost of taxation determined under the regulatory model.

This is largely expected given that all NSPs have some level of expenditure and/or income that does not relate to the regulated operating activities of the NSP. Accordingly, there is always expected to be an observable difference between actual tax paid and the estimated cost of taxation. This is one of the fundamental restrictions associated with adopting an actual tax paid pass through approach because invariably the amount of actual tax paid would always need to be allocated between:

- amounts referable only to the regulatory operations carried on by the NSP; and
- amounts not related to the operation of the regulated business (i.e. non regulated revenue and costs not recoverable under the regulated framework).

In this regard a detailed exercise would need to be undertaken to reconcile what portion of the tax actually paid by the NSP (and its upstream investors where the NSP is held in a flow through structure including foreign taxes) is related to the regulated operating activities to ensure integrity with the broader regulatory framework. Any difference in actual tax paid as compared to the amount calculated under the estimated cost of taxation relating to inefficient or unregulated expenditure not recoverable by the NSP under the regulatory framework is appropriate.

Further details regarding our findings regarding the tax paid by NSPs is outlined in section 3.1 of this Report.

Observations relating to private sector entities

An examination of the available information has confirmed the ATO's initial observation that the AER forecast of tax is generally higher than the tax paid by private sector taxpaying entities is broadly correct. However, whilst the ATO acknowledges that in coming to their initial view certain assumptions and exclusions needed to be made by the ATO due to limitations in the data available, it is not clear from the ATO Note to what extent the ATO considered the fundamentals of the regulatory return building blocks (i.e. ring-fencing) in its analysis. In particular the maximum regulated return is set having regard to the efficient operation of a network which identifies recoverable costs. Accordingly, any observations relating to a difference between actual tax paid and the forecast cost of tax relating to the regulated operating business needs to have this as its central point of reference because otherwise there is a risk that any conclusions are misleading.

In this regard, certain expenditure unrelated to the efficient operation of the regulated assets would generally be excluded (i.e. ring-fenced) and not recoverable in the regulated return. For example, costs associated with Merger and Acquisition (**M&A**) activity are unrelated to the efficient operation of the regulatory business and are not recoverable costs. On this basis such costs are excluded from the Regulated Asset Base (**RAB**). For this same reason, such

costs should not be taken into account in determining the estimated cost of taxation for regulatory purposes.

In considering the reasons why tax paid by private sector entities has been less than the forecast cost of tax, we note the following observable differences were identified based on the tax return information, Capex information and other associated data provided by these private sector entities:

Holding Structures

- The ATO indicated that holding structures were likely a key factor in the difference between actual tax paid and the estimated cost of tax for regulatory purposes, especially where upstream investors are concessionally taxed. In this regard the ATO observed that where the NSP is in a flow through structure, tax is typically paid at the investor level and not at the entity level. We agree with this latter observation.

- Putting to one side finance costs at this stage (which we have not considered), the only difference between the actual tax paid and the forecast cost of taxation that can arise as a consequence of different holding structures relates to the rate of tax ultimately payable on the regulated operating profits. The estimate cost of tax for regulatory purposes applies the corporate tax rate. Accordingly, no difference in the rate of tax applies where the NSP is held in a company (including where that company is part of a tax consolidated group). Our investigations indicate that approximately 72.3% of the NSP assets (by TAB value) are held by entities who are subject to tax at the corporate tax rate.

- As noted by the ATO, a difference in the tax rate applied to the regulated profits will arise where the ultimate investors in certain flow through structures are either exempt from Australian tax or concessionally taxed (i.e. at a rate below the corporate tax rate). We note that some of the upstream investors in flow through holding structures we have observed are also taxed at the corporate tax rate including State Owned NTER registered entities. Such entities have been included in the 72.3% referred to above.

- However we also have observed certain concessionally taxed investors in flow through holding structures. Whilst they comprise a small minority of the overall investment in the regulated network assets (by TAB value) being a maximum of 16.6% (13.7% of which may currently attract a headline tax rate as low as 15%, and 2.9% of which may currently attract a tax rate of nil – refer section 2.2.1 below) it is also worth noting that at this stage there has not been a significant distribution of taxable profits which would attract concessional tax rates from the information we have been provided. Accordingly, in the first instance (subject to our comments below), the lack of profits seems to be the primary explanation of the difference between tax paid and the forecast cost of taxation for regulatory purposes, rather than the concessional tax rates which may be applied to certain upstream investors.

- Based on the information provided for our review, the absence of taxable profits in the asset entity that comprises part of a stapled structure (where we observed preferentially taxed upstream investors) appears to primarily relate to immediate deductions claimed in relation to M&A transaction costs. As noted above, such costs are not referable to the efficient operation of the regulated business and are not recoverable costs. In our view, such costs should not be taken into account in determining the estimated cost of tax for regulatory purposes, consistent with the regulatory approach in respect of other inefficient costs that are not recoverable.

- However, whilst the lack of taxable profits in the first instance associated with the asset entity that comprises part of a stapled structure would suggest there has not been a historical discrepancy in tax paid as compared to the forecast of tax costs due to concessional tax rates, this in our view does not give appropriate regard to the

ring-fencing approach underpinning the regulatory regime discussed above. Specifically, the same ring-fencing approach should be applied to determine whether the existence of preferentially taxed investors would result in a discrepancy to the forecast tax cost if only the regulatory income and expenditure is taken into account in a like for like comparison.

- Specifically, unregulated expenditure (including expenditure relating to M&A activity and any increases in depreciation relating to an uplift in depreciable basis) should be ignored in this comparison. Accordingly, we would expect the tax paid in respect of only the regulatory activities by upstream investors entitled to concessional tax rates (i.e. below the corporate tax rate used for regulatory purposes) would be lower than the forecast tax cost when considered on this basis. This tax rate differential would in our view cause a misalignment between the actual tax payable and the estimate cost of taxation when limited to only the regulated operating activities.

- We have also outlined proposed legislative changes which will limit the availability of these concessional tax rates following the expiry of transitional grandfathering arrangements.

Tax Losses

- Generally, the information provided on a voluntary basis shows that significant tax losses have been carried forward and utilised by all private sector NSPs (including corporate taxpayers). Whilst this results in a discrepancy between actual tax paid and the estimated cost of tax for regulatory purposes, as noted above, only those tax losses referable to the regulated operations would cause a relevant misalignment between actual tax paid and the estimated cost of taxation in respect of operating the regulated businesses.

- We do not have sufficient information to reconcile the source of the tax losses as between items that relate to the efficient operation of the regulated assets (recoverable costs) and those that do not (non-recoverable costs). That said, due to the nature of the regulatory model as discussed above, the only categories of expenditure that we have observed as relevant in determining whether there is a discrepancy between actual tax paid and the regulatory cost of tax are the treatment of regulatory Capex and financing costs. This is because these are the only recoverable costs where a divergence in actual tax practices and the assumptions within the regulatory model may arise.

- There are other items which sit outside of the regulatory ring-fence (i.e. non recoverable costs which do not relate to the efficient operation of the network assets) which are likely to have contributed to the tax losses carried forward and utilised by the NSPs, such as depreciable tax cost uplifts and immediate deductions attributable to M&A activity, grouping of losses attributable to unregulated activities in a tax consolidation environment, costs of financing not related to the regulated assets, and Research and Development (**R&D**) tax offsets.

- A substantial exercise would be required to determine whether any of the carried forward tax losses actually arose from the regulated operations in isolation.

Treatment of Capex

- We have identified a divergence in the actual tax treatment of regulatory capex which would explain why any actual tax attributed to the regulatory operations when determined on stand-alone basis would not align with the estimated cost of taxation within the regulatory model.

- The information provided on a voluntary basis has allowed us to perform detailed analysis in respect of capital expenditure related adjustments (discussed in detail in section 2.2.2 and 3.2.1 below).

We have not been provided with sufficient information on a voluntary basis to determine any difference applicable to financing costs at this stage. Further information regarding the impact of M&A activity, tax consolidations, finance structures and R&D have been requested from the NSPs in the RINs, and accordingly, our observations in respect of these aspects are predominately qualitative at this stage.

Observations relating to NTER entities

An examination of the available information has confirmed that the general observation made in the ATO Note is broadly correct – that is, for NTER entities the AER estimated cost of taxation is generally lower than the tax equivalent amounts payable by those entities under the NTER.

In considering the reasons why tax paid by NTER entities has been greater than the forecast of taxation costs for regulatory purposes, we note the following observable differences were identified based on the tax return information and Capex information provided by NTER entities:

- The average amount of income included in the NTER returns was in all instances higher than the revenue reflected in the estimated cost of taxation calculation for regulatory purposes over the same time period. This discrepancy may indicate that additional revenue has been derived by the NTER entities, sourced from non-regulatory activities.

- The tax written down value of depreciable assets included in the tax fixed asset registers (**TFAR**s) provided by NTER entities in aggregate was less than the regulatory TAB written down values by approximately $2.73 billion. This factor would objectively indicate that deductions for depreciation in calculating tax payable by NTER entities is likely to have been lower than the depreciation deductions taken into account in determining the forecast of taxation costs for regulatory purposes in more recent years.

- In contrast to the two factors noted above (which would result in greater tax payable than the AER estimated cost of tax), all NTER entities claimed some portion of regulatory Capex that was included in TAB as an immediate deduction for tax purposes. The amount of immediate deductions claimed varied between entities. This is likely to be one of the key reasons for the discrepancy between the tax written down value of assets included in the TFARs as compared to the written down value of the TAB.

In addition to the above factors, we note that financing costs may also be a factor in explaining the difference between the actual tax equivalent payments observed and the AERs forecast cost of tax but we have not undertaken sufficient work at this stage to be able to objectively conclude on this particular matter including the quantum of the impact.

Conclusion in relation to whether there is an observable tax differential

On the basis there is an observable difference between actual tax paid and the regulatory forecast cost of tax in relation to the regulated operations on a standalone basis, we have considered in more detail the key drivers of the difference. In this regard the following sections discuss our detailed findings and recommendations in respect of:

- Holding structures applicable to ownership of the NSPs;
- The tax treatment of regulatory Capex;
- The impact of M&A activity and tax consolidations; and
- Items to be considered further following the receipt of RIN responses.

2.2 Key drivers

Based on the information we have reviewed, we have considered the following potential drivers to determine whether they give rise to a misalignment between the actual tax paid by NSPs and the estimated cost of taxation determined under the existing regulatory approach.

2.2.1 Holding structure

In determining the estimated cost of tax for regulated asset owners, the current tax building block approach assumes the benchmark efficient entity is a company, and is liable to tax at the corporate tax rate (currently 30%).

We have therefore investigated the holding structures adopted by industry participants to determine whether any of the structures cause a misalignment between the estimated cost of tax applied in the regulatory model and the actual tax paid by NSPs.

Based on the voluntary information provided, we observe the following broad classifications of holding structures from a tax perspective:

1. State Owned Enterprise subject to the NTER: 5 NSPs

2. Private sector entity taxed as a company in Australia: 7 NSPs

3. Flow-through investment vehicle taxed in the hands of investors: 5 NSPs

Taxable profits of the NSPs within holding structures (1) and (2) above are taxed at the corporate tax rate of 30% (noting the NTER applies a tax equivalent regime whereby the notional tax is paid to the relevant State/Territory owner). As outlined in the table below, these entities account for **72.3%** of the total regulated asset base (with reference to TAB value)[1]. Accordingly, the tax rate applicable to these structures should not of itself give rise to a divergence between the estimated cost of tax and actual tax paid.

Taxable profits of the NSPs within holding structure (3) above are taxed in the hands of investors. As noted above, a differential between the estimated cost of tax and actual tax paid can arise whereby investors in flow through vehicles are either exempt or receive a concessional tax rate below the existing corporate tax rate (currently 30%), in respect of any taxable profits distributed.

Whilst the voluntary information provided a broad overview of the holding structures, it did not provide sufficient detail on the tax profile of upstream investors in the NSPs where flow through structures have been adopted. As such, we have supplemented the voluntary information with publicly available information to understand the likely tax profile of the upstream investors. We acknowledge that the public available information may be incomplete or outdated and may not account for any changes in the upstream investor group.

Based on our investigations, of the 5 NSPs held in flow through investment vehicles, 3 are held in stapled structures comprising an asset entity and an operating entity, while the remaining 2 are held in stand-alone flow through vehicles. With respect to the NSPs held in stand-alone vehicles, the information provided to us indicates that the taxable profits derived by these NSPs are distributed to entities taxed as companies. Accordingly, these structures should not give rise to a discrepancy between actual tax payments and the forecast cost of tax (as profits will ultimately be subject to tax at the corporate tax rate). Therefore, it should only be relevant to consider the tax discrepancy arising in respect of NSPs held in flow through vehicles that form part of a stapled structure.

[1] Refer categories (1), (2) and (8) of the Table in Figure 1

Broadly, for NSPs that are held in stapled structures, distributions of taxable income from the asset entity (that forms part of the stapled structure) to non-resident investors generally qualify for the concessional Managed Investment Trust (**MIT**) withholding rate of 15% which applies under current law. This rate may effectively be further reduced as a consequence of debt funding structures adopted by individual upstream investors. In addition, distributions from an asset entity to sovereign wealth funds may be exempt from tax under the sovereign immunity exemption. Distributions of income from the operating entity (which also forms part of the stapled structure and is the operator of the network) may be subject to a rates of tax ranging from 0% (in the case of an eligible sovereign wealth fund investor) to 30% (in the case of a corporate investor) depending on the upstream structure adopted by the investor.

Given that the tax rates applicable to distributions of taxable income made by the NSPs held in stapled entities is generally lower than 30%, we consider that there is a discrepancy between the estimated cost of tax and actual tax paid for NSPs held in stapled structures. However, it is noted that legislation is currently before Federal Parliament which, if passed, will limit the availability of concessional tax rates in respect of stapled structures going forward, with transitional arrangements for existing projects. Subject to transitional arrangements, the legislative changes will also deny access to the sovereign immunity exemption for all distributions from the operating entity, and limit the availability of the exemption in respect of distributions from the asset entity (and require satisfaction of additional conditions). In addition, the tax impact from the use of upstream debt funding will be neutralised with effect from 1 July 2018. Taken together, we expect that these legislative changes should result in a reduction to the tax discrepancy (noting that the effect of this will not be observable until the transitional arrangements applicable to the NSPs have expired). Figure 1 below summarises the different investor profiles which have been observed having regard to the three types of holding structures outlined above, including the likely tax profile of upstream investors in flow through structures. Investor tax profiles (3) to (8) of Figure 1 hold interests in the regulated assets via flow-through vehicles. In some instances, Australian companies (investor tax profile (2)) also hold their interest through flow through vehicles.

Figure 1: Tax profile of regulated asset holders tracing flow-through vehicles

Investor tax profile	% of TAB	Expected tax rate
1. NTER entity	**40.00%**	30%
2. Australian company	**29.98%**	30%
3. Australian States or Territories (tax exempt, non-NTER)	**11.10%**	N/A
4. Australian managed investment fund[2,3]	**7.86%**	15%-30%
5. Australian superannuation funds	**3.79%**	15%
6. Foreign Sovereign Wealth Funds[4]	**2.90%**	0%-30%
7. Foreign pension funds[5]	**2.07%**	15%-30%
8. Foreign companies	**2.30%**	30%

Based on the findings in Figure 1, we make the following additional observations:

- 11.10% of assets (by TAB value) are held by Australian States or Territories which are not subject to the NTER and therefore do not pay a tax equivalent amount. This will cause a divergence between the estimated cost of tax for regulatory purposes and actual tax paid to the extent profits are distributed by the NSP. Assessment of the appropriateness of the application of the regulatory tax building block approach in respect of government bodies is outside of the scope of our review, as this is a matter of policy rather than tax law.

- 8.76% of assets (by TAB value) are held by entities which are expected to attract tax rates below 30% on any profits distributed (refer categories 5, 6 and 7). This will also cause a divergence between the estimated cost of tax for regulatory purposes and actual tax paid to the extent regulated profits are distributed by the NSP.

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[2] The MIT concessional tax rate of 15% for investors in Exchange of Information [EOI] countries will only remain available for the flow through entities holding regulated assets through stapled arrangements until 30 June 2034, after which time a 30% tax rate will apply. Profits attributable to the operating side of a staple will not be eligible for MIT status and therefore subject to 30% non-resident withholding.

[3] Due to the lack of information available in respect of tax profiles for investors in managed investment funds, we are unable to confirm the expected tax rate for these investors. In many cases, we would expect the concessional MIT rate of 15% to be available for certain foreign investors resident in an EOI country. Likewise, investments by superannuation funds in the managed investment funds would also attract a tax rate of 15%. In other cases, the corporate rate of 30% may apply.

[4] Sovereign wealth funds may be treated as tax exempt on certain passive classes of income, which is generally confirmed through a ruling request with the ATO. Sovereign wealth funds with an interest of 10% or more will pay withholding tax of 30% on Australian profits from energy businesses for any new investments after 27 March 2018 or from 2026 for assets acquired before that date. Sovereign wealth funds with an interest of less than 10% (and no influence over the NSP) will remain exempt.

[5] Foreign pension funds would generally access the 15% MIT concession (subject to reform of law and transitional arrangements) on the asset side of a staple, and be subject to 30% withholding tax in respect of the operating side of the staple.

- 7.86% of assets (by TAB value) are held by investors in Australian managed investment funds. The applicable tax rate for these investors vary, and as such we cannot determine what this would be on average. In many cases we would expect foreign investors from Exchange of Information countries to be eligible for the concessional MIT rate of 15% in respect of distributions from the asset entities. Others may be subject to 30%.

Whilst our investigations in relation to the information provided on a voluntary basis have not identified any significant taxable profits being distributed to investors in flow through structures where upstream investors attract a tax rate below 30%, this does not give appropriate regard to the ring fencing approach underpinning the regulatory regime discussed above. Specifically, a strict ring fencing approach should be applied to determine whether the concessional rates of tax would result in a discrepancy to the forecast tax cost if only the regulatory income and expenditure is taken into account in a like for like comparison. It is likely that taking such an approach would result in a misalignment when applied just to the regulated operations for upstream investors with a concessional tax rate below 30%.

Recommendation

In our opinion, given the majority of NSPs are held via companies, the assumption that the benchmark efficient entity is a company and taxed at the corporate tax rate is reasonable. Relevantly:

- 72.3% of regulated asset owners (by TAB value) currently adopt a structure which is subject to the corporate tax rate. This is indicative that the benchmark efficient entity should remain a company for the purpose of determining the regulatory tax allowance.

- The instances where the tax rate for non-government asset owners is below the corporate tax rate is not wide spread and is limited to 8.76% of the industry participants by TAB value. The investor tax rate cannot be approximated for a further 7.86% of TAB value where investments are held through managed investment funds, but the headline rate may be as low as 15%. Further, legislative reform is likely to limit the availability of concessions for foreign investors such as the MIT regime and sovereign wealth fund exemptions once the applicable grandfathering period ends.

- After the grandfathering period ends there is a risk that the actual tax paid by ultimate investors in these flow through structures, applying the strict ring-fencing approach discussed above may be more than the regulatory tax allowance given that in some instances foreign taxes may also be payable by these investors without a credit for any Australian tax paid.

- If a flow through vehicle were adopted as the benchmark efficient entity, it would be necessary to determine the investors in the structure and the tax rate applicable to them in order to calculate a benchmark tax rate. The flow through entity is not liable to tax and it is not the flow through structure of itself that creates any differential in the tax paid as compared to the amount determined under the regulatory allowance.

- Even if a flow through structure could be validly adopted as the benchmark efficient entity (which would be contrary to our observations above), it would be difficult, costly and impractical for the NSPs currently held in companies to restructure into a flow through holding structure, as this would likely trigger commercial and tax costs (e.g. stamp duty, capital gains tax). The difficulty in adopting such a benchmark efficient entity would be seen as unfavourable.

- In the observed flow through structures, multiple investors with different tax profiles hold varying interests in the same network assets. Accordingly, there is complexity associated with trying to determine a blended rate where consortium members have substantially different tax profiles. This is not only inconsistent with the tax legislative framework (which levies tax on an identified taxpayer) but it also has the potential to

create winners and losers if parties are effectively cross subsidising each other to account for differences in tax rate(s).

- We have considered whether as an alternative to changing the benchmark efficient entity, it would be possible to make adjustments to the forecast cost of tax by applying a "flow through" approach in respect of tax rates. This will be difficult and costly to achieve given (1) the requirement to identify the actual tax rate for all upstream investors in respect of each distribution, and (2) the requirement to adjust only in respect of taxable profits attributable to the efficient operation of the network assets (e.g., within the ring-fence). We do not see how this could practically be achieved given the aggregated nature of taxable distributions and the requirement to obtain information regarding the tax position of each individual investor (e.g. the tax position of investors which have obtained an interest through a managed investment fund). Given the fact that tax rates of below 30% may only apply in respect of 16.62% of investors (by TAB value) at most (some of the 16.62% may in fact attract a 30% tax rate regardless, however we have not been able to verify this due to information limitations relating to upstream investors), and current reform will remove the benefit of the concessional rates (with the exception of Australian superannuation funds, representing 3.79% of the population), from as early as 2026, we do not recommend any changes are made to the current regulatory framework in respect of tax rates.

- As noted above, assessment of the appropriateness of the benchmark corporate tax entity approach to entities which are subject to the NTER regime and/or State/Territory owned is outside of the scope of our review, as this is a matter of policy rather than tax law.

2.2.2 Tax treatment of regulatory Capex

Observation

Depreciation deductions

We have undertaken a detailed review of the tax treatment adopted by the NSPs with respect to regulatory Capex and compared that to the treatment of such expenditure in determining the tax allowance. We observed that the treatment of Capex for tax purposes is a factor which causes a misalignment between actual tax paid and the tax allowance in respect of the regulatory operations. Even though the items responsible for the misalignment that have been identified are only timing in nature, they are likely to have a cost in net present value terms.

Specifically, based on the information we reviewed, we observed the following **timing** factors:

- All but one of the energy networks that provided responses to question 11 of the voluntary information request were claiming an immediate deduction for tax purposes for a component of costs (i.e. such as refurbishment, overhead and capitalised labour costs) included in the estimated cost of taxation.

- Whilst the amount being immediately claimed varied between respondents, overall the average amount being claimed where this information had been provided was significant and is likely to be a key factor causing a misalignment between tax paid and the estimated cost of taxation for regulatory purposes. From the entities which responded to the request for information relating to this item, on average $81.5m of the regulatory capex included in TAB was claimed as immediate deduction by each regulated entity annually, and an average of $108.7m was claimed by each NSP (as some NSPs hold multiple regulated entities) annually.

- Whilst we have observed that a majority of depreciable assets are currently being depreciated using the prime cost method (approximately 57.39% by value) this outcome is

largely skewed by the adoption of the prime cost method by NTER entities in respect of 96.05% of assets by value.

Accordingly, the adoption of the diminishing value method (largely by private sector entities) is likely to cause a misalignment between tax paid and the estimated cost of taxation for regulatory purposes.

- We note that whether the adoption of the diminishing value method has historically been a chief cause of the difference between tax paid and the forecast cost of taxation for regulatory purposes during the period of the ATO's review is not as obvious for the following reasons:
  - During the period covered by the ATO Note (2013- 2016) a not insignificant portion of the private sector entities were actually adopting the diminishing value method for regulatory purposes. This is not addressed by the ATO based on their terms of reference. This continued to be the case until the most recent regulatory determinations for all NSPs other than Jemena.
  - Further, during the period considered in the ATO Note it also needs to be acknowledged that the NSW electricity assets were owned by the NSW State Government for some or all of that period. We do not have any data confirming the methodology adopted in respect of the NSW network assets whilst these assets were owned by the NSW State Government during 2013 to 2016 (or part thereof).
- The average effective life applied to depreciable assets (by value) in the gas industry for tax purposes is approximately 27.83 years which is materially lower than the average effective life applied in determining the depreciation for the forecast cost of taxation for regulatory purposes which is 35.12 years. This differential arises because the 20 year statutory life capping applied to gas transmission and distribution assets for income tax purposes (introduced by the Federal Government as part of a broader policy consideration) is not being uniformly adopted in respect of all gas networks. Specifically, of the eleven gas networks only six are applying the 20 year cap on their gas distribution and transmission assets in determining the estimated tax cost for regulatory purposes.

Each of the above factors generally results in the energy networks having, to varying degrees, higher deductions for Capex in the earlier income years as compared with the depreciation allowance determined by the AER for the purpose of determining the estimated cost of tax.

Recommendation

In relation to Capex, we recommend the following changes be made to the methodology for calculating the estimated cost of taxation for regulatory purposes:

- Refurbishment capital expenditure and other immediately deductible expenses create a misalignment between tax paid and the regulatory tax allowance. The AER should consider whether a change is appropriate to capture this differential having regard to the potential non-tax commercial implications.
- In particular, consideration should be given to whether a change to the regulatory tax forecast to treat amounts such as refurbishment costs as immediately deductible could lead to sub-optimal asset replacement decisions and policies by NSPs. This would be an additional factor that the AER would need to take into account in considering the long term interests of consumers.
- The diminishing value method should be applied to all new assets rather than the straight line method which is currently applied (except in respect of intangible assets or capital works expenditure captured by Division 43 of the ITAA 1997 that are required to be deducted for tax purposes on a straight line basis). However, we note that this change might not initially have a significant impact on narrowing the tax differential as a

consequence of how the tax rules apply to determine an identifiable "depreciable asset" which is discussed in more detail in section 3.3.2. The consequence of this is that a substantial portion of regulatory Capex may initially relate to existing assets as opposed to new assets. As discussed above, we have recommended that this change be adopted on a prospective basis, meaning that it should only apply to new depreciable assets that are acquired or constructed by the energy network, not existing assets. This is because there is no technical basis to retrospectively change the depreciation methodology to existing assets. In this regard, it is also noted that additional work may need to be undertaken by the AER to develop appropriate policies in relation to:

  - the classification of functional assets (i.e. replacement vs refurbishment), including the potential development of further integrity measures to ensure that the commercial decisions made by energy networks in relation to refurbishment of assets are not driven by tax outcomes; and

  - the treatment of assets during the transition phase (e.g. what happens to replacement assets that are added to existing assets).

- The AER should consider applying the 20 year statutory effective life cap uniformly to all regulated gas pipelines for the purposes of determining the forecast cost of taxation to rectify the misalignment in the effective life observed.

We note that the above recommendations are timing in nature only. Accordingly, there will be no difference in actual taxes paid and the estimated cost of taxation over the life of these assets relating to the implementation of one or more of these measures. These changes just recognise the delay in paying tax as a consequence of certain deductions being available earlier under the tax legislation as compared to the existing assumption used in calculating the tax allowance. Importantly however, these temporal differences will result in a cost in net present value terms.

2.2.3 M&A activity and tax consolidations

Observation

Privatisations and M&A activity may result in uplifts in the depreciable asset base for tax purposes. These uplifts are a permanent difference as there is no equivalent uplift to the tax base of those assets for the purposes of TAB and therefore in determining the forecast cost of tax for regulatory purposes.

Specifically, the step up in the tax base of depreciable assets arises as a consequence of changes in ownership of the regulated assets. Generally, such step ups in this industry have typically arisen as a consequence of the buyer being a tax consolidated group.

In addition, it is noted that recent privatisation transactions incurred significant stamp duty costs that were immediately deductible for tax purposes, however these costs are not recoverable to the NSP under the regulated return.

In our view, it would be inconsistent with the regulatory framework to take such acquisition costs (including additional depreciation associated with a step up in the tax basis of depreciable assets) into account in determining the forecast cost of tax given such amounts:

1. cannot be recovered by the NSPs; and
2. are not cost incurred in the efficient operation of the regulated business (i.e. they are costs associated with the acquisition of the regulated business).

Recommendation

Whilst further information regarding the quantitative impact of M&A activity, including tax uplifts under the tax consolidations regime and stamp duty, will be provided by the NSPs in

response to the formal RINs, from a conceptual perspective we would not recommend that any changes should be made to the regulatory tax allowance to address any of the observable differences discussed above. This is for the following reasons:

- Neither the direct costs associated with the M&A activity nor the step up in the cost base of assets (generally as a consequence of acquisition proceeds over and above the existing base) are referable to the efficient operation of the regulatory assets. As a consequence these costs are not recoverable under the RAB.

- The step up in the tax cost base is generally (but not in all instances) matched by a tax cost to the seller (e.g. taxable gains can arise to the seller which recapture previous depreciation that had been claimed). Any adverse tax costs to the seller would arguably also need to be taken into account.

- The application of the tax consolidation rules especially around the resetting of the tax base of depreciable assets introduces substantial integrity risk not consistent with the regulatory regime. For example, the existence of liabilities and the cost of any equity at the date of the NSP joining a tax consolidated group which are unrelated to the regulated assets would be taken into account in resetting the tax cost base of the regulated assets. This introduces substantial integrity risks as liabilities associated with non-performing unregulated business assets could inappropriately skew value into the regulated depreciable assets and vice versa which would be not be acceptable.

2.2.4 Financing

The ATO Note identified financing as a key driver of the tax differential – that is, financing assumptions used to calculate the tax allowance differ from actual finance costs.

Given time limitations, our investigations have been broken up into two phases. The first phase has been based on a request for voluntary information issued by the AER which has focused on discrepancies in income tax paid resulting from holding structures, the existence of tax losses and the treatment of capital expenditure – discussed above.

The second phase of our investigations will focus on financing arrangements which the ATO Note highlighted as a potential key factor in the difference between the amount of tax paid and the forecast cost of tax for regulatory purposes.

To date, we have not received sufficient information in relation to the financing arrangements of the NSPs (and where relevant its upstream investors) to form any objective opinion including whether financing is in actual fact a key driver that results in a material misalignment. However, notwithstanding that we reserve our judgment relating to financing at this stage pending the receipt of relevant evidence, we note that the following recent reform and judicial decisions are likely to narrow any gap on a prospective basis between actual debt deductions being claimed for tax purposes and the debt assumptions used to calculate the forecast cost of tax:

- Related party loans have been an area of focus for the ATO in recent years. Given ATO activity and the *Chevron* case,[6] it is expected that interest rates applicable to shareholder loans (and consequently interest deductions) obtained by some energy networks may be lower in the future.

- Legislation is currently before Parliament which proposes to amend the thin capitalisation rules to prevent foreign investors from using multiple layers of flow through entities (i.e. trusts and partnerships) each issuing debt against the same underlying asset to achieve a higher level of gearing.

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[6] *Chevron Australia Holdings v Commissioner of Taxation* [2017] FCAFC 62

- The Australian Government has recently passed hybrid mismatch legislation which seeks to neutralise circumstances where cross-border arrangements give rise to payments (including, for example, interest, royalties, rent, dividends and, in some cases, amounts representing a decline in the value of an asset) that either (a) are deductible under the tax rules applicable to the payer, and not included in the income of the recipient; or (b) give rise to duplicate deductions from the same expenditure.

- In 2017, the Australian Government introduced a diverted profits tax (**DPT**) which aims to ensure that the tax paid by significant global entities (**SGEs**) properly reflects the economic substance of their activities in Australia and aims to prevent the diversion of profits offshore through arrangements involving related parties.

2.2.5 R&D tax incentive

The R&D tax incentive is designed to encourage companies to engage in R&D which benefits Australia, by providing a tax offset for eligible R&D activities. For energy networks, the relevant component of the incentive is the non-refundable 38.5% tax offset for eligible R&D spend, which can be carried forward subject to satisfying certain rules.

The AER forecast cost of tax does not factor in any R&D tax incentive offsets. This means that for the two energy networks who claimed R&D deductions for the year ended 30 June 2017, part of the difference between their actual tax paid and the AER tax allowance can be explained by the R&D tax incentive.

It is worth noting that only eleven NSPs currently meet the criteria to be registered R&D entities and claim the R&D tax concessions. In this regard, flow through vehicles (partnerships and trusts) are not able to register for R&D. Of the eleven NSPs that could register, nine NSPs provided lodged income tax returns for the FY17 year. Of these nine NSPs, only two claimed R&D tax concessions for the year ended 30 June 2017 based on the tax return information we received (noting however, that it is common for companies to claim R&D tax concessions through a subsequent amendment letter to the lodged income tax return). Given the small number of energy networks claiming the R&D tax incentive and the quantum of those claims, we do not consider this to be a significant driver for the tax discrepancy highlighted in the ATO Note.

Subject to receipt of responses to the RINs, we currently do not recommend changing the AER tax allowance model to take into account the impact of R&D tax incentives as:

- The current impact of R&D tax incentives on the tax differential is not expected to be material (albeit this will be confirmed on receipt of the RIN responses).

- The R&D tax incentive is designed to encourage companies to engage in R&D – adopting a forecast cost of tax for regulatory purposes which effectively removes this tax incentive would appear to be at odds with the intended outcome of the policy.

- Where the R&D expenditure is not recoverable under the regulated tariff, in our view any R&D tax concessions should in any case be excluded from the calculation of the tax allowance in line with the broader regulatory framework.

- Legislation proposing to amend the R&D tax incentive is currently before Parliament which, if passed, will mean the R&D tax incentive program will be more targeted and therefore harder to access.

3 Detailed analysis

This section sets out a detailed commentary of our review findings which form the basis for our recommendations in this Report.

3.1 Difference between actual tax paid and the regulatory provision for tax costs

3.1.1 Summary of our process to investigate tax differential

We have been requested to identify whether a discrepancy exists between actual tax paid and the estimated cost of tax for regulatory purposes, and if so, identify the drivers for this discrepancy. Given the limited timeframe available, our review has been limited to the information that was obtained from the NSPs on a voluntary basis (requested by the AER through a voluntary information request). The voluntary information request is attached for reference at **Appendix C**.

As part of the voluntary information request, the AER requested lodged income tax returns for the past 5 years (or period of existence if less than 5 years) from all businesses. In particular, the AER requested the NSPs provide the following information on a voluntary basis:

> *3. Provide a copy of any income tax returns lodged by the NSP, whether Federal or NTER, in the last 5 years (or period of existence if less than 5 years).*
>
> *4. Where the NSP is a member of a tax consolidated group please provide tax calculations for the NSP on a stand-alone basis to the extent these calculations have already been prepared (e.g. these calculations already exist), which support the latest income tax return lodged by the Head Company of the tax consolidated group in the last 5 years (or period of existence if less than 5 years).*
>
> *5. Where the NSP is part of a stapled entity arrangement please also provide the income tax returns lodged for the other stapled entity(s) that hold direct interests in the network asset (i.e. the Asset Trust/Partnership) in the last 5 years (or period of existence if less than 5 years).*

We summarise below the status of information received:

	Private sector	NTER
Income tax returns provided for all or some of the years requested	8 of 12 entities[7]	5 of 5 entities

Based on this information, we were able to observe tax paid information as reported in the income tax returns for those entities which are taxed as a company (including NTER entities). We have been able to compare the tax paid by the NSPs to the forecast cost of taxation included in the regulatory tariff determinations in respect of the same income years. Our findings are outlined in section 3.1.3 below.

We note the following limitations in reviewing this information:

[7] Note, one of the NSPs did not provide any income tax returns on the basis it has recently been established and it had not yet reached the lodgement date for its first income tax rate.

- Tax payable for each income year is only disclosed in income tax returns by entities which are taxed as a company. These disclosures are also subject to amendment by the taxpayer at a later time (which is common for R&D and fixed asset related adjustments).

- No tax was evident in the tax returns of the NSPs that were held in partnership and trust structures, which is consistent with the fact that the tax is borne by upstream investors in these structures. The tax paid by upstream investors is ultimately dependent on the tax profile and other associated transactions (e.g. other deductions or assessable income) of that investor. Whilst the tax paid by upstream investors was requested on a best endeavours basis, no information was ultimately provided. The partnership and trust returns however do disclose the taxable profits of the business (referred to as the 'net income') which will be distributed to its investors for each income year. This has allowed us to understand in the first instance whether taxable profits existed during the relevant period and were distributed to upstream investors in these flow through structures.

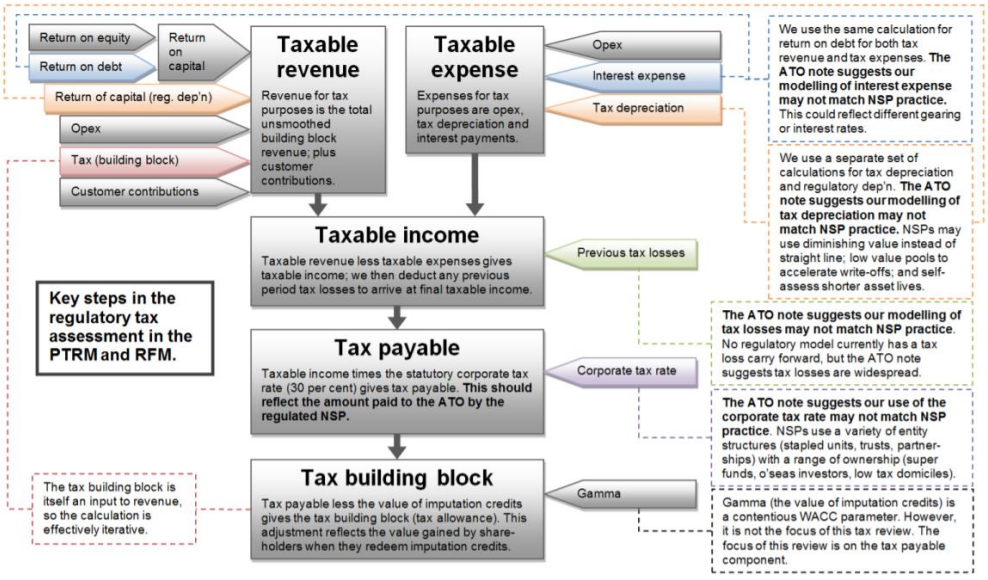
- Income tax returns are prepared on an identified taxpayer approach, rather than a regulated entity approach. Further, we have observed that all NSPs which are held in a private corporate structure were members of a tax consolidated group. Under the tax consolidation regime, the tax positions of all wholly-owned subsidiaries of a corporate group are aggregated and reported on a single entity basis. As such, there is naturally a difference between the tax positions disclosed in the income tax returns and the tax positions of the regulated businesses on a stand-alone basis. Information regarding the stand-alone tax position of regulated businesses which are held within consolidated structures and/or businesses with both regulated and unregulated activities has been requested in the RINs, and will be reflected in our Addendum where relevant.

- The extent to which our findings can be documented in this Report is limited due to confidentiality requirements relating to information received from the NSPs. Our comments regarding the tax paid information provided by the NSPs has generally been aggregated with our observations about classes of taxpayers (e.g. NTER, corporate, flow through).

3.1.2 Tax allowance determined under the regulatory model

Before discussing our interpretation of the information provided for our review, it is useful to provide an overview of how the estimated cost of taxation is determined for regulatory purposes.

As noted above, the National Energy Rules apply a building block approach to determining the revenue allowances provided to the NSPs. The cost of corporate taxation is one element of the revenue allowance. The following illustrative diagram was included in the AER's Initial Report:



As shown above, the tax allowance (or tax building block) is calculated broadly by having regard to the estimated income tax payable by a business based on the regulated revenue, operating expenses, financing costs and tax-specific depreciation profile, which determines the estimated taxable income of an entity, and assumes income tax will be payable on that amount at the corporate tax rate of 30%. This amount is referred to in this Report as the AER's estimated cost of taxation (or AER's forecast of tax costs) applied for regulatory purposes.

Regulated revenues are set by AER determinations which cover a pre-determined period, the range of which is from two years to ten years (noting in the majority of instances the period is five years). The estimated cost of corporate taxation is agreed by the AER and included in the relevant determination for commencement of the tariff period. Unlike capital and operating expenditures, the AER generally does not undertake a comparison of the estimated tax allowances to the actual expenditure incurred by the NSPs in a previous tariff period, in determining the appropriateness of allowances applied in a subsequent determination.

The direct tax allowance (or tax building block) is equal to the forecast of tax payable (described above) less an assumed benefit which will be received by shareholders following distribution of franking credits to those investors (**Gamma**). Gamma is currently generally set at 0.4 (i.e. the income tax payable will be reduced by 40% to arrive at the tax allowance), however it is proposed to be increased to 0.5 under the Rate of Return review currently being undertaken by the AER. The remaining tax allowance post application of Gamma is referred to in this Report as the tax allowance (or tax building block).

It is noted that the assumed benefit that is implied by Gamma is consistent with the benchmark approach used by the AER to determine the regulated return for energy networks and therefore does not reflect the actual benefit obtained by specific shareholders. In particular, it is noted that for energy networks owned by non-residents or NTER entities, Gamma may not reflect the benefit received by investors in those networks as they may not always be able to utilise franking credits.

The scope of our review is limited to observations and recommendations aimed at creating a better alignment between the actual tax practices of NSPs and the estimated cost of taxation for regulatory purposes prior to the application of Gamma. Accordingly, we have not made any suggestions for changes to Gamma as a result of our findings. We understand this will be considered by the AER as part of its broader assessment of the appropriate rate of return to be provided to the NSPs.

As noted above, the forecast of tax payable for regulatory purposes is essentially an estimate of tax payable based on a hypothetical tax profile of the regulated business on the assumption it is held by a stand-alone company paying tax at the corporate rate. The only items taken into account in determining the forecast of tax payable, apart from the notional interest costs are the operating expenditure (**Opex**) and Capex costs associated with the efficient operation of the regulated business consistent with broader regulatory framework.

Therefore, only a departure in either the applicable rate of tax, or the tax treatment of items included in the calculation of the forecast tax payable is relevant to ensure consistency with the broader regulatory framework. Our recommendations and observations are therefore based on the extent of, and reasons for, key differences in treatment of these items between the calculation of the forecast tax payable and actual tax outcomes for NSPs and whether changes to the current approach to determining forecast tax payable could practically achieve a better alignment.

The forecast cost of tax for regulatory purposes assumes Opex is immediately deductible. Accordingly, it is unlikely that there would be any departure in the treatment of this expenditure from that adopted in determining actual tax payable. As noted above, we do not have sufficient information to make any objective observations relating to finance costs at this stage. Our Addendum will contemplate any departure in the treatment of financing costs including gearing levels. Accordingly, our investigations to date have focused on whether there is any departure in the following items included in the calculation of the forecast tax payable:

1. The rate of tax that would apply to profits from the regulated activities which requires an analysis of holding structures. This is discussed in detail at section 3.2 below.
2. Treatment of regulatory Capex. This is discussed in detail at section 3.3 below.

3.1.3 Findings regarding tax paid by the regulated entities

The lodged income tax returns provided for our review can be classified as follows:

- Corporate income tax returns which disclose income tax liabilities (if any) payable by private sector entities to the Commonwealth;
- Partnership or trust (flow through vehicles) tax returns which disclose taxable distributions (if any) which will be distributed to the relevant upstream investors; and
- NTER returns which disclose tax equivalent amounts payable to the State/Territory owner.

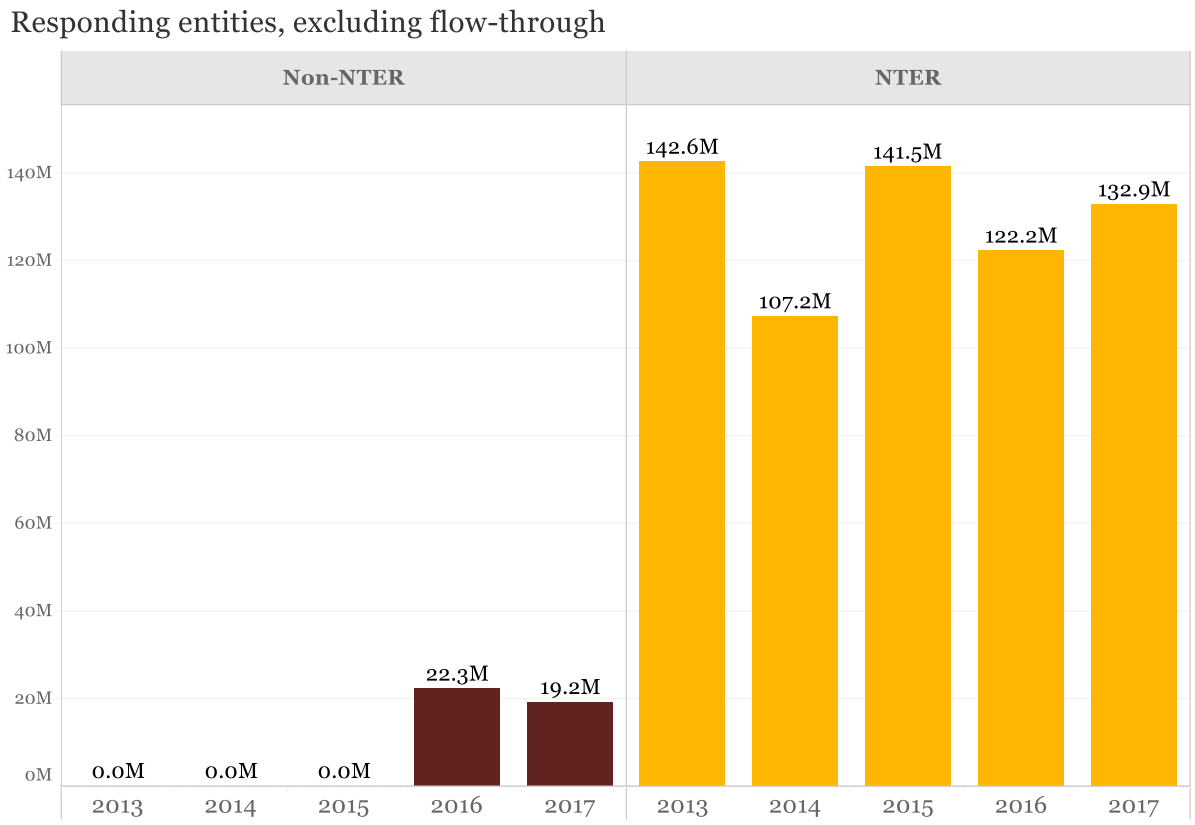
As previously highlighted, we did not receive any income tax returns relating to upstream investors where the NSP is held in a flow through vehicle.

The figures on tax paid reflect payments of income tax prior to any offset of imputation credits against personal tax. As such, the appropriate comparison against the regulatory approach is to the regulatory forecast of tax costs in the AER models, prior to the adjustment for Gamma.

Observation regarding tax paid generally

We have summarised in the graph below the information received from the NSPs in relation to tax paid.

Figure 2: Tax payable per tax returns for corporate entities (including NTER)

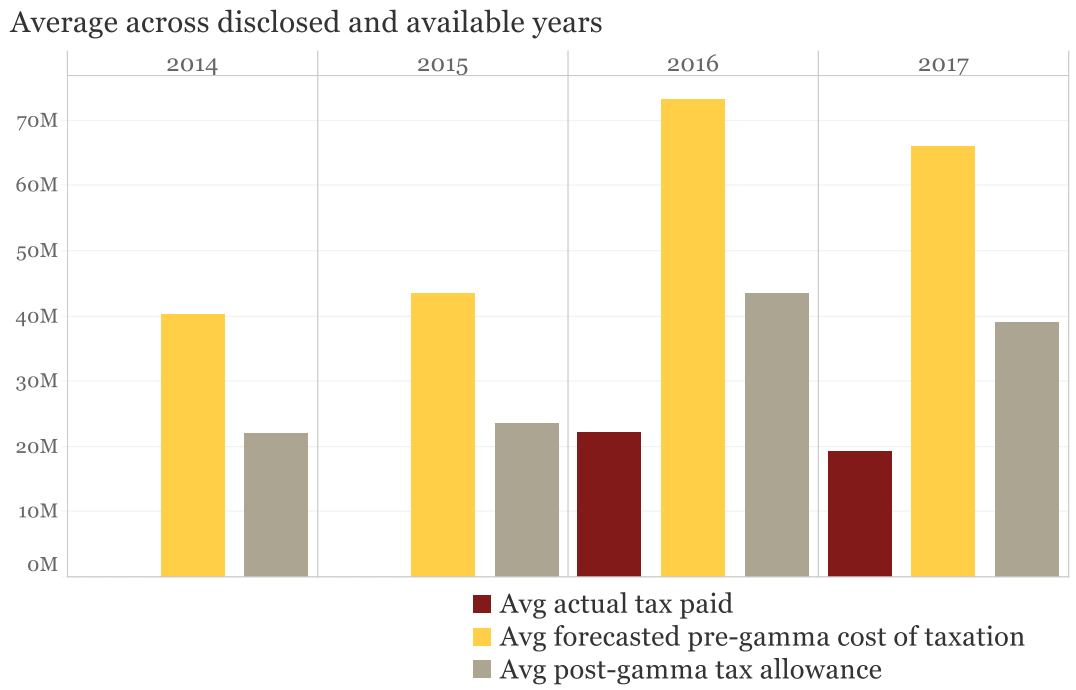


Notes relevant to interpretation of information:

- The above graph displays average income tax payable for private sector and NTER corporate entities on an annual basis.
- The information has been sourced from tax returns provided on a voluntary basis by the NSPs. Tax returns only disclose tax paid for corporate taxpayers, not for flow through vehicles (e.g. trusts and partnerships). Accordingly, the tax paid information above only relates to corporate vehicles.
- Of the NSPs subject to review, 12 are taxed as companies rather than on a flow through basis (including NTER entities). Of these 12, 3 did not provide any tax payable information. The 9 which provided at least some information are reflected in the above graph for years in respect of which income tax returns have been provided by those entities (consisting of 4 private sector ("non-NTER") entities and 5 NTER entities). Not all responding entities were able to provide income tax returns for all years shown above (for valid reasons).

Figure 2 demonstrates that actual tax paid by the observed private sector entities is substantially less than the actual tax paid by the observed NTER entities, on an average annual basis. Figures 3 and 4 below compare the actual tax payments made by the private sector and NTER entities to the forecast cost of tax and tax allowances provided to the same NSPs for regulatory purposes.

Figure 3: Private sector NSPs taxed as companies – actual tax paid v regulatory tax allowance

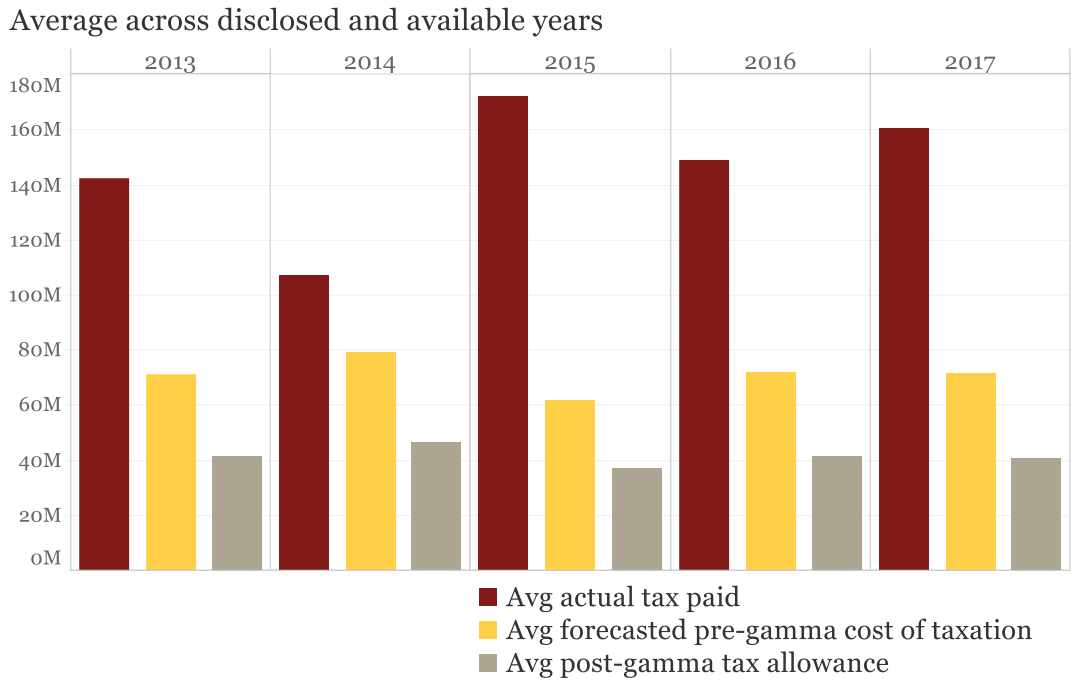


Notes relevant to interpretation of information:

- Of the 12 private sector NSPs subject to review, 7 are taxed as companies rather than on a flow through basis. Of these 7, 3 did not provide any tax paid information. The remaining 4 who provided at least some information are reflected above, in an annual year-on-year comparison of average actual tax paid against the average forecast of tax cost and related regulator tax allowance.
- The number of private sector NSPs (taxed as companies) that have provided income tax returns and are therefore reported above are as follows:
    - 2014: 3
    - 2015: 3
    - 2016: 4
    - 2017: 4

Figure 3 confirms that in all cases, the average annual actual tax payments made by the observed private sector NSPs have been significantly lower than the average annual forecast cost of tax for the same entities for regulatory purposes (noting no tax has been evidenced as paid by the responding entities in 2014 and 2015).

Figure 4: NTER entities – actual tax paid v regulatory tax allowance



Notes relevant to interpretation of information:

- The above graph compares the average tax payable by NTER entities (as reported in the NTER returns provided on a voluntary basis) to the average forecast cost of tax and relating tax allowance for those same entities for regulatory purposes, on an annual basis.
- To the extent regulatory tax information is not available, the equivalent NTER return tax payable information has also been omitted. This explains why the tax payable averages in the above graph differ to Figure 2 above.
- The number of NTER NSPs that have provided income tax returns and have available tax allowance information, and are therefore reported above are as follows:
    - 2013: 3
    - 2014: 3
    - 2015: 4
    - 2016: 4
    - 2017: 4

Figure 4 confirms that in all cases, the average annual actual tax payments made by the observed NTER NSPs have been significantly higher than the average annual forecast cost of tax for the same entities for regulatory purposes.

On this basis, we confirm that there is a difference between the estimated cost of tax for regulatory purposes and the actual tax liabilities for the NSPs.

It is important to note the following in interpreting the above graphs:

- Tax paid information has only been received in respect of entities which are taxed as a company. As noted above taxis not levied on flow through entities such as trusts and

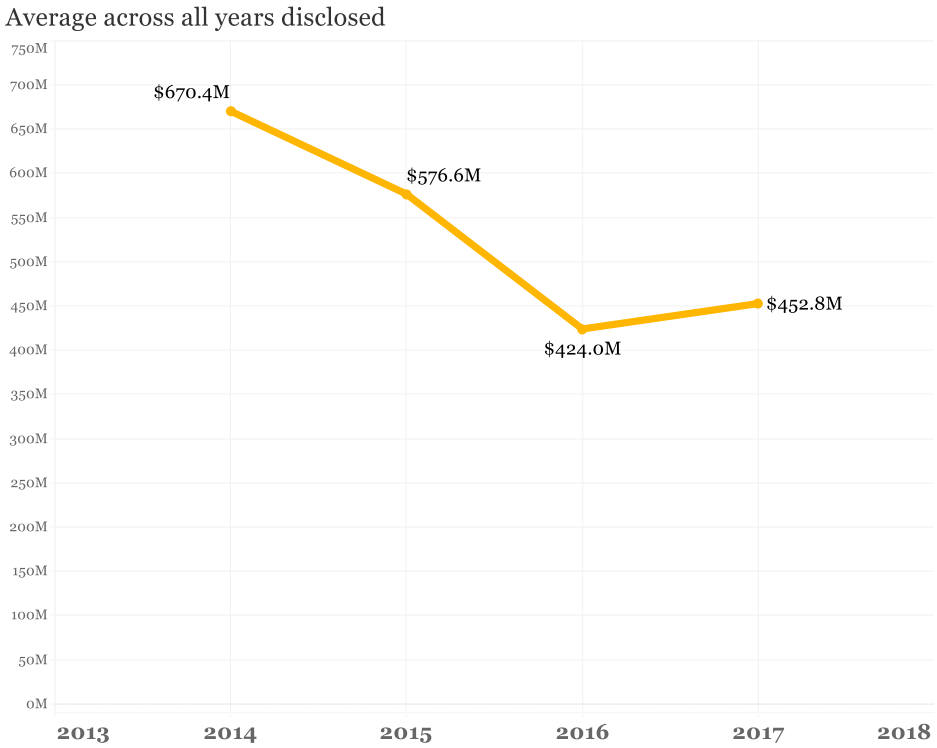
partnerships. Tax paid information would only be available at an investor level for these entities, and has not been provided on a voluntary basis. Accordingly, the graph does not capture tax paid data for these entities or their investors.

- Where entities have provided less than 5 years of tax return information, this may be due to the fact the entity has been in existence for less than that period of time (e.g. as a consequence of M&A activity), or the fact the information has not been provided on a voluntary basis. For the latter, this information is expected to be received in response to the RINs.

Additional commentary relating to private sector corporate taxpayers

As noted above, we have only observed limited amounts of tax being paid by private sector corporate taxpayers based on the information provided in respect of the 5 year period. A primary factor for this appears to be the fact that in most instances, the private corporate entities have carried forward and utilised tax losses, as evidenced in the figure 5 below.

Figure 5: Tax losses carried forward



Notes relevant to interpretation of information:

- The above graph outlines the average total carried forward revenue tax losses disclosed in the tax returns for private sector corporate taxpaying NSPs.
- Consistent with the tax paid graphs noted above, carried forward tax losses have only been depicted for entities which are taxed as a company.

Figure 5 demonstrates that private sector corporate taxpayers have carried forward and utilised material tax losses over the review period. Tax losses may be carried forward by companies, subject to certain loss utilisation integrity rules. An overview of the loss integrity rules is provided for reference at **Appendix F**. This is a driver for the discrepancy between the estimated cost of tax for regulatory purposes and actual tax paid for these entities.

In the first instance the existence of the tax losses for private sector corporate taxpayers supports the ATO's conclusion that the actual tax paid is lower than the forecast of the tax cost for regulatory purposes due to the existence of tax losses for these entities. However, any tax losses attributable to expenditure not taken into account for regulatory purposes (i.e. and therefore not included in the calculation of the forecast tax cost) because they are not costs incurred in the efficient operation of the regulatory business would create a justifiable departure. Such costs would include:

- Incremental tax deductions which may arise as a result of M&A activity, including a step-up in the depreciable basis of assets for income tax purposes, or immediate deductions allowable for stamp duty paid on entering into a long term lease over network assets;
- R&D tax concessions; and
- Expenditure or other losses relating to unregulated activities (including tax losses as may apply in a tax consolidation environment).

In this regard, only tax losses attributable to the tax treatment of regulatory Capex and financing costs would create a relevant departure between actual tax paid and the estimate cost for tax purposes.

Due to the limitations in the time frame for the review it is difficult to ascertain objectively what portion of the observed carried forward tax losses relate to differences in treatment in respect to regulatory Capex or financing costs.

As noted in our findings in the section 3.3 below there are observable departures in the tax treatment of Capex that have accelerated the timing of deductions for some portion of Capex costs for NSPs. We have recommended certain changes be made to the regulatory model in respect of determining the estimated cost of tax to resolve any continuing misalignment to the actual tax practices of NSPs in respect of Capex. Financing costs will be considered in our Addendum.

Additional commentary relating to NTER entities

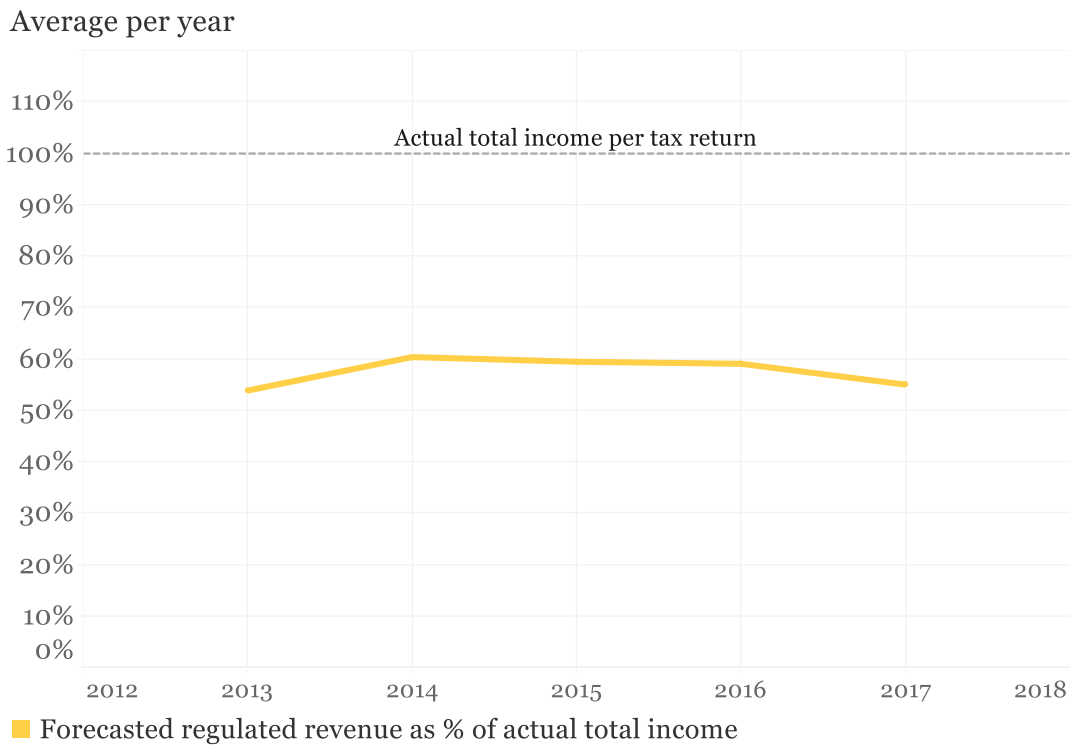
Figure 4 demonstrated that on average the actual tax paid by NTER entities exceeds the forecast cost of tax for regulatory purposes. We have undertaken further investigations to determine the drivers behind this differential.

The potential drivers for an excess of actual tax over the forecast cost of tax for regulatory purposes identified on our review of voluntary information include:

- A discrepancy between actual income reporting in the NTER returns for these entities and the forecast regulated revenue for NTER entities; and
- TAB balances for the NTER entities in excess of the TFAR balance, potentially leading to greater tax depreciation deductions for regulatory purposes.

Our first finding is that the average income included in the NTER returns exceeds the average income included in the regulatory tax allowance calculation, as depicted in Figure 6 below. The difference in revenue suggests that the taxable revenue reported in the NTER returns includes unregulated income and potentially regulated income in excess of the estimated return (i.e. actual as opposed to estimated).

Figure 6: NTER– Forecast regulated revenue as a percentage of total income per NTER return



Notes relevant to interpretation of information:

- The above graph displays the average regulatory revenue for NSPs which are subject to the NTER as a proportion of average total income disclosed in the NTER returns for those entities on an annual basis.
- In interpreting the data above, the AER have advised that:
    - Forecasted regulated revenue relates to distribution/transmission standard control services only
    - Total income for NTER purposes is expected to include (in addition to those standard control services) capital contributions, alternative control services, jurisdictional charges, and (for electricity distribution networks) Transmission Use Of Service (**TUOS**) charges.

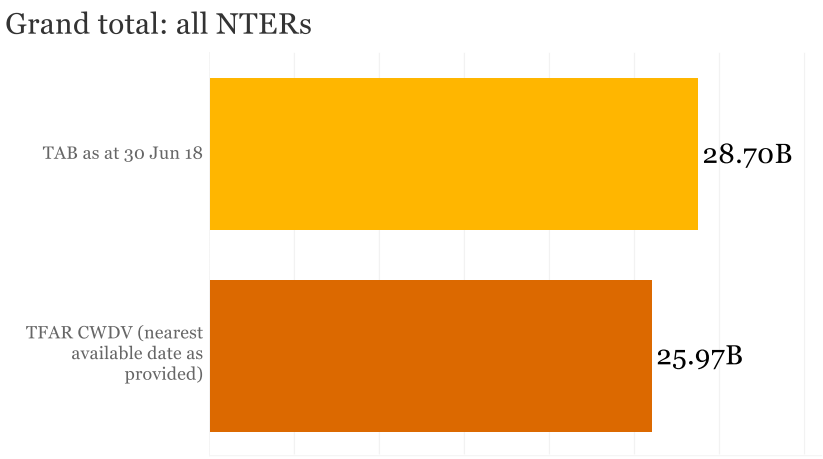
As outlined in the notes accompanying Figure 6, the AER have sought to provide some guidance on the potential reasons for these discrepancies. This includes charges which may 'flow through' the NTER entity for actual tax purposes (e.g. alternative control services, TUOS charges, and jurisdiction charges) whereby an amount of income and a matching expense may be recognised for the purposes of preparing the NTER return, but where the charges are ignored for the purposes of the forecast regulated revenue for that entity. Further, capital contributions may be treated as income for reporting purposes (and therefore be disclosed as income in the NTER return), but are not included in the calculations to determine the forecast regulated revenue.

Other reasons which may give rise to a differential between income reported in the NTER returns and the forecast regulated revenue may include revenue relating to unregulated activities, or a difference between estimated regulated revenue and actual regulated revenue year on year.

Whilst the factors outlined above may explain the difference between actual tax payments by the NTER entities and the forecast cost of tax for regulatory purposes, we consider that other than any potential variances between estimated regulated revenue and actual year on year final regulated revenue, the factors identified relate to items outside of the regulatory ring-fence and therefore represent an explainable discrepancy between actual tax paid and the forecast cost of tax for regulatory purposes. We have been unable to quantify any potential differences between estimated regulated revenue and actual final regulated revenue and therefore have not been able to determine whether this is a material reason for any discrepancy between actual tax paid and the forecast cost of tax for regulatory purposes.

In respect of the TAB and TFAR comparison, Figure 7 below demonstrates that the aggregate written down value in the actual tax fixed asset registers provided to us by NTER entities on a voluntary basis is lower than the aggregate TAB written down value for the same entities. This is depicted in the graph immediately below. This infers that the tax depreciation being claimed by the NTER entities in determining their actual tax liability is lower than the tax depreciation included in the TAB for the purpose of estimating the cost of taxation for regulatory purposes.

Figure 7: NTER – TFAR opening value v TAB opening value



Notes relevant to interpretation of information:

- The above graph compares the 30 June 2018 TAB values for NTER entities to the TFAR written down values in the register provided by those entities on a voluntary basis.
- Whilst individual NSP determinations generally only disclose TAB balances on an opening written down value basis (e.g. at the start of the determination period), we have used the additional information included in the relevant post-tax revenue models to estimate the TAB value for each NSP at 30 June 2018.
- TFAR information was requested as at 30 June 2018, however some entities have provided the information for the nearest possible date to 30 June 2018 for which the information has been prepared. All values related to closing balances of the asset register within the FY17 and FY18 years. As such, this comparison may not be on an exact like for like basis.
- Items in the TFARs and TABs which are not depreciated by the NSPs have been excluded from the balance above.

This difference in written down value is likely to relate in some part to the fact that we have observed that substantial deductions for expenditure included in the TAB are being deducted immediately to varying extents by NTER participants in determining their actual tax liability. Refer further comments in section 3.1.3 for further information in this regard, where we have made recommendations in respect of changes to the regulatory model in respect of this factor.

In addition to the above factors, we also note that financing costs may also be a factor in explaining the difference between actual tax paid and the AER's estimate of tax but we have not undertaken sufficient work at this stage to be able to objectively conclude on this particular matter.

We note for completeness that NTER entities may be less likely to seek to accelerate deductions where there is uncertainty in the tax law, as they are restricted in disputing a position taken in the event of challenge by the ATO. In contrast, the private sector have more avenues to challenge the ATO on interpretive matters including having matters heard by the Courts.

Additional commentary relating to flow through entities

As noted, partnerships and trusts are not of themselves liable for tax as they are flow through entities (with the exception of public trading trusts). The partnership and trust tax returns show taxable distributions made to investors, however do not disclose how much tax is ultimately paid by those investors (the reasons for differences in these amounts are discussed further in section 3.3.12 below).

Whilst the factors relating to capital allowances (refer section 3.3) and financing (to be addressed in the Addendum to our report) are also relevant to NSPs taxed on a flow through basis, an additional relevant consideration is whether any tax payable attributable to taxable profits will be taxed at the benchmark efficient entity rate of 30% (being the current corporate tax rate for large businesses), or whether a lower rate would apply. This factor is considered in detail in the holding structures section in section 3.2 below.

We have received tax returns for 4 of the NSPs which are taxed on a flow through basis. The tax returns for these entities show that:

- 2 of the responding flow through NSPs adopt stapled structures whereby the profits attributable to the networks assets and operations flow through different arms of the staple (stapled structures are discussed in further detail in section 3.2.2 below). In both cases, the asset entities have incurred significant tax losses over the period for which tax returns have been requested (with no net income representing taxable distributions). Net income attributable to the operating entity has been reported.

- The 2 flow through NSPs which are not held in stapled structures have reported net income (i.e. taxable distributions) consistently over the period for which tax returns have been requested.

The driver for the flow through NSPs which have incurred tax losses for the period in the asset holding vehicles for which tax returns have been requested appears to be costs associated with M&A activity. We have requested further information in this regard in the RINs. Therefore, for these entities, given the absence of taxable profits in the asset entities, no real tax rate discrepancy has been observed. That said, it is important to consider the potential tax rate which would apply if the tax position of these entities were determined in relation to the efficient operation of the network assets (e.g. excluding M&A costs). This is also considered further at section 3.2 below.

The distributions made by the 2 flow through NSPs which are not held in stapled structures appear to have in all instances been received by entities which would be taxed as a company.

Accordingly, we would not expect any tax rate differential to arise in respect of the taxable profits attributable to these flow through structures.

It is noted that the 2 NSPs which distributed taxable profits to corporate taxpayers have been in existence for some time, whereas the 2 NSPs which did not distribute taxable profits in respect of the asset entity comprising part of the stapled structure have been more recently privatised. It is important to note when these NSPs were privatised, any historical tax losses could not be transferred from the NTER owner into the private sector. It is therefore clear from the information provided that the absence of taxable distributions for the asset entities for the recently privatised NSPs relates to upfront deductions claimable by those entities as a result of transaction costs relating to the privatisations (e.g. stamp duty which is immediately deductible under section 25-20 of the ITAA 1997). As noted above, such costs are not recoverable under the regulatory framework and create a justified discrepancy to the estimated cost of tax for regulatory purposes. The considerations associated with M&A activity for the purpose of our review are discussed further at section 3.6.1.

As noted, where the flow through entities have distributed taxable profits to investors, we have been unable to verify how much income tax was ultimately paid by those investors in respect of these distributions. The potential reasons for why tax paid by investors may be less than 30% of the gross value of taxable distributions received are discussed further at section 3.2.2.

3.1.4 Tax pass through approach

The Martin Lally Report dismissed applying a "complete pass through" approach on the basis a pass through approach may encourage actions by NSPs to raise corporate tax payments and potentially lead to higher prices for consumers. Further, Dr Lally dismissed a "capping" approach (e.g. capping the tax allowance at the lower of the regulatory tax allowance and the actual tax paid by the NSP) on the basis "that it implicitly and wrongly attributes all tax shortfalls to tax minimisation behaviour".

Consistent with Dr Lally's findings but for different reasons, we also do not see merit in adopting an approach which applies a complete pass through of actual taxes paid for the following reasons:

- The actual tax paid by the NSP (or a related stapled entity where relevant) or upstream investors, is generally calculated to include other costs and revenue not captured within the regulated operations on which the return for the NSP is calculated. A detailed exercise would need to be undertaken to reconcile what portion of the tax actually paid by the NSP (and its upstream investors where the NSP is held in a flow through structure including foreign taxes) related to the regulated activities to ensure integrity with the broader regulatory framework. Any difference in actual tax paid as compared to the amount calculated under the tax allowance relating to inefficient or unregulated expenditure not recoverable by the NSP under the regulatory framework is appropriate. Accordingly we have recommended changes to the regulatory model to better align the estimated cost of taxation for regulatory purposes to the actual tax practices of the NSPs in respect of the relevant regulatory expenditure.

- Under a pass through regime, it is possible that there would be winners and losers among different consumer groups depending on the lifecycle of the relevant energy network and the relevant tax profile of investors including upstream investors where flow through structures have been adopted (i.e. rate of tax payable on regulatory profits). To ensure a fair outcome, it would be necessary for the AER to neutralise the impacts of these differences which could potentially be a complex exercise.

- A tax pass through regime would also be complex to implement and administer, particularly having regard to:

- *Tax consolidation regime*: All non-government corporate owners of the energy networks are held in entities which are members of an income tax consolidated group, meaning tax is paid by the group on a consolidated basis on taxable income from regulated and unregulated sources. For these energy networks, determination of the actual tax paid by the regulated business would likely require separate calculations to be undertaken by the energy network and verified by the AER (as the ATO would only review the tax position of the group on a consolidated basis) which is actually inconsistent with the intention of the tax consolidation regime to reduce compliance costs.

- *Ownership changes*: For energy networks held in a flow-through entity, a change in ownership may result in a change in the actual tax paid. This becomes even more complex if a previous owner of a network asset is subject to an amended assessment as noted below. It would raise complexities for AER in respect to how it would administer any additional tax during a tariff period for changes in ownership, particularly having regard to the limits on information that can be requested at the investor level.

- *Amended assessments*: The ATO may issue an amended assessment to the energy network, or its investors (in the case of energy networks owned by a trust or partnership), at any time during the relevant amendment period (which is typically 4 years in most instances, noting that there is no time restriction relating to transfer pricing matters). Under a pass through approach, this would cause additional complexity potentially requiring the AER not only to reconcile actual tax paid against the forecast cost of tax to ensure the ring-fencing is appropriately being adhered to but also potentially having to consider prior regulatory periods. This may be further complicated by changes in ownership for energy networks held in flow through entities.

  Using the result of the Chevron decisions as an example, where there was no amendment period limitation for transfer pricing adjustments, amendments that relate to a number of years ultimately modify the tax profile of a taxpayer. In this situation, the actual tax paid by a taxpayer cannot be accurately determined using a single year of assessment. Adopting an actual tax paid approach in these circumstances has the potential to create potential inter-generational issues.

- *Legislative change impacting on tax outcomes*: Legislative changes may occur part way through a regulatory period, or may give rise to uncertain tax outcomes which take some time to resolve. The AER would need to constantly monitor and adjust the tax allowance to factor in these changes and uncertainties, taking into account the specific circumstances of each energy network.

- *Change in the interpretation of the law*: The way the tax law is interpreted by the Courts and/or administered by the ATO may change during a regulatory period. Where this occurs, the AER would be required to assess the likely impact of any changes on the actual tax paid by each energy network and adjust the tax allowance accordingly.

3.2 Holding structures

3.2.1 Summary of our process to investigate holding structures

The ATO Note considered that a key driver for the difference between actual income tax paid by the electricity distribution businesses which were subject to the ATO's review and the regulatory tax allowance was the fact "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)".

As noted above, where the relevant regulated network assets are held in a company (including NTER entity), any taxable profits would be subject to income tax or tax equivalent (in the case of NTER) at the rate applicable to corporate entities (currently 30% for large businesses). This is consistent with the benchmark efficient entity approach currently adopted in the regulatory model for estimating the cost of tax where the NSP is considered to be in a standalone company taxed at the corporate rate. As such, the use of corporate structures should not result in any divergence between the estimated cost of tax and actual tax payments in respect of the tax rate to be applied to any taxable profits relating to the regulated operations.

Where the regulated network assets are held in a flow through vehicle (e.g. partnership or trust), any taxable profits relating to the regulatory operations are distributed to the investors (either the partners in the partnership or beneficiaries in the trust) and subject to tax in accordance with the relevant investor's tax profile. As such, further investigations are required in order to determine whether or not the tax payments made by investors in flow through vehicles in respect of regulated revenues are consistent with the benchmark efficient entity approach adopted in the regulatory model.

For the purpose of this report, the AER requested the following information relating to holding structures and tax lodgements through the voluntary information request:

1. *Provide a diagram illustrating the group holding structure of the NSP (and any related stapled entities), its downstream associated entities[8] and any upstream equity participants[9] as at 30 June 2018, or its most recent financial year end. For completeness, the group structure diagram should indicate:*
    a. *The nature of the vehicle (e.g. trust, company, partnership)*
    b. *Where entities are stapled (contractually or otherwise)*
    c. *The existence of partnership arrangements including any Limited Partnerships*
    d. *The jurisdiction in which the entity is a resident for tax purposes*
    e. *Entities which are members of a Australian tax consolidated group (where relevant)*
    f. *In the case of trusts the Trustee entity*
    g. *Whether the entity is classified a Managed Investment Trust*

8 For the purpose of this request, "downstream associated entities" refers to "associates" of the NSP as that term is defined in section 318 of the ITAA 1936, however only to the extent that the NSP has a direct or indirect control interest in that entity of greater than 10%.

9 For the purpose of this request, "upstream equity participants" includes any entities which have a direct or indirect equity interest in the NSP of greater than 10%. This would include a total participation interest as defined in section 960-180 of the ITAA 1997, but only to the extent that the participation interest is greater than 10%. Direct and indirect interests held by a foreign entity in the NSP only need to be disclosed to the extent the foreign entity has a direct interest in an Australian resident vehicle. For the avoidance of doubt, an equity interest for these purposes would also include a partner's interest in a partnership.

h. *Where the entity is government owned confirmation that it is subject to the National Tax Equivalent Regime*

i. *The existence of a special purpose finance company*

2. *Confirm whether there have been any changes to the group structure since 30 June 2018.*

As noted above, any differential between the estimated cost of tax and actual tax paid relating to financing adopted by the NSPs and their investors will be considered on the receipt of RIN responses and our findings in this respect will be included as a subsequent Addendum to this Report.

3.2.2 Holding structures used by NSPs

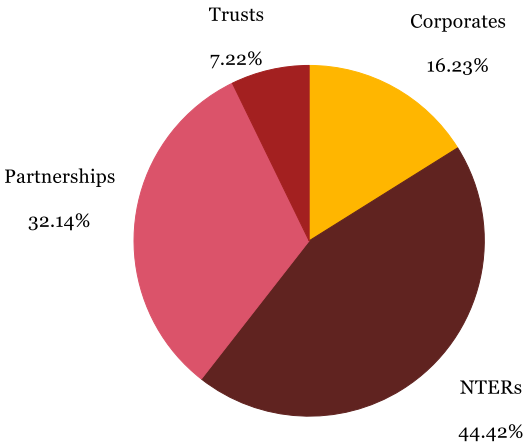
Private sector interests in Australian assets or businesses are generally acquired under corporate, trust (including stapled trusts) or partnership (including stapled partnerships) structures.

Assets which are still owned by the public sector are held within corporate vehicles which are established under State law (**State Owned Enterprises**). States/Territories may choose to add the entity to the NTER register for State Owned Enterprises.

To determine the holding structures adopted by the NSPs, we have reviewed the group structure diagrams provided by the NSPs on a voluntary basis and supplemented this with publicly available information (relating primarily to upstream investors in flow through vehicles) where possible. There is the potential for the publicly available information to have limited reliability due to the potential for inconsistent reporting and changes to group structures over time.

That said, based on the information available for our review we have summarised the relevant holding structures adopted by the NSPs in Figure 8 below. This graph does not outline the tax profile of the vehicles per se (for example, in Australia certain trusts may be taxed as if they are a company and therefore be subject to corporate tax at the entity level), but rather summarises the legal structures observed in our review in the first instance.

Figure 8: Comparison of holding structures by TAB value and count



By count of NSP	
Corporates	6
NTERs	5
Partnerships	4
Trusts	2

Notes relevant to interpretation of information:

- The above graph provides an overview of legal structures adopted by NSPs, weighted with reference to the estimated TAB value as at 30 June 2018.
- Where information relating to holding structures has not been provided on a voluntary basis, we have supplemented our understanding with publicly available information.
- Note, the legal structures identified above only relate to the NSP level. Where there are multiple levels of investors (e.g. a trust investing in a partnership), this is not disclosed above.

The information displayed in Figure 8 above shows the holding structure adopted at the NSP level only. For example, partnership interests may be held by trusts which are interposed between the partnership and the upstream investors. Of the 4 partnerships identified, 3 have State/Territory partners, indicating this structure has been used to facilitate the retention of an interest by the State/Territory in the project assets. Trusts (or stapled trusts) are generally used by investors to facilitate flow through taxation in relation to the project assets. This is discussed in further detail below.

Prior to discussing the expected impact of the observed holding structures on tax paid by the NSPs, we have outlined a general overview of the relevant tax profile for each structure below. The impact of observed holding structures on tax paid by the NSPs is then subsequently critiqued at section 3.2.4 below.

Taxation of Companies

Under Australian income tax law, companies and certain other entities which are taxed as if they were a company (e.g. Division 6C public trading trusts[10]) are liable to pay income tax at the corporate tax rate (currently 30% for large businesses), in respect of taxable profits

[10] We have identified one Division 6C public trading trust that is taxed like a company based on our investigations.

determined in respect of each income year. This is consistent with the tax rate applied for the purposes of determining the estimated cost of tax for regulated purposes. Accordingly, the adoption of these structures will not give rise to a difference in the tax rate applicable to the regulated profits from that modelled for regulatory purposes.

All privately owned NSPs which are taxed as a company have elected to adopt the tax consolidation regime. The tax consolidation regime seeks to treat all legal entities which are part of the same wholly owned corporate group as a single entity in determining the income tax liability of the group. This results in the lodgement of a single income tax return in respect of the tax consolidated group, the offsetting of gains and losses of different members of the same group, and the elimination of any inter-group transactions when determining the tax position.

The regulatory tax building blocks currently apply a corporate tax paying benchmark entity approach, and accordingly, we do not expect any misalignment between the estimated cost of tax for regulatory tax purposes and actual tax payable relating to the tax rate applicable to the corporate structures (e.g. relating to income and expenditure within the regulatory ring-fence). As such, the remainder of this section focuses on scenarios where the holding structure adopted may result in a different tax rate being applied to regulated profits for the purposes of the regulatory forecast of tax costs and the actual tax position of the NSPs.

Taxation of NTER entities

In accordance with Division 1AB of the ITAA 1936, statutory bodies which are wholly owned by Australian States or Territories are exempt from the Federal income tax regime. In order to support the principle of competitive neutrality[11], Australian States and Territories are able to choose to impose an income tax equivalent liability on State Owned Enterprises (for these purposes, the term State Owned Enterprises also includes statutory bodies owned by Australian territories) under the NTER.

The NTER was introduced in 2001 to provide a consistent regime which would be overseen and administered by the ATO. The NTER broadly applies the Federal income tax legislation to State Owned Enterprises which are nominated by the relevant State/Territory, with certain modifications to the law, including the following:

- Any income tax equivalent or related payments (e.g. interest and penalties) are paid directly to the State/Territory owner rather than to the Commonwealth;
- Certain State/Territory impost restructures (e.g. privatisations) can be treated in a "tax neutral" manner (e.g. no taxable gain would arise on disposal); and
- Taxpayer rights to challenge positions adopted by the ATO are more limited than for the private sector (e.g. NTER entities have restricted ability to dispute a private ruling outcome).

These modifications mean that even though NTER entities which own regulated assets are subject to an income tax equivalent liability, the "notional tax" payable is paid back to the relevant State/Territory shareholder and not the Federal Government. Consistent with the income tax regime for corporate entities, tax equivalent liabilities are calculated by applying the corporate tax rate (currently 30% for large businesses) to any taxable income derived by the business. This is consistent with the benchmark efficient corporate tax paying entity approach applied for regulatory purposes, and accordingly we expect the tax rate applicable to taxable profits of NTER entities to align for regulatory and actual tax purposes.

[11] Refer OECD publication: Competitive Neutrality: Maintaining a level playing field between public and private business, published 30 August 2012.

Taxation of Trusts and Partnerships (including stapled arrangements)

Generally, trusts and partnerships are flow through vehicles for Australian tax purposes, meaning that any taxable profits derived by these vehicles are distributed to the investors and subject to tax in accordance with the relevant investor's tax profile. The use of flow through vehicles is common for institutional and other investment groups. These structures result in the receipt of distributable profits from the relevant investments on a pre-tax basis.

Concessional tax rates may be available to certain types of investors in respect of the income they derive from flow through vehicles (e.g. complying Australian superannuation funds and distributions to foreign investors in a MIT from certain Exchange of Information countries are subject to tax at a rate of 15%). Further, sovereign wealth funds may be treated as tax exempt in respect of particular classes of passive income under the principle of sovereign immunity (noting this treatment has historically been confirmed through a ruling request with the ATO). For these investors, the use of a flow through vehicle means that they are still able to access the concessional tax rate and/or tax exemption in respect of the income derived from the underlying investment.

In Australia, collective passive investments have traditionally been facilitated through a unit trust structure. In many other jurisdictions, the local corporate laws allow investments of a flow through basis through specifically designated collective investment corporate vehicles. Australia has recently announced introduction of a Corporate Collective Investment Vehicle (**CCIV**) regime which seeks to introduce a flow through corporate vehicle as this is more readily known and understood by foreign investors (including investors from Asia, as these changes have been introduced alongside the broader Asia Region Funds Passports package).

In introducing the package of reform, the following was noted by the Honourable Minister Kelly O'Dwyer in a media release dated 21 December 2017:

> *CCIVs will increase the competitiveness of Australia's managed funds industry by aligning Australia's legal funds structures with those found in the rest of the world," Minister O'Dwyer said.*
>
> *The Australian funds market currently uses **unit trusts** whereas the rest of the world generally uses corporate and limited partnership investment vehicles.*
>
> *The proposed tax framework for the new CCIV has been designed to **broadly align with the attribution tax regime for managed investment trusts (MITs)**. One of the key features of the CCIV tax regime is capital gains tax relief for attribution MITs that convert into CCIVs and meet the eligibility requirements for attribution tax.*

The availability of concessional tax rates for investments in Australian infrastructure projects has been subject to significant reform over recent years, and draft legislation currently proposes to remove the ability of foreign investors in MITs and sovereign wealth funds to benefit from concessional tax treatment for any new infrastructure projects (for tax periods from 1 July 2019 onwards). Transitional rules apply in respect of existing infrastructure projects, such that investors in existing stapled structures through MITs will continue to receive the concessional 15% tax rate until 30 June 2034, and sovereign wealth funds will continue to be treated as income tax exempt until 30 June 2026 (or until their private ruling from the ATO expires). It is noted that post-law change, sovereign wealth funds with an interest of less than 10% in a MIT or company will continue to be treated as tax exempt under the codified sovereign immunity exemptions but only to the extent they do not influence an entity's key decision making. The tax reforms relating to stapled structures, MITs and sovereign wealth funds are discussed further at section 3.2.3 below.

Consistent with the comments above, Australia has historically supported foreign direct investment into asset classes such as commercial and industrial real estate, privatised assets and other critical infrastructure through tax policy supporting flow through taxation for over 10 years. These policies have been aimed at increasing Australia's ability to compete with other developed countries that are seeking to attract the same institutional capital through lower corporate tax rates and specific tax concessions.

The policy considerations that led to the current tax legislative framework, including modifications over the past decade, can be understood with regard to the following two key features of the current Australian tax framework which encourage foreign investment into Australian assets:

- Transparent taxation of public trusts in stapled structure that carry on an "eligible investment business"; and
- The MIT withholding tax regime.

Each are discussed in further detail below.

It is also useful to understand some of the commercial drivers which have also been relevant to the implementation of flow through structures in this industry. The commercial drivers expressed by the infrastructure community throughout the consultation process regarding the amendments to the staples regime include:

- *Flexibility in the repatriation of income*. As discussed further below, a trust structure allows the payment of excess cash back to investors in an easier manner than a corporate structure (due to the need to accrue accounting profits prior to payment of a dividend from a company).
- *Increased capacity for debt financing*. As banks generally determine lending capacity based on post-tax cash flows, an investment vehicle which is treated as "flow through" for tax purposes can generally obtain a greater level of external debt funding (or a better rate). This is due to the fact that under a flow through structure the tax liability rests with the investor rather than the project vehicle (or investment vehicle). This can be contrasted with a corporate structure where tax is remitted to the ATO prior to the distribution of profits to shareholders.
- *Reporting of income for fund managers*. The use of a flow through investment vehicle allows the recipient funds to report the gross income (which is then subject to tax in the hands of that fund), rather than a net receipt of an after tax profit. This is particularly relevant for Australian superannuation funds, as whilst the fund ultimately pays the same amount of income tax whether an investment is held through a corporate structure or a flow through structure (as franking credits are generally available to enable the fund to recoup any income tax paid at the corporate level), the fund managers would generally prefer to report income derived by the fund on a pre-tax basis (rather than reporting the net after tax receipt).

Division 6C

Division 6C of the ITAA 1936 seeks to limit this "flow through" taxation treatment for widely held or public unit trusts that carry on, or control, a trading business. This is consistent with the policy intention of making this concession available for managed fund investments. Division 6C defines a trading business as a business that does not consist wholly of "eligible investment business". Accordingly, the phrase "eligible investment business" effectively limits or restricts the income that can be generated by a public flow through trust.

Eligible investment business is defined in section 102M of the ITAA 1936 to include businesses which:

a invest in land for the purpose, or primarily for the purpose, of deriving rent;

b invest or trade in a range of listed financial instruments (e.g. secured and unsecured loans, bonds, debentures, stock, shares in a company, units in a unit trust, derivative contracts), or

c invest or trade in other financial instruments that arise under financial arrangements.

In 2008 the Government amended Division 6C "*to streamline and modernise the eligible investment business rules for managed funds*" and "*make it easier for managed funds, in particular property trusts, to comply with the law by reducing the scope for them to inadvertently breach Division 6C*".[12]

These amendments:

- clarified the scope and meaning of "investing in land" by ensuring that investing in movable property (i.e. chattels) customarily supplied, incidental and relevant to the renting of the land and ancillary to the ownership and utilisation of the land are deemed to be investments in land (deeming rule);
- introduced a safe harbour for non-rental, non-trading income from investments in land;
- expanded the range of permitted financial instruments that a trust may invest or trade in to include any financial instrument (not already covered by paragraph (b)) that arises under financial arrangements, other than certain excepted arrangements; and
- provided a 2 per cent safe harbour allowance at the whole of trust level for non-trading income to reduce the scope for inadvertent minor breaches of the eligible investment business rules.

As a result of the approach taken by Parliament with the meaning of "eligible investment business" and the legislative amendments in 2008 to "make it easier" for taxpayers to comply with the rules, Australia's flow through trust taxation rules are designed to permit most forms of "passive" investment to be held in a trust, offering tax transparency for both resident and foreign investors.

The Managed Investment Trust (MIT) regime

The MIT regime came into effect in 2008 and was aimed at enhancing the competitiveness of the Australian funds management industry and increase their ability to attract foreign investment.

The MIT regime allows certain foreign investors in a widely held trust to benefit from concessional tax rates on distributions from an "eligible investment business" (aligned to the Division 6C definition discussed above), along with certain other benefits for Australian residents.

A trust qualifies as a MIT if all of the following apply for the income year in which it operates:

- The trustee is an Australian resident, or the central management and control of the trust is in Australia;
- The trust does not carry on or control an active trading business (with reference to the Division 6C eligible business investment definition discussed above);
- The trust is a managed investment scheme (**MIS**) (in accordance with the Australian Corporations Act definition);
- The trust is operated or managed by a holder of an Australian Financial Services Licence;

[12] Paragraphs 5.1 and 5.3 of the Explanatory Memorandum to Tax Laws Amendment (2008 Measures No. 5) Bill 2008

- The trust meets the widely held requirement, which generally requires greater than 25 investors for a wholesale MIS; and
- The trust meets the closely held restriction. A trust will satisfy this condition unless:
    - fewer than 10 persons have a total MIT participation interest in the trust of 75% or more; or
    - a foreign resident individual has a MIT participation interest in the trust of 10% or more.

The Explanatory Memorandum to the bills which enacted the MIT regime stated:[13]

> *At present, **less than 3 per cent** of the fees derived by the Australian funds management industry are attributable to foreign investment. **Industry has contended this is due, in part, to the high withholding tax** that currently applies to certain distributions from the industry to foreign investors, namely, the 30 per cent non-final withholding rate that predominantly applies to distributions of Australian source rental income and capital gains from Australian property trusts.*
>
> *Industry argues the headline rate of withholding discourages foreign investment in the Australian funds management industry as it is higher, on average, than the withholding tax rates imposed by other countries, particularly those in the Asia-Pacific region.*
>
> *The Government, in furthering its objective to secure Australia's position as a financial services hub in the Asia-Pacific region, will replace the existing non-final withholding regime with a new final withholding tax regime with reduced withholding tax rates, to be implemented over a three year period. Once fully implemented, foreign investors of jurisdictions with which Australia has effective exchange of information on tax matters will be subject to **a 7.5 per cent final withholding tax,** which will be one of the lowest internationally. This will enhance the competitiveness of the industry and ensure it is well-placed to attract and retain foreign investment. [Emphasis added].*

As a result of further changes, the rate of withholding under the MIT regime for foreign investors in jurisdictions with which Australia has an exchange of information agreement was set at 15 per cent from 2012 onwards.

These principles and above statements in the Explanatory Memorandum were echoed by the Assistant Treasurer, Chris Bowen, in his speech at the time of introducing the Bill into Parliament in 2008:

> *"We have an industry in Australia which…has the fourth largest pool of funds under management in the world—not per capita but in the world…**We have an industry which has built up great skills but which does not export those skills, because we have an industry which has been saddled with an uncompetitive tax regime**…*
>
> *We have an uncompetitive tax regime where we have big superannuation funds and pension funds around the world looking at where to invest their money and they say: 'Well, Australia is pretty good at this. They have got a well¬ developed superannuation system. Australia is in a strategic time zone, placed between the United States and Asia. Australia has a well - respected prudential regulation system. Australia has stable government and a stable democracy. It is a good place to invest. Why don't we invest our money in Australia? **Because the withholding tax rate is 30 per cent**.'*
>
> *Yet around the world the average is 15 per cent, and some countries are as low as 10 or 7.5 per cent. Why don't we give this industry a break? Why don't we say to this industry: 'We*

[13] Paragraphs 1.6 to 1.8 of the Explanatory Memorandum to Tax Laws Amendments (Election Commitments No. 1) Bill 2008, Income Tax (Managed Investment Trust Withholding Tax) Bill 2008 and Income Tax (Managed Investment Trust Transitional) Bill 2008

> *will give you a level playing field'? Why don't we say to this industry: 'You go out and win the business; why don't you export more than 21/2 per cent of your capacity?' ... 'we'll give you a tax system which allows you to compete'? Those opposite will give them a tax rate of 30 per cent and shame on them! Shame on them for holding back an industry that wants to compete on its own. It is not asking for government assistance, it is not asking for special favours, but it is asking for a tax regime which allows them to be competitive. That is exactly the tax regime this government will give them and it is a tax regime that those opposite stand against." [Emphasis added]*

This commentary provides context for the introduction of the flow through and MIT regimes, and demonstrates why the flow through structures have been adopted more broadly by foreign investors.

Stapled arrangements

As noted above, some of the NSPs are held via stapled structures, involving the use of a partnership or trust. Broadly:

- A stapled structure involves the use of two vehicles, an asset entity and an operating entity. The ownership interests in the two vehicles are generally "stapled", meaning they cannot be separately traded.

- In an infrastructure context, the asset entity will generally hold the land assets of the project (including fixtures on land). The asset entity will lease the land assets to the operating entity, in return for the payment of rent (referred to as cross-staple rent). The operating entity will then operate the assets for the purposes of deriving income.

- The ATO have historically accepted (or agreed via a Tax Deed) that for electricity networks and/or gas projects, the fixtures which comprise of the majority of the network (e.g. transmission lines or gas pipeline) are fixtures on land. This means that where the asset entity is a trust, it will be regarded as carrying on an "eligible investment business" (being an investment in land for the purposes of deriving rent) meaning it does not carry on a trading trust and may be eligible to be a MIT.

- The asset entity's taxable income should consist primarily of rental income (received from the operating entity), less any allowable deductions (such as depreciation deductions in respect of the network assets). The taxable income distributed by the asset entity should flow through to the investors at their respective tax rates. This may be 15% for certain foreign investors, or lower for other tax preferred entities (e.g. sovereign wealth funds, which are exempt from tax).

- The operating entity will derive income from the operation of assets (in the case of an NSP, this will be the regulated return as determined by the AER), less any allowable deductions which will include the rent paid to the asset entity. If the operating entity is taxed as a company, its profits should be subject to tax at the corporate tax rate. However, if the operating entity is a flow through vehicle, the taxable income distributed to its investors should be subject to tax at their respective rates.

In our experience, the taxable income distributed by the asset entity will generally be subject to tax at the concessional MIT rate of 15% (or nil if the sovereign wealth fund exemption applies) as the activities carried on by the asset trust constitute an eligible investment business. The effective tax rate may be further reduced if additional debt funding is used at the upstream investor level.

In contrast, given that the activities of the operating entity do not qualify as "eligible investment business", it may be subject to tax as a company if the trust is also a public unit trust. If the operating entity is a flow through vehicle, taxable income distributed by the operating entity may be subject to tax at a higher rate depending on the upstream structure adopted by the investor – for example, a distribution to a corporate investor would generally be subject to tax at 30%, whereas a distribution to a MIT would be subject to tax at 15% where the income is further distributed to an investor from an information exchange

country. Distributions to non-resident beneficiaries from a trust which is not eligible for MIT status are subject to a 30% withholding tax.

Legislation is currently before parliament which, if passed, will limit the availability of concessional tax rates in respect of stapled structures going forward, with transitional arrangements for existing projects. These reforms are discussed immediately below.

3.2.3 Change in law – taxation of foreign investors

On 20 September 2018, *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* (the Bill) was introduced into Parliament to give effect to the Government's proposal to reform the tax treatment applicable to stapled structures and certain foreign investors.

As relevant to the privately owned NSPs and their investors, the Bill includes measures that seek to:

- subject converted trading income to MIT withholding at the corporate tax rate (currently 30%);
- prevent double gearing through thin capitalisation changes;
- limit the foreign pension fund withholding tax exemption for interest and dividends to portfolio like investments; and
- create a legislative framework for the sovereign immunity exemption.

A summary of these measures is set out below.

Stapled structures and MITs

The Bill proposes to increase the MIT withholding tax rate from 15% to the corporate tax rate (currently 30%) from 1 July 2019 for:

- certain income derived by a MIT (being cross-staple rental payments, cross-staple payments made under some financial arrangement such as total return swaps and distributions of active income from trading trusts); and
- MITs receiving distributions from trading trusts (referred to as "vertical MITs").

Acknowledging the long-term nature of economic infrastructure, the Bill includes a 15 year transitional rule which will be available for existing economic infrastructure that is held in an MIT (subject to certain integrity measures). A seven year transitional rule applies in relation to vertical MITs (being a MIT holding a non-controlling interest in a trust).

The table below sets out the potential impact of this change for NSPs that are held in stapled structures.

Aspect	Historical tax positions	Future tax positions
Distributions of income from the asset entity	Taxable income distributed by the asset entity is subject tax at the investor's applicable rate – generally the concessional MIT rate of 15% or lower.	Distributions of income from the asset entity to a non-resident investor that are attributable to cross-staple rent should be subject to tax at the corporate tax rate (currently 30%). Existing infrastructure projects continue to access the concessional 15% rate for a transitional period of 15 years (i.e. to 30 June 2034) in respect of cross-staple rent that satisfies the integrity rules. Broadly, the 15% rate only applies to the lesser of a statutory rental cap and the arm's length rental amount. Excess rent will be subject to 30% withholding tax.
Distributions of income from the operating entity	Taxable income distributed by the operating entity may be subject to concessional MIT rate of 15% depending on the upstream structure adopted by an investor, otherwise the corporate tax rate of 30% should generally apply	Distributions of income by the operating entity should be subject to tax at the corporate tax rate (30%). Existing investments made via MITs (including vertical MITs) continue to access the concessional 15% rate for a transitional period of 7 years (i.e. to 30 June 2026).

Thin capitalisation

The thin capitalisation rules in Division 820 of the ITAA 1997 apply to foreign controlled Australian entities, Australian entities that operate internationally and foreign entities that operate in Australia. Broadly, the rules operate to deny interest deductions if the entity's debt exceeds the thin capitalisation limits, being the greater of the "safe harbour" debt amount, the "worldwide gearing" debt amount and the "arm's length" debt amount.

The Bill proposes to amend the thin capitalisation rules to prevent foreign investors from using multiple layers of flow through entities (i.e. trusts and partnerships) each issuing debt against the same underlying asset. This will be achieved by reducing the threshold at which an entity becomes an "associate entity" from ownership of 50% or more to 10% or more for the purposes of applying the thin capitalisation rules. In addition, the Bill clarifies that the thin capitalisation arm's length debt test requires consideration of gearing against the underlying assets of an entity.

These thin capitalisation measures are proposed to apply to income years commencing on or after 1 July 2018 and no transitional period will be available.

The impact of financing deductions on actual tax payments by the NSPs will be considered in an Addendum to this report once RIN information has been received.

Foreign pension funds

Foreign pension funds are currently exempt from Australian interest and dividend withholding tax.[14]

The Bill proposes to limit the foreign pension fund withholding tax exemption to portfolio investments (i.e. where a foreign pension fund investor holds ownership interests of less than 10 per cent and does not have influence over the entity's key decision making). This measure is proposed take effect from 1 July 2019 and arrangements in existence at 27 March 2018 will have access to a seven year transitional period.

This measure should have implications for shareholder loans made to NSPs by foreign pension fund investors following the transition period.

Sovereign wealth funds

The Bill proposes to legislate a framework for sovereign immunity, which will continue to exempt sovereign investors where they hold less than 10 per cent of an entity's ownership interest and do not influence an entity's key decision making. The Bill will also preclude active income (including where it is converted to rent) from the exemption.

The codification of the sovereign immunity exemption is proposed to take effect from 1 July 2019. Investments in existence at 27 March 2018 will have access to a seven year transitional period (unless a tax ruling is in place which extends beyond the seven year period).

The table below sets out the potential impact of this change for sovereign wealth funds investors in NSPs that are held in stapled structures.

Aspect	Historical tax positions	Future tax positions
Distributions of income from the asset entity	Sovereign wealth funds who are eligible for the sovereign immunity exemption are exempt from tax on income distributions from the asset entity. (Note: ATO does not specify any ownership limits to qualify for the sovereign immunity exemption, but generally requires <20%, non-controlling interest.)	Sovereign wealth funds will only have access to the sovereign tax exemption on holdings of less than 10% in the asset entity, but only to the extent they do not influence an entity's key decision making. Transitional relief will apply up to 30 June 2026 (or later if an ATO ruling is in place). A 15% rate may be available until 30 June 2034 under the MIT transitional rules if the sovereign jurisdiction is an exchange of information country.
Distributions of income from the operating entity	Sovereign wealth funds who are eligible for the sovereign immunity exemption are exempt from tax on income distributions from the operating entity.	The sovereign wealth fund exemption will not apply to income derived from an operating entity. Transitional relief will apply up to 30 June 2026 (or later if an ATO ruling is in place).

[14] Section 128B(3)(jb) of the ITAA 1936.

3.2.4 Observations regarding applicable holding structures

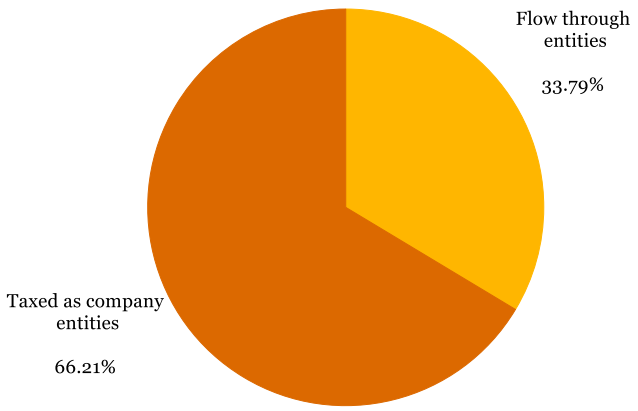
For the purpose of our review, we have classified the holding structures applied to the NSPs as follows:

- NSPs which are taxed as companies (corporates, NTERs, Division 6C trusts); and
- NSPs which are taxed on a flow through basis (trusts and partnerships, including stapled structures).

The observed tax profiles in this regard are outlined in Figure 10 below:

Figure 10: Tax profile of regulated entities by TAB value and count

By TAB value



By count of NSP

Flow through	5
Taxed as company	12

Notes relevant to interpretation of information:

- The above diagrams depict the proportionate values of regulated assets (weighted with reference to the estimated TAB value as at 30 June 2018 for each NSP) which are held within vehicles taxed as a company against vehicles which are taxed on a flow through basis.
- Where information relating to holding structures has not been provided on a voluntary basis, we have supplemented our understanding with publicly available information.

The purpose of this section of our Report is to consider whether any discrepancy between actual tax paid and the forecast cost of tax for regulatory purposes arises in respect of the tax rate at which any regulated profits will be taxed. The 66.21% (by proportion of TAB value) of NSPs which are taxed as a company will not give rise to any tax rate differential, as taxable profits will be subject to the Australian corporate income tax rate (currently 30% for large businesses), consistent with the regulatory benchmark efficient entity approach. For the 33.79% (by proportion of TAB value) of NSPs taxed on a flow through basis, the applicable

tax rate will depend on the tax profile of the upstream investor. This is considered further below.

Flow through investors identified

From the 5 NSPs which are taxed on a flow through basis, 3 of the NSPs have adopted a stapled structure (either stapled trusts or partnerships). As noted in section 3.2.2 above, under a stapled structure a portion of the profits derived by the operating entity from regulated activities are used to pay cross-staple rent to the asset entity for the lease of the network assets.

For regulatory purposes, the AER does not distinguish between the asset and operating entities of the stapled structure, but rather applies the regulatory framework and tax building blocks on a consolidated basis with reference to the efficient operating costs of the network assets. Accordingly, any tax payable in respect of the asset and operating entities of a stapled structure has been considered on a consolidated basis for the purpose of our review.

As noted in section 3.1.3 above which outlined our findings from review of the tax returns provided by the NSPs on a voluntary basis, for the 2 NSPs which have adopted stapled structures and provided us with tax returns for the asset and operating entities (noting that the third NSP in a stapled structure has not provided any information for valid reasons), we have only evidenced taxable profits (e.g. net income) in relation to one of the operating entities. No taxable profits have been evidenced in respect of the asset entities. This is largely attributable to costs associated with M&A activity, which are treated as immediately deductible for income tax purposes (e.g. stamp duty). The net income observed in respect of the operating entity is considered a relatively small proportion of the overall revenue of the consolidated entities. This is in line with our expectation that the majority of profits attributable to efficient operation of the network assets would flow through the asset entity.

Accordingly, we have not observed significant taxable profits attributable to stapled entities which could potentially be subject to concessional tax rates. That said, M&A related costs would not be considered relevant to the efficient operation of the network assets. Therefore, to the extent concessional tax rates are available through flow through stapled structures, we consider this to be a relevant factor in assessing any potential discrepancy between actual tax payments and the forecast cost of tax for regulatory purposes when the analysis is limited only to the regulated activities (i.e. non regulated expenditure such as M&A costs are ignored).

As also noted in section 3.2.4 above, 2 of the NSPs which have adopted flow through vehicles (but not stapled structures) have reported taxable profits (e.g. net income) in all years for which tax returns of the NSP have been provided. Based on the information provided to us on a voluntary basis, it appears the taxable profits derived by these NSPs are distributed to entities taxed as a company. Therefore, we do not expect the tax rate applicable to the flow through structures in this instance to give rise to a discrepancy between actual tax payments and the forecast cost of tax, as profits are ultimately subject to tax at the corporate tax rate.

The commentary above demonstrates that structures which may give rise to tax rates below the corporate tax rate applied for the purposes of benchmark efficient entity approach are not widespread across the responding NSPs.

Another way to consider the materiality of any observable tax rate differential is to compare the investor profiles of all recipients of regulated profits at the point at which those profits may be first subject to tax (e.g. not “flowed through” to investors).

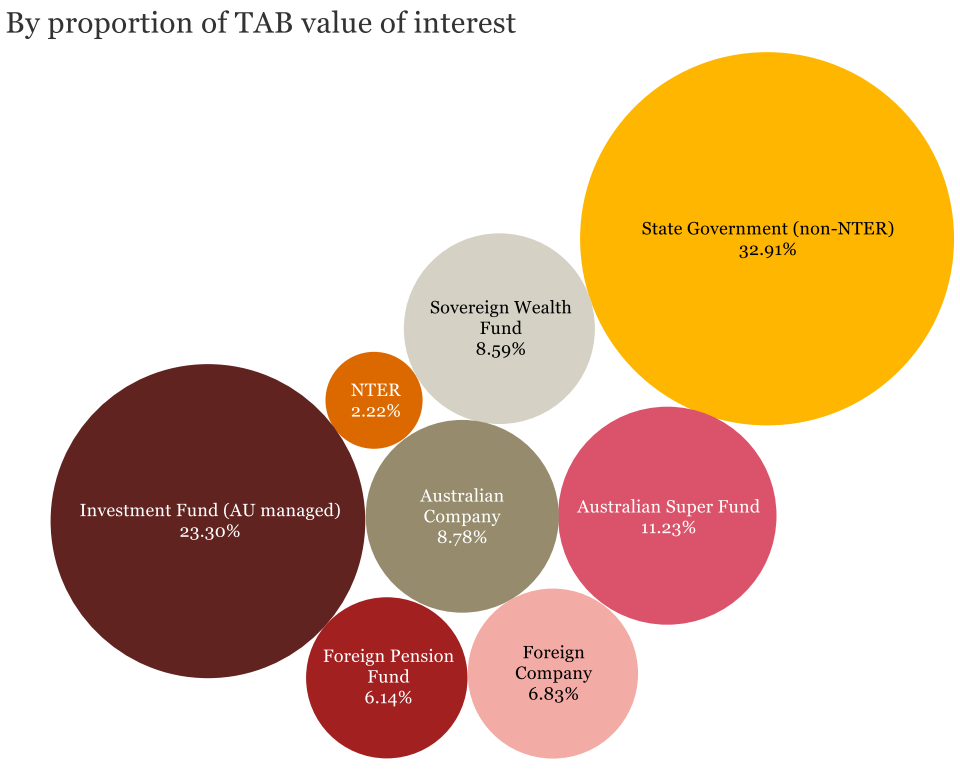
We were provided with limited information regarding the tax profile of investors in flow through vehicles on a voluntary basis (noting that in many cases we would not expect the NSPs to have immediate access to that information). As such, we have supplemented our understanding of the investor profiles with publicly available information. While caution must be exercised in assessing the tax profile of investors based on publicly available

information, the following broad categories of investors in the NSPs held in flow through vehicles have been identified:

1. Investors taxed as a company in Australia;
2. State/Territory owners applying the NTER;
3. State/Territory owners not applying the NTER;
4. Australian managed investment funds;
5. Australian superannuation funds;
6. Foreign pension funds;
7. Sovereign wealth funds; and
8. Foreign company taxed in Australia.

From the 33.79% of regulated assets by TAB value which have been observed as held in flow through vehicles in Figure 10 above, the following diagram depicts the tax profiles of these investors having regard to the categories outlined above:

Figure 11: Taxation profile of upstream investors in flow through vehicles



Notes relevant to interpretation of information:

- The above diagram outlines the various categories of investor profiles in flow through vehicles, displayed with reference to proportion of TAB held by those investors (with reference to the opening TAB value for the latest available determination period for each NSP). This excludes any assets which are directly held by a company or an entity taxed as a company.
- Where information relating to holding structures has not been provided on a voluntary basis, we have supplemented our understanding with publicly available information.

Any taxable profits distributable to upstream investors which are taxed as a company (categories 1, 2 and 8 from the list above) will be subject to corporate income tax at the current rate of 30% for large businesses (either Federally or within the NTER), and accordingly, support the benchmark efficient entity of a corporate taxpayer as currently applied in determining the estimate cost of tax for regulatory purposes.

Any taxable profits distributable to State/Territory upstream investors which do not elect to apply the NTER (category 3) will not be subject to income tax, as the relevant State/Territories have not elected to apply the NTER. As noted above, the States and Territories generally seek to impose the NTER on State Owned Enterprises in order to further the principles of competitive neutrality. Where the State Owned Enterprises own a minority interest in the NSP through a flow through structure (e.g. a partnership), we understand the NTER has not been applied in all cases, given the State Owned Enterprise has a passive role in the operation of the network assets and therefore the principle of competitive neutrality has less relevance. We note the decision to impose tax equivalent payments on a State Owned Enterprise is a matter of policy rather than tax law, and accordingly, we have not sought to make any recommendations in this respect.

Any taxable profits attributable to Australian managed investment funds (category 4) will be subject to Australian income tax at the tax rate applicable to each relevant investor in the managed investment fund. We have not been provided with any information regarding the tax profile of these investors (and do not expect to be able to receive this given the nature of investment funds and related privacy considerations). Accordingly, we cannot comment on whether or not the tax payable in respect of taxable profits of the NSPs (if any) would be consistent with the benchmark efficient entity of a corporate taxpayer as currently applied in determining the estimate cost of tax for regulatory purposes.

We would expect any taxable profits attributable to superannuation/pension funds (investor categories 5 and 6) to be subject to a concessional tax rate of 15%, in accordance with Federal government policy relating to pension funds. In Australia, complying superannuation funds receive a concessional tax rate of 15%. As discussed in section 3.2.2, foreign funds with eligible investments in MIT structures have historically also received a concessional tax rate of 15%. This is subject to currently proposed changes in law, however we expect the existing investors identified in our investigations will continue to receive the concessional tax rate of 15% until 2034.

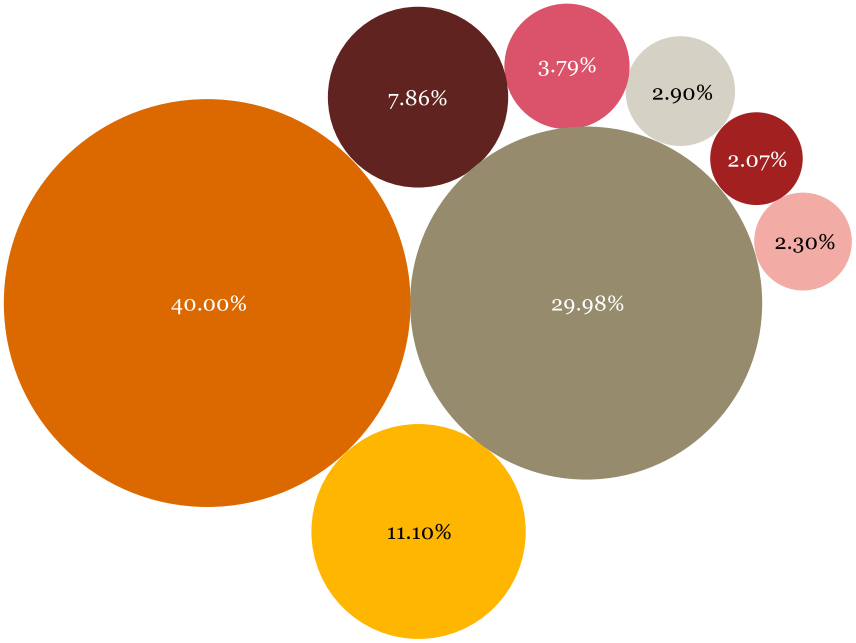
We would expect any taxable profits attributable to sovereign wealth funds (category 7) to be exempt from income tax (assuming the sovereign immunity exemption applies in respect of these investments). Consistent with our comments above, this concession has been subject to recent reforms and is only expected to continue to apply to the investors noted in our investigations until 2026.

Comparison of applicable tax rates across all holding structures (corporate and flow through)

In order to understand the potential impact of concessional tax rates applied to upstream investors in flow through vehicles for regulatory purposes, the following diagram outlines the tax profile of all entities which can be considered to have an immediate interest in the profits of the regulated assets from an income tax perspective (e.g. the first point at which tax is payable in the structure). This provides an indication of the tax profiles under which all profits of the regulated assets may be subject to income tax.

Figure 12: Profile of all interest holders

By proportion of interest in TAB value



Notes relevant to interpretation of information:

- The above diagram outlines the various categories of investors at the point at which taxable profits attributable to the regulated network assets are potentially first taxable. The first level for companies and NTER entities is the company or NTER entity itself. The first level for flow through vehicles is generally the first upstream investor which is potentially subject to tax (e.g. not a subsequent flow through vehicle).
- The proportion of assets held displayed above relates to the estimated TAB value for each NSP as at 30 June 2018.
- Where information relating to holding structures has not been provided on a voluntary basis, we have supplemented our understanding with publicly available information.

The expected tax rate applicable to each of the investor categories identified above (along with the relevant proportionate interest in the regulated assets by TAB value) is also outlined in the table below.

Figure 13: Tax profile of regulated asset holders tracing flow-through vehicles

Investor tax profile	% of TAB	Expected tax rate
1. NTER entity	**40.00%**	30%
2. Australian company	**29.98%**	30%
3. Australian States or Territories (tax exempt, non-NTER)	**11.10%**	N/A
4. Australian managed investment fund[15,16]	**7.86%**	15%-30%
5. Australian superannuation funds	**3.79%**	15%
6. Foreign Sovereign Wealth Funds[17]	**2.90%**	0%-30%
7. Foreign pension funds[18]	**2.07%**	15%-30%
8. Foreign companies	**2.30%**	30%

Based on the findings in Figure 13 above, we make the following additional observations:

- **11.10%** of assets (by TAB value) are held by Australian States or Territories which are not subject to the NTER regime and therefore do not pay a tax equivalent amount. This will cause a divergence between the estimated cost of tax for regulatory purposes and actual tax paid to the extent profits are distributed by the NSP. Assessment of the appropriateness of the application of the regulatory tax building block approach in respect of government bodies is outside of the scope of our review, as this is a matter of policy rather than tax law.
- **8.76%** of assets (by TAB value) are held by entities which are expected to attract tax rates below 30% on any profits distributed (refer categories 5, 6 and 7). This will also cause a divergence between the estimated cost of tax for regulatory purposes and actual tax paid to the extent profits are distributed by the NSP.

[15] The MIT concessional tax rate of 15% for investors in Exchange of Information (**EOI**) countries will only remain available for the flow through entities holding regulated assets through stapled arrangements until 30 June 2034, after which point a 30% tax rate will apply. Profits attributable to the operating side of a staple will not be eligible for MIT status and therefore subject to 30% non-resident withholding.

[16] Due to the lack of information available in respect of tax profiles for investors in managed investment funds, we are unable to confirm the expected tax rate for these investors. In many cases, we would expect the concessional MIT rate of 15% to be available for certain foreign investors resident in an EOI country. Likewise, investments by superannuation funds in the managed investment funds would also attract a tax rate of 15%. In other cases, the corporate rate of 30% may apply.

[17] Sovereign wealth funds may be treated as tax exempt on certain passive classes of income, which is generally confirmed through a ruling request with the ATO. Sovereign wealth funds with an interest of 10% or more will pay withholding tax of 30% on Australian profits from energy businesses for any new investments post 27 March 2018 or from 2026 for assets acquired before that date. Sovereign wealth funds with an interest of less than 10% (and no influence over the NSP) will remain exempt.

[18] Foreign pension funds would generally access the 15% MIT concession (subject to reform of law and transitional arrangements) on the asset side of a staple, and be subject to 30% withholding tax in respect of the operating side of the staple

- **7.86%** of assets (by TAB value) are held by investors in Australian managed investment funds. The applicable tax rate for these investors may vary, however we would expect in many cases a concessional tax rate of 15% would apply.

As noted above, the tax exemptions and concessions available to foreign investors have recently been reviewed and as a result legislative reform will limit the availability of those concessions, albeit that there is an effective grandfathering for existing investments up to 2026 (for sovereign wealth funds with an interest of greater than 10%) or 2034 (for MITs with an investment in stapled structures).

Quantum of profits subject to tax

The above comments address the impact of tax rate applicable to flow through structures for the purpose of our analysis. In addition, tax payable on taxable distributions received by investors in flow through vehicles may also be reduced by deductions available at the investor level in respect of their interest.

In our experience any tax difference in the quantum of profits subject to tax would generally relate (but not be limited to) the following types of expenditure:

a) Day to day running and compliance costs of maintaining these structures (i.e. accounting, tax and legal fees);

b) Original advisory and associated costs with the successful acquisition of the assets (including the regulatory assets); and

c) Additional debt related costs in the form of additional shareholder or third party funding (this is on a case by case basis and not always evident).

For completeness we note that we would not expect costs under items (a) or (b) above to be recoverable under the regulatory regime and accordingly to the extent that such costs cause a misalignment between actual tax paid and the estimated cost of taxation, this is appropriate in the context of the principles of the regulatory framework. We have no information to be able to make any objective comments on item c) at this stage.

In addition, where investors have an existing carried forward tax loss balance, in many cases the taxable distribution may result in a reduction of the carried forward tax loss balance rather than an income tax payable liability.

3.2.5 Recommendation

In our opinion, given the majority of NSPs are held via companies, the assumption that the benchmark efficient entity is a company is reasonable. Relevantly:

- 72.3%[19] of regulated asset owners (by TAB value) currently adopt a structure which is subject to the corporate tax rate. This is indicative that the benchmark efficient entity should remain a company for the purpose of determining the regulatory tax allowance.

- The instances where the tax rate for non-government asset owners is below the corporate tax rate is not wide spread and is limited to 8.76% of the industry participants by TAB value. The investor tax rate cannot be determined for a further 7.86% of TAB value where investments are held through managed investment funds, however we would expect the rate applicable to be 15% in many cases. Further, legislative reform is likely to limit the availability of concessions for foreign investors such as the MIT regime and sovereign wealth fund exemptions once the applicable grandfathering period ends.

[19] This is the total of investor tax profiles (1), (2) and (8) in Figure 13

Consistent with our comments in section 2.1 above, we do not recommend a pass through approach is adopted in respect of holding structures and applicable tax rates. In addition to the observation above that the majority of regulated network assets are held in vehicles which are taxed as a company, we do not recommend moving to a model which seeks to apply actual tax rates on the basis:

- If a flow through vehicle were adopted as the benchmark efficient entity, it would be necessary to determine the investors in the structure and the tax rate applicable to them in order to calculate a benchmark tax rate. The flow through entity is not liable to tax and it is not the flow through structure of itself that creates any differential in the tax paid as compared to the amount determined under the regulatory allowance.

- Even if a flow through structure could be validly adopted as the benchmark efficient entity (which would be contrary to our observations above), it would be difficult and costly for the NSPs held via companies to restructure into a flow through holding structure, as this would likely trigger commercial and tax costs (e.g. stamp duty, capital gains tax). The inability to adopt a benchmark efficient entity would be seen as unfavourable.

- In the observed flow through structures, multiple investors with different tax profiles hold varying interests in the same network assets. There is complexity associated with trying to determine a blended rate where consortium members have substantially different profiles. This is not only inconsistent with the tax legislative framework (which applies tax to an identified taxpayer) but it also has the potential to create winners and losers if parties are effectively cross subsidising each other to account for differences in tax rate(s).

- We have considered whether as an alternative to changing the benchmark efficient entity, it would be possible to make adjustments to the forecast cost of tax by applying a "flow through" approach in respect of tax rates. This will be difficult and costly to achieve given (1) the requirement to identify the actual tax rate for all upstream investors in respect of each distribution, and (2) the requirement to adjust only in respect of taxable profits attributable to the efficient operation of the network assets (e.g., within the ring-fence). We do not see how this could practically be achieved given the aggregated nature of taxable distributions and the requirement to obtain information regarding the tax position of each individual investor (e.g. the tax position of investors which have obtained an interest through a managed investment fund). Given the fact that tax rates of below 30% may only apply in respect of 16.62% of investors (by TAB value) at most (some of the 16.62% may in fact attract a 30% tax rate regardless, however we have not been able to verify this due to information limitation relating to upstream investors), and current reform will remove a substantial portion of the concessional rates (with the exception of Australian superannuation funds, representing 3.79% of the population), from as early as 2026, we do not recommend any changes are made to the current regulatory framework in respect of tax rates.

- As noted above, assessment of the appropriateness of the benchmark corporate tax entity approach to government entities is outside of the scope of our review, as this is a matter of policy rather than tax law.

As noted in section 3.4 below, the issue of flow through taxation is especially common in the United States, where the impact on the regulatory tax allowance has been considered in detail by the regulators. In particular, the electricity and gas transmission and distribution industries in the US have been largely privatised, with many common structures adopted which allow for flow-through taxation. Given the extent to which profits of the private utility investors are taxed on a flow-through basis, the US has implemented a regime which seeks to apply a blended rate and relies on the relevant investment structures to compensate investors through subsequent adjustments to the distribution of the relevant income.

Due to the relatively minor proportion of income subject to flow through taxation in Australia, we do not believe the complexity associated with transitioning to such a regime (noting specific limitations and challenges in the Australian tax system relating to access to

investor tax profile information, the ability to amend trust deeds and the impact of foreign taxes) outweighs the benefits especially as legislative reform will likely limit the concessional rates available.

3.3 Capital expenditure and depreciation deductions

The ATO Note identifies certain choices made by NSPs in respect of tax depreciation methodology and effective life as giving rise to differences between actual tax paid and the estimated cost of taxation for regulatory purposes.

Whilst not identified in the ATO Note, submissions also raised the tax treatment of replacement/refurbishment costs for income tax purposes as being a key driver between actual tax paid and the estimated cost of taxation. [20]

In addition to the above two matters, the step up in the tax cost base of depreciable assets by certain NSPs has also been highlighted as a significant reason for the discrepancy between actual tax paid and the tax allowance for those particular NSPs.

We have therefore investigated whether some or all of the above matters are significant factors in the discrepancy between tax paid and the estimated cost of taxation and whether in our view any changes are required to the existing approach to determining the estimated cost of tax to eliminate any misalignments.

3.3.1 Regulatory model treatment of capital expenditure

The AER's existing approach to estimating the cost of tax makes a number of simplifying hypothetical assumptions to facilitate the estimation of benchmark tax costs. It seeks to apply the relevant tax treatment within the context of those simplifying assumptions.

In this regard, the current regulatory approach to determining the estimated cost of taxation accounts for estimated Capex during the tariff period in the following manner:

1. All estimated net Capex is included in the TAB and depreciated. There is no distinction made between amounts that would be treated as immediately deductible and amounts that are part of the cost of a depreciating asset for tax purposes, having regard to the tax legislation.

2. In all but one instance, the TAB currently adopts the prime cost method to calculate depreciation. The exception is Jemena were the diminishing value method is adopted in respect of their gas network assets.[21] The diminishing value method was also adopted by several other networks during the period referred to in the ATO Note as a consequence of the transition of these entities from a State based regulator(s) to be under the jurisdiction of the AER, however all of these entities with the exception of Jemena have now been migrated to a prime cost method.

3. The effective life for the estimated Capex that is added to the TAB is generally based on the Commissioner's determination of effective life but does not apply the 20 year effective life cap applicable to gas transmission and distribution assets uniformly across gas participants. Specifically, the statutory 20 year life cap has only been applied to six out of the 11 gas participants.

4. The start time (i.e. the date from which the asset is first depreciated) for depreciating assets generally commences the year after Capex is commissioned (for electricity transmission networks) or the year after capex is incurred (for electricity distribution

[20] Refer section 3.5 of ENA submission "Review of Regulatory Tax Approach - Response to the AER Initial Report" dated 26 July 2018.

[21] Refer Jemena Gas Networks (NSW) Ltd Access Arrangement 2015-20.

and gas). The models always operate in end of year terms (though there is an adjustment to bring Capex incurred in the middle of the year to end of year terms).

5. The model also contemplates the disposal of assets (which is included in the calculation of net Capex in item 1 above) which would ordinarily give rise to balancing adjustments under the tax legislation, albeit that the disposal date is typically deemed to occur at the end of the year which would in most instances not align with the actual date of disposal as set out in the tax law.

6. Gifted assets are recognised as assessable income for the purposes of determining the tax allowance, and an amount equal to the amount included in assessable income is treated as the cost base of the asset and depreciated over time.

3.3.2 Tax depreciation framework

Division 40 of the ITAA 1997 provides for a deduction over time for the cost of a depreciating asset. Under Subdivision 40-B, the deduction is calculated by reference to the effective life of the asset using either the diminishing value method under section 40-72 or the prime cost method under section 40-75.

Importantly, in applying the mechanics for determining the deduction for depreciation under Division 40 it is first necessary is to identify the 'asset". A depreciating asset may be comprised of any number of components. Under subsection 40-30(4):

> *"Whether a particular composite item is itself a **depreciating asset** or whether its components are separate **depreciating assets** is a question of fact and degree which can only be determined in the light of all the circumstances of the particular case."*

A very simplistic example of this is a car, with the car generally being the depreciating asset rather than each component (i.e. tyres, engine, radio).

The identification of the "depreciating asset" is critical in determining the tax treatment of expenditure on or in relation to assets for income tax purposes. Specifically, the identification will determine whether expenditure is:

- treated as immediately deductible for income tax purposes (i.e. repairs to an existing depreciating asset under section 25-10 ITAA 1997);
- added to the cost base of an existing deprecating assets (i.e. second element of cost base pursuant to section 40-190 ITAA 1997); or
- included in part of the cost of a new and separate depreciating asset for the purposes of Division 40.

This is a clear departure from the approach in determining the regulatory tax allowance which does not delineate the Capex in this level of detail or in this manner.

In the very simple example of the car, where a tyre is damaged and replaced, the expenditure on the replacement tyre is not added to the cost base of the car and depreciated. The expenditure on the tyre would be treated an immediately deductible repair to the extent the car is being used for a taxable purpose.

In this context, the policy driving the legislative tax treatment of composite assets is relatively straightforward. However, when the administration of this policy intent and subsequent interpretation of the relevant legislation is required, this can result in outcomes that are not consistent across an industry group or specific set of taxpayers. For example, whether replacement assets are repairs, improvements to an existing asset or a separate new depreciating asset is a contentious area of law and the appropriate income tax treatment is situation and fact specific.

As a result of the difficulties that can arise when attempting to consistently administer the law, specific administrative guidance can be provided by the ATO by publishing a set of guidelines that the ATO sees as appropriate and aligned to the ATO interpretation of the legislation.

Generally, the tax ruling system in Australia is a mechanism through which the ATO provides the public its view on how tax law should be interpreted or administered.[22] It is a system that is predominantly intended to provide guidance to taxpayers in fulfilling their tax obligations and is also used by the ATO itself in fulfilling its role as tax administrator.[23]

The ruling system has evolved over many years to address increasingly complex tax law and now exists as an essential part of Australia's tax law administration. Rulings are not law and the relevant legislation governing the ruling system does not contemplate that rulings are to be treated as law, or even as a supplement to the law.[24]

It is important to note that public rulings issued by the ATO are not binding on taxpayers or the judiciary as they only represent the view of the ATO, as the administrator of tax legislation. In addition, the ATO cannot argue a position in Court that is contrary to a view that is published in a ruling.[25]

The ATO has followed the process above and released draft taxation ruling *TR 2017/D1 Income tax: composite items and identifying the depreciating asset for the purposes of working out capital allowances*, which deals with the treatment of composite items for the purposes of working out capital allowance deductions on depreciating assets. TR 2017/D1 sets out the Commissioner's views on:

- determining whether a composite item is itself a depreciating asset or whether its components are separate depreciating assets for the purposes of Division 40; and

- whether an "'interest in an underlying asset" for the purposes of section 40-35 of the ITAA 1997 requires an entity to have an interest in all or any parts of a depreciating asset.

According to the draft ruling, a composite item will be considered a depreciating asset if the component is capable of being separately identified or recognised as having commercial and economic value. The draft ruling provides guiding principles which are taken into account as part of the functionality test to determine whether a component of a composite item can be separately identified as a depreciating asset. The draft ruling also considers whether modifications or alterations of an existing asset can itself be treated as a separate depreciating asset.

When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).[26]

The draft ruling replaces Taxation Determination TD 2002/5 (now withdrawn) which explained what is considered to be a "distribution line" in the electricity distribution industry

[22] Taxation Ruling TR 92/20, 'Income and other taxes: guidelines on the use of date of effect paragraphs in Taxation Rulings and Taxation Determinations' 17 December 1992, Australian Taxation Office, Canberra, para 3.

[23] Taxation Ruling TR 92/1, 'Income tax and fringe benefits tax: public rulings' 1 July 1992, Australian Taxation Office, Canberra, para 9.

[24] Income Taxation Ruling IT 1 'Taxation Ruling system: Explanation and Status' 25 May 1989, Australian Taxation Office, Canberra.

[25] See *Intoll Management Pty Ltd v Commissioner of Taxation* [2012] FCAFC 179.

[26] Paragraph 76 of TR2017/D1.

for depreciation purposes. In TD 2002/5, it was considered that a "distribution line" in the electricity industry comes into existence when all of its components (which may incorporate conductors, cross arms, insulators, poles and transformers) are assembled. Further, where a network owner builds an addition to an existing line to supply customers who were not previously supplied by the network, there is a new and separate depreciating asset, capable of being separately identified and having a separate function of providing electricity to the customers connected to the network by the addition. Arrangements covered by TD 2002/5 are now covered in the new draft ruling.

TR 2017/D1 contains three examples specific to electricity distribution networks which illustrate the different tax implications that can arise based on the identification of the relevant "depreciable asset" and nature of the expenditure. These three examples are reproduced in their entirety below.

> ***Example 8 – A new electricity distribution line – an addition to an existing distribution line (Paragraphs 54 to 59)***
>
> *An electricity distribution network owner builds distribution lines and additions to existing distributions lines to supply customers who were not previously supplied by the network. In both cases there is the addition of a new distribution line which is new and separate depreciating assets from any existing distribution infrastructure. An above ground electricity distribution line incorporates conductors, cross arms, insulators and fittings, poles made from concrete, wood, steel or combination thereof, and (where relevant) a pole or ground pad mounted transformer or transformers.*
>
> *Whilst each of these items has its function or purpose at an individual item level, the relevant function in the context of the business being conducted is the distribution of electricity to end users who are connected to the network by the addition. This function is only able to be performed when the system is complete. A new depreciating asset in the form of a distribution line comes into being when all its components have been assembled.*
>
> *The new distribution line (or addition) is a separate asset from any existing distribution infrastructure. The new distribution line is capable of being separately identified or regarded as having a separate function from any existing distribution infrastructure; it performs an identifiable function of distributing electricity to a new group of customers. The new distribution line is planned, designed, built and developed to operate as one system. Each item of a distribution line is planned, designed, built and developed to operate as one system. Each item of a distribution line is physically connected and commences its function of distribution of electricity at a different time to the original distribution line or other elements of the distribution network. While it is reliant on its supply of electricity from the original distribution line or other elements of the network, its function as a medium of distribution for the electricity is otherwise independent of those things. It does not matter that the new distribution line may be incapable of independent operation without connection to an existing distribution line or other element of the network.*
>
> ***Example 9 – Replacing electricity pole (paragraphs 60 and 61)***
>
> *An electricity network owner replaces a pole in a distribution line after it was destroyed in a storm. The new pole is made from the same material and has the same specifications as the previous one.*
>
> *The replacement of a pole does not create a new depreciating asset separate from the distribution line of which it is a part. There has been no substantial alteration to the function of the distribution line of which the relevant pole is a part. The replacement of the pole gives rise to a deductible repair expense.*
>
> ***Example 10 – Upgrade of transformer (paragraphs 62 to 65)***
>
> *An electricity distribution network owner upgrades a pole mounted distribution transformer which forms part of an existing distribution line. The upgrade will enable the distribution line to deal with higher electricity load demands.*
>
> *The function of the electricity distribution transformer is to transform high voltage electrical current to a usable voltage for consumers. In the context of a functional*

> *electricity distribution line, each element of the system is physically connected to each other part of the system, each part is reliant upon the other elements of the system (wires, poles, distribution transformers etcetera) for their functionality to form a single integrated distribution system which is intended to function as a whole. Each of the functions of the individual parts are subsumed into the larger system when it is constructed. Therefore the overall function of the distribution line is to transmit electricity to consumers.*
>
> *Once the function of the system is determine to be an electricity distribution line, an improvement of an element of that system will constitute an improvement to the distribution line itself, rather than constituting the acquisition and installation of a separate depreciating asset. In this case, the original transformer was integral to the function of the distribution line. The replacement of the existing transformer ready for use are included in the second element of cost of the distribution line that was delineated at the time the distribution line was connected ready for use to the electricity distribution network.*

The examples above illustrate how the identification of the "depreciating asset" is critical in determining the tax treatment of expenditure on or in relation to assets for income tax purposes. As a consequence, the identification of the depreciating asset for the purposes of Division 40 has the potential to create differences between the timing of actual tax payments by the NSPs as compared to the estimated cost of taxation determined under the existing approach (where all regulatory Capex is depreciated over time). Whilst this only creates a timing difference, (i.e. there should not be any difference between actual tax paid and the regulatory tax allowance as a consequence of the difference in tax treatment over the life of the asset), there will be a real cost in net present value terms.

We have set out further analysis of relevant judicial decisions and ATO guidance material relating to the identification of a depreciating asset in **Appendix E**.

3.3.3 Other Capex factors impacting the tax differential

Once the depreciable asset is identified for the purposes of Division 40, the cost of the relevant depreciating asset must be determined. The effective life and the choice of depreciation method (i.e. diminishing value or prime cost method) must then be determined to calculate the depreciation and any balancing adjustments in respect of the identified depreciating asset. These choices are made on an asset by asset basis.

As noted above, the ATO Note and various submissions identified the choices made in respect of effective life (principally the self-assessment of shorter effective lives including immediate deductibility of expenditure and allocation to low value pools), and the adoption of the diminishing value method as potential key drivers for the differences between actual tax paid and the regulatory forecast of tax costs.

Having regard to the above discussion, we have undertaken detailed investigations into the key matters, namely:

- **Capex Investigation Matter One** - What capital expenditure for TAB is in practice being immediately deducted for tax purposes by the NSPs. This is discussed in section 3.3.4.
- **Capex Investigation Matter Two** - Tax choices made by NSPs in respect of effective life and the choice of depreciating method. This is discussed in section 3.3.5.

In addition to the above two matters, the step up in the tax cost base of depreciable assets by certain NSPs has also been highlighted as a potentially significant reason for the discrepancy between actual tax paid and the tax allowance for those particular NSPs. This discrepancy was highlighted in the Martin Lally Report which states (at page 6):

> *Tenthly, in respect of uplifts to the tax book values of assets, which can occur but are not recognized in the AER's tax allowances, the effect of these uplifts on the taxes paid could be substantial. Adjustment to the AER's tax allowances for the firms receiving them so as to*

> *reflect such uplifts would reduce the allowed revenues of businesses to the level consistent with the NPV = 0 principle, which is in the long-term interests of consumers. This approach also appears to be free of any drawbacks. In particular, it would not target any tax minimization activities by businesses, it does not appear that it would discourage any efficient (or encourage any inefficient) behaviour by firms, and the administrative effort in doing so (by requiring regulated businesses to inform the regulator of any such uplifts, followed by amendment of the regulatory tax allowance) would likely be small because such events are presumably rare. I therefore recommend that this be done. Furthermore, since these uplifts presumably arise from events that are at least partly beyond the control of a firm, they should be firm-specific.*

Whilst we have provided a detailed summary outlining the genesis of how these step ups in the tax bases of depreciating assets can arise in some circumstances below (refer to the section 3.3.6 titled "Capex Investigation Matter Three - Cost base of depreciable assets"), we have not at the date of this Report received the relevant information quantifying these step ups from the relevant NSPs. This is because, as noted above, based on the time limitations associated with this review the request for information from NSPs has been split into a voluntary request for information phase and formal RIN phase. Accordingly, our Report is currently limited to providing qualitative commentary on this particular matter only.

3.3.4 Capex Investigation Matter One – immediate deductions

Summary of Information Requested - Capex Investigation Matter One

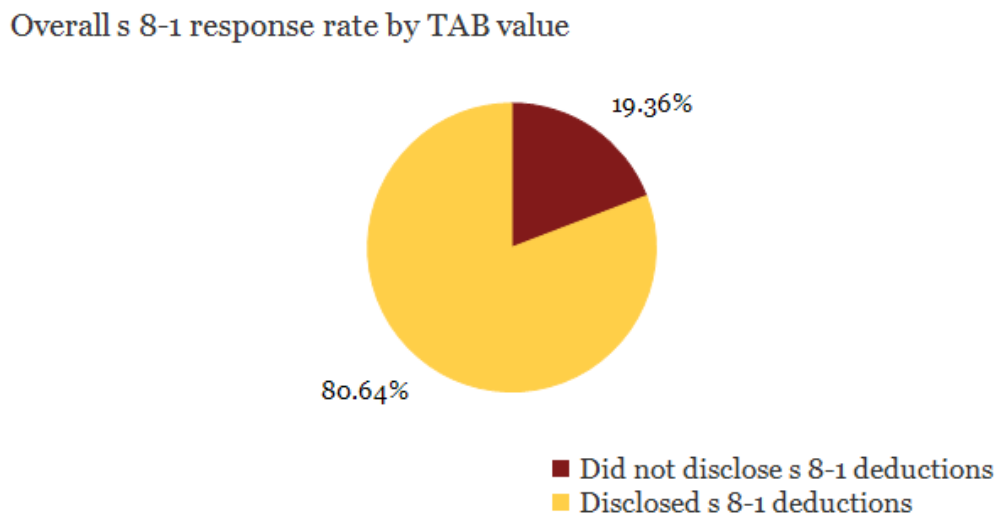
For the purpose of investigating what capital expenditure for TAB is in practice being immediately deducted for tax purposes by the NSPs, the AER requested the NSPs to voluntarily provide the following information:

> *Provide existing documentation of capitalisation policies of the [Distribution/Transmission] network service provider and any related stapled entities that hold direct interests in the network assets (e.g. Asset Trust/Partnership) for tax purposes which provides guidelines for distinguishing when expenditure should be classified as capital or immediate deductible on revenue account (e.g. repairs and maintenance) and the identification of functional assets.*
>
> *Provide a summary which identifies the total quantum of expenditure which is included in the regulatory fixed asset register (e.g. reported actual capex for regulatory purposes), but has been treated as immediately deductible for income tax purposes (e.g. refurbishments, overheads), in respect of income in the past five years.*

Summary of Information Received – Capex Investigation Matter One

Figure 14 below reflects the breakdown between the entities that provided and those that did not provide responses in respect of Capex included in the TAB which has been treated as immediately deductible for tax purposes.

Figure 14: Responses to quantum of Capex treated as immediately deductible



Notes relevant to interpretation of information:

- Entities which disclosed deductions for any period appear as 'disclosed s 8-1 deductions'. Only those entities which did not disclose any of their s 8-1 deductions appear as 'did not disclose'.
- The percentages displayed above relate to the opening TAB value for the latest available determination period for each NSP.

Summary of our observations and conclusions - Capex Investigation Matter One

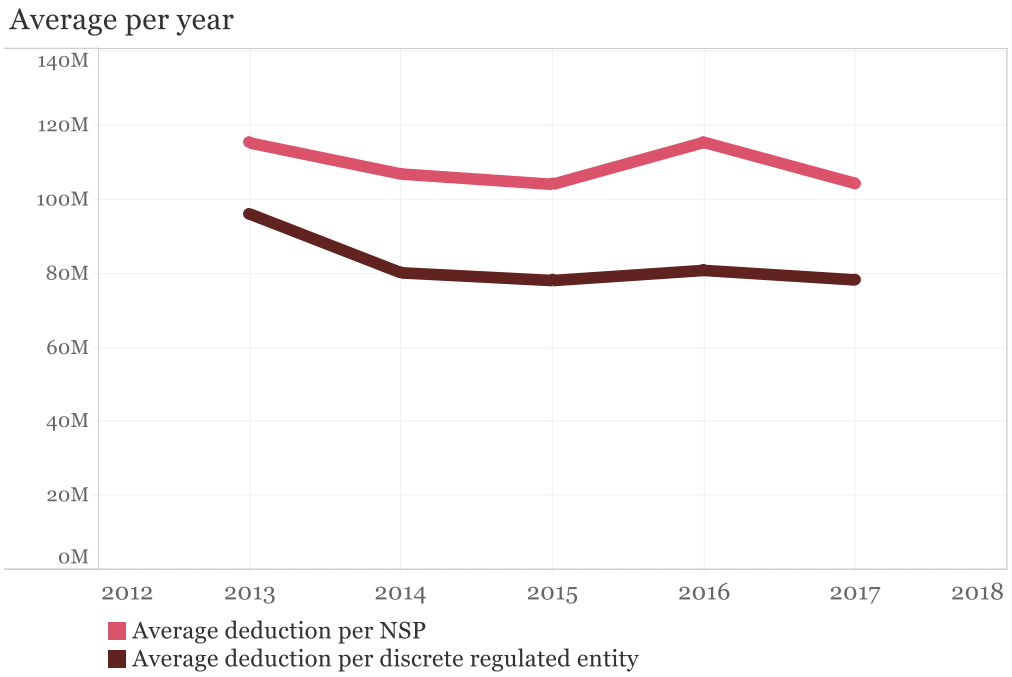
Figure 15 below depicts the **average** amount of the Capex included in the TAB which was treated as immediately deductible for tax purposes per year (both by regulated entity and by consolidated NSP). Based upon our review of the material provided we make the following key observations:

- Generally the respondents claimed an immediate deduction for income tax purposes for a component of costs included in the TAB.
- Where the information requested was provided, on average $81.5m of the regulatory capex included in TAB was claimed as an immediate deduction by each regulated entity annually, and an average of $108.7m was claimed by each NSP (as some NSPs hold multiple regulated entities) annually.
- As noted in Figure 15 there were material variances in the average amounts claimed as immediately deductible.
- Not all respondents provided a detailed description of the items being treated as immediately deductible. However, items treated as immediately deductible Capex where information was provided included:
  - overheads;
  - replacement assets; and
  - capitalised labour.

Claiming immediate deductions for costs of this nature in this industry is not unexpected albeit there are differing views relating to the immediate deductibility of capitalised labour costs.

- It was unclear in some responses whether the amounts described as immediately deductible included amounts which had been expensed for both accounting and tax purposes but included in regulatory Capex. In this regard, some responses appeared to only pick up amounts which were book to tax adjustments in the tax returns and accordingly the annual amount being deducted immediately could potentially be understated.

Figure 15: Average amount of Capex in the TAB immediately deducted annually for actual tax purposes



Notes relevant to interpretation of information:

- This graph shows the average quantum of regulated Capex which has been treated as immediately deductible annually for income tax purposes (per NSP, across NTER and private sector entities), based on the voluntary responses provided by the NSPs. Amounts disclosed represent gross deductions claimed (not tax effected).
- There was considerable variation between entities. The range extended from less than $5 million to greater than $200m (calculated as the annually deductions for individual entities, averaged across the period).
- Information regarding the quantum of immediate deductions claimed was provided by 10 of 17 NSPs on a voluntary basis.

In addition to reviewing the Capex amounts included in the TAB that were treated as immediately deductible we also undertook a high level review of the tax capitalisation policies of the respondents where capitalisation policies were provided. We make the following key observations based on our review:

1. There was a divergence in policy on the treatment of low cost items, with the threshold used to determine where costs are automatically expensed or included in the low value pool ranging from $100 to $20,000. Technically, only assets that cost less than $1,000

or have been depreciated over a number of years resulting in a written-down value of less than $1,000 can be added to a low value pool (with respect to the latter only if the taxpayer has previously worked out deductions for it using the diminishing value method) unless the taxpayer is considered to be a Small Business Taxpayer.

2. As the majority of the respondents who provided details of their capitalisation policy followed accounting policy, the financial impact of this was not necessarily evident.

3. Otherwise, there was broad consistency in the criteria used to determine generally if costs should be capitalised or expensed. This was not unexpected given the nature of such policy documents. However, this does not necessarily mean that in application the approach would be consistent. For example, there could be differing interpretation which is not uncommon in practice, as well as different views on what constitutes a composite unit of property (level of aggregation) would affect the capital or expense classification.

Recommendation

The amount of regulatory capex claimed as immediate deductions annually by industry participants is an observable difference that results in a divergence in the timing of actual tax paid and the tax allowance determined under the existing regulatory approach in respect of industry participants. Whilst this issue was not raised in the ATO Note, it was not unexpected and was identified by various NSPs in their submissions to the AER Issues Paper.

As noted above, certain submissions raised concerns that the treatment of expenditure on refurbishment of network assets as immediately deductible for the purpose of the tax allowance could act as a disincentive to appropriately maintain the network, at the long term expense of the consumers' interest.

We recommend that the immediate deductibility of some of these costs should be taken into consideration for the purposes of determining the estimated cost of taxation subject to the AER assessing the commercial impact of any amendments to the regulatory approach raised by NSPs in their submissions which are non-tax considerations. We note that we would recommend that any adjustments should be participant specific (as opposed to introducing some type of industry average given there is no technical basis for such an approach under the legislation).

3.3.5 Capex Investigation Matter Two – effective life and choice of depreciation method

Summary of Information Requested - Capex Investigation Matter Two

NSPs were asked to provide the following information on a voluntary basis in respect of Capex Investigation Matter Two:

> *Provide the tax fixed asset register which supports the capital allowance balances reported in the last lodged tax return for the [Distribution/Transmission] network service provider and any related stapled entities that hold a direct interest in the network assets (e.g. the Asset Trust/Partnership). This should include without limiting the information to be provided:*
>
> *(a) Description of the asset;*
>
> *(b) Effective life of the asset;*
>
> *(c) Depreciation method applied;*
>
> *(d) Depreciation claimed; and*

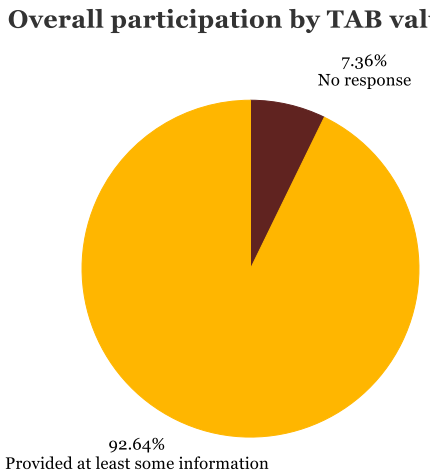
(e) Starting cost, including starting cost determined under Division 58.

To the extent this information can be separated into regulated and non-regulated assets operated by the [Distribution/Transmission] network service provider provide the information only for the regulated assets in an excel template.

Summary of Information Received - Capex Investigation Matter Two

As noted in Figure 16 below, we received responses (i.e. detailed depreciation registers) on a voluntary basis from NSPs that accounted for 92.64% based on industry participation by TAB value.

Figure 16: Summary of detailed depreciation responses received by TAB value



Notes relevant to interpretation of information:

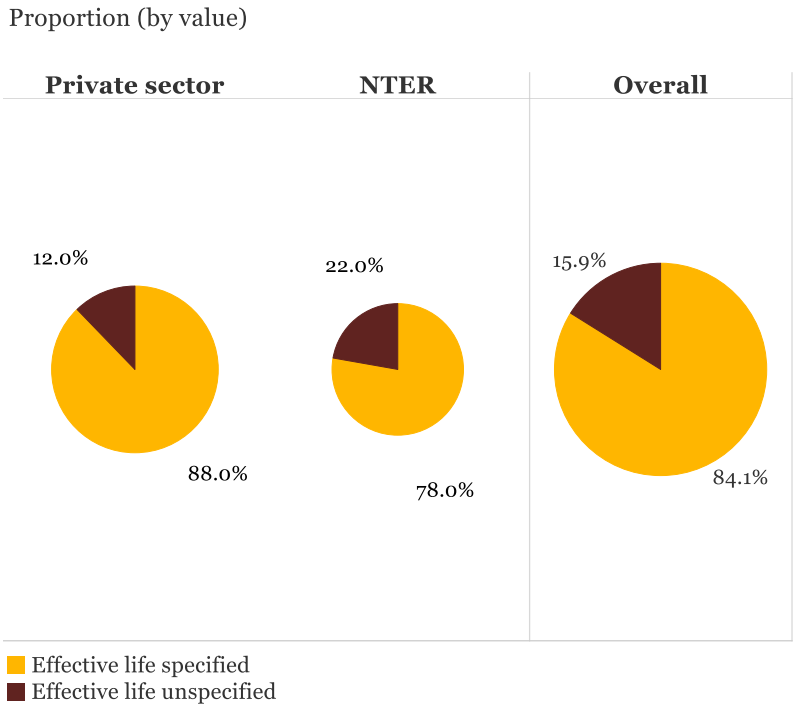
- If an entity provided any information then it was taken as responding (regardless of the scope of information provided).
- The percentages displayed above relate to the opening TAB value for the latest available determination period for each NSP.

However, of the detailed depreciation register information received, a portion of the data requested in relation to effective lives or choice of depreciating method was either not evident, not reliable or simply not contained in the information provided. This is diagrammatically represented in Figures 17 and 18 which show the following:

- Only 2.65% (by value) of the tax registers actually received did not contain detailed information on depreciation method chosen.
- Of the tax registers actually received, 15.9% (by value) did not provide effective life information.

Figures 17 and 18 below provide a further break down between NTER and private sector respondents which does not show any significant bias.

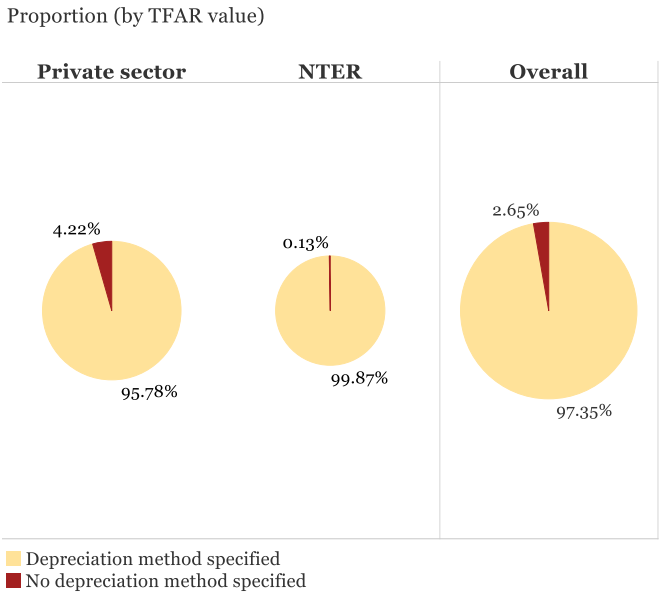
Figure 17: Portion of overall responses that provided effective life



Notes relevant to interpretation of information:

- The percentages displayed above relate to the TFAR balances at the latest reporting period provided by the NSPs on a voluntary basis.

Figure 18: Portion of overall responses that provided depreciation method data



Notes relevant to interpretation of information:

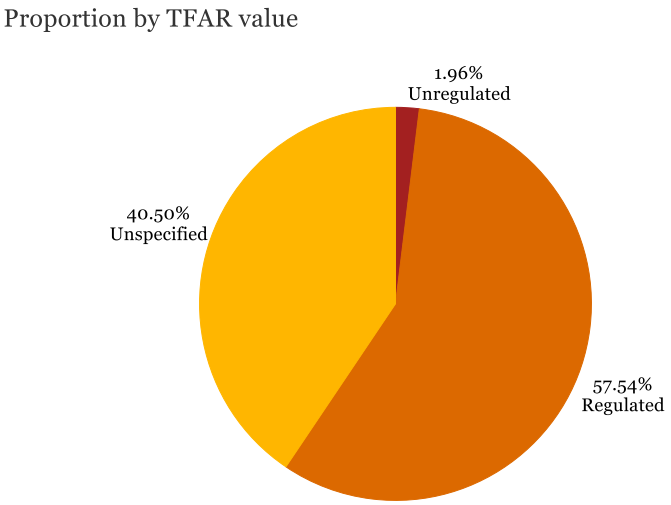
- The percentages displayed above relate to the TFAR balances at the latest reporting period provided by the NSPs on a voluntary basis.

Regulated and Non Regulated ring-fencing

Whilst information was also requested to be separated into regulated and non-regulated assets operated by the NSP to the extent possible it was inevitable given the timetable of this review that that level of separation was unlikely in all instances. Accordingly, for completeness we also set out in Figure 19 below the percentage of data that was clearly designated to be only in relation to regulated assets (by value) which totalled 57.54%. Figure 19 also indicates that only 1.96% of assets contained in the depreciation registers received were clearly designated as unregulated assets (by value).

Of the remaining unspecified assets, (i.e. those comprising 40.5% of all assets by value contained in the tax depreciation registers received which were not designated as either regulated or unregulated), we have assumed without any valid evidence to the contrary that these contain both regulated and unregulated assets.

Figure 19: Representation of the depreciation data classified as regulated or unregulated by all participants



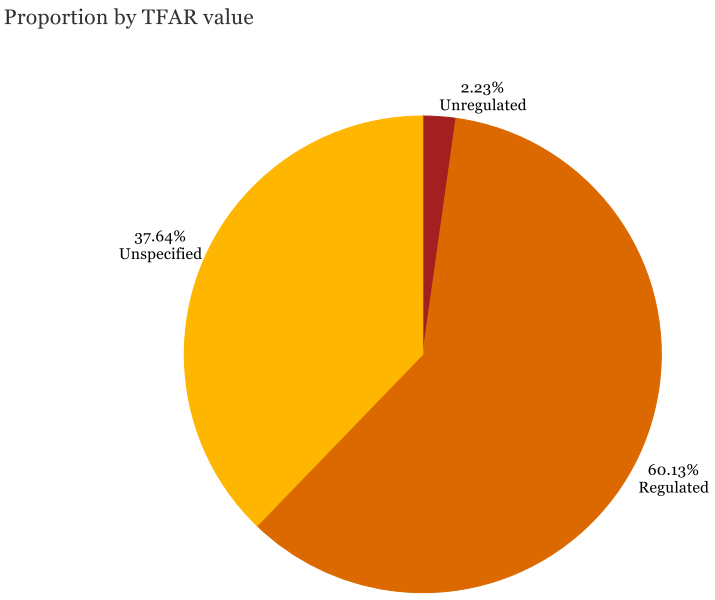
	Regulated	Unregulated	Unspecified	Grand Total
Number of assets	575,386	124,235	674,180	1,373,801
TFAR CWDV (nearest available date as provided)	39.07B	1.33B	27.50B	67.90B
% of total TFAR CWDV	57.54%	1.96%	40.50%	100.00%

Notes relevant to interpretation of information:

- This graph outlines the proportion of fixed asset information provided on a voluntary basis, which has been classified as regulated or unregulated across electricity and gas assets.
- Where respondents have specified data as regulated, this does not necessarily mean that all fixed asset balances have been reported by that entity. In some instances, the NSP may also hold unregulated assets which are not included in the total quantum of fixed assets outlined above.
- Accordingly, the above graph should not be read as an indicator of the actual split of regulated and unregulated assets owned by the NSPs, but rather as an indicator of whether the regulated or unregulated nature of the assets has been specified by the respondent.

We set out in Figures 20 and 21 the split between regulated and unregulated assets by industry sector. Specifically, Figure 20 below shows the relevant split between regulated, unregulated and unspecified assets in respect of electricity networks. Figure 21 shows the same split in respect of the gas network assets.

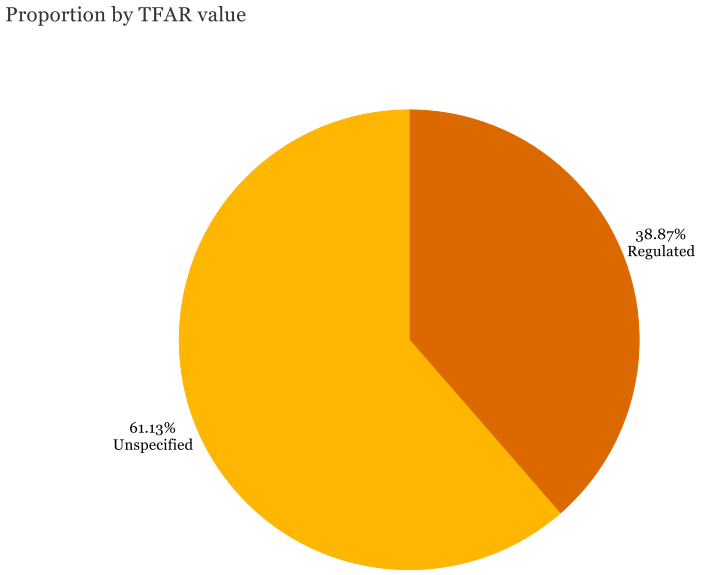
Figure 20: Representation of the depreciation data classified as regulated or unregulated by Electricity participants



Notes relevant to interpretation of information:

- This graph outlines the proportion of fixed asset information provided on a voluntary basis, which has been classified as regulated or unregulated across electricity assets.
- Where respondents have specified data as regulated, this does not necessarily mean that all fixed asset balances have been reported by that entity. In some instances, the NSP may also hold unregulated assets which are not included in the total quantum of fixed assets outlined above.
- Accordingly, the above graph should not be read as an indicator of the actual split of regulated and unregulated assets owned by the NSPs, but rather as an indicator of whether the regulated or unregulated nature of the assets has been specified by the respondent.

Figure 21: Distinction of Regulated and Unregulated assets by Gas participants



- This graph outlines the proportion of fixed asset information provided on a voluntary basis, which has been classified as regulated or unregulated across gas assets.
- Where respondents have specified data as regulated, this does not necessarily mean that all fixed asset balances have been reported by that entity. In some instances, the NSP may also hold unregulated assets which are not included in the total quantum of fixed assets outlined above.
- Accordingly, the above graph should not be read as an indicator of the actual split of regulated and unregulated assets owned by the NSPs, but rather as an indicator of whether the regulated or unregulated nature of the assets has been specified by the respondent.

Assessment of the overall quality and reliability of data received

In order to be able to provide a valid objective view, we needed to be able to satisfy ourselves that we had received sufficient and reliable information to be able to reach reasonable objective conclusions. In this regard we make the following overall observations:

- Whilst not all NSPs responded to the voluntary information request to provide detailed depreciation registers, we believe the quantum of the responses received covers a sufficient percentage of the relevant industry data to be reliable and not misleading with respect to choice of effective life and choice of depreciation method.

- Whilst approximately 40.5% of the assets by value are not clearly distinguishable as either regulated or unregulated, in our view that should not of itself impact the conclusions reached. That is, we think the data provides sufficient evidence of the trends in respect of choices made in respect of effective lives and depreciation method. Further, the unregulated assets are likely to be reasonably close to the regulated assets in nature and therefore a reasonable proxy in any case.

- Any comparison between the aggregate opening tax written down value and the TAB opening value where this is assessed having regard to the average effective life data by value as set out below may be misleading. This is because the unspecified assets (i.e. those not specifically designated as either regulated or unregulated) may contain depreciable assets that are outside of the RAB (including for example capital contributions to the extent they are not included within the RAB). This is discussed in more detail under the section headed “Capex Investigation Matter Three – Cost base of depreciable assets”).

Summary of our Observations and Conclusions - Capex Investigation Matter Two

We have separated our analysis and investigations in respect of Capex Investigation Matter Two into two subparts being:

- Part A – which focuses on the Depreciation Method adopted
- Part B – which focuses on the Choice of Effective Life

In each of these subparts we have first set out an overview of the relevant legislative framework. We then set out the observations and conclusions from our investigations based on the information we have received.

Part A - Depreciation method Adopted – Diminishing Value v Straight Line

Under Division 40 of the ITAA 1997, a taxpayer can deduct an amount equal to the decline in value of a depreciating asset, provided that the taxpayer meets various requirements prescribed under this division.

Under section 40-65 of the ITAA 1997, a taxpayer has a choice of two methods to work out the decline in value of a depreciating asset being the diminishing value method or prime cost method (also commonly referred to as the straight line method).

There is a presumption that the diminishing value method will always be the best choice for Federal taxpayers to minimise their income tax liabilities. However this presumption is unlikely to be correct in all circumstances. Whilst the diminishing value method provides larger tax deductions at an earlier stage of the effective life of a depreciable asset in comparison to the straight line method, this is not the only factor taken into account by Federal taxpayers in determining a choice of the tax depreciation method.[27]

For example, if a taxpayer already has substantial carried forward tax losses they may deliberately choose to be more conservative and adopt the prime cost method thereby deferring the deduction profile of the asset and reducing the build-up of additional tax losses that are unlikely to be utilised in the short to medium term. This approach is typically adopted to manage any potential risks associated with a pool of carried forward tax losses ultimately not being available due to unforeseen or unexpected M&A activity which could have a negative impact on the ability of the entity to satisfy the applicable loss utlisation tests.

Specifically, to utilise carried forward tax losses there are certain loss tests that need to be satisfied. The ability to satisfy these tests is often impacted by changes in the ownership of entities and assets resulting from M&A activity. Accordingly, if a taxpayer is already in tax losses, it may choose not to adopt accelerated depreciation as this may just add to the loss pool that is put at risk on a change of control.

Given the estimated cost of taxation for regulatory purposes does not take into account carried forward tax losses related to non-regulated expenditure (including M&A related deductions) which in some instances will be substantial, it would appear that a reasonable approach would be to dismiss this as a relevant factor in determining what depreciation method a benchmark efficient entity would choose to adopt when the regulatory operations are considered in isolation.

[27] Paragraph 16(c) Review of regulated tax asset base for regulated revenue purposes – addendum to the report of Vaughan Lindfield dated 21 November 2014.

Further, it is worth noting that the diminishing value method results in an undeducted amount remaining at the end of the effective life of a depreciating asset whereas there is no such undeducted amount arises under the straight line method. Given these characteristics of the depreciation methods and the size of the capital investments, infrastructure taxpayers will generally choose the method that provides the best after tax return based on discounted cash flows.[28] This is considered on a case by case basis and will have regard to the tax profile of the broader business and the effective life of the relevant asset. However we would generally expect that the predominant method (once the availability of tax losses referred to above is ignored) chosen by Federal taxpayers would be the diminishing value method. The timing benefits associated with diminishing value method would typically have a positive net present value benefit on a project as compared to the straight line method in respect of long life infrastructure assets.

Improvements or alteration to an existing asset are treated as part of that depreciable asset. Costs such improvements or alterations are therefore added to the cost of that depreciable asset and depreciated under the same depreciation method that has been adopted for the original existing asset. There is no option under tax law which allows taxpayers to treat such improvements or alterations as a separate depreciable asset.

Furthermore, whilst section 40-130 of the ITAA 1997 does not allow taxpayers to change the choice of depreciation method for those assets, in some instances a taxpayer is allowed or in some instances required to reassess the effective life applicable to the asset. This is discussed in more detail under the section relating to 'choice of effective life' below.

As noted above, whether replacement assets are a repair, improvement or alteration to an existing composite asset or indeed treated as a new depreciable asset for tax purposes is a contentious area of the tax law, in particular in relation to distribution network assets.

Part A - Summary of our Observations and Conclusions - Choice of Depreciation Method

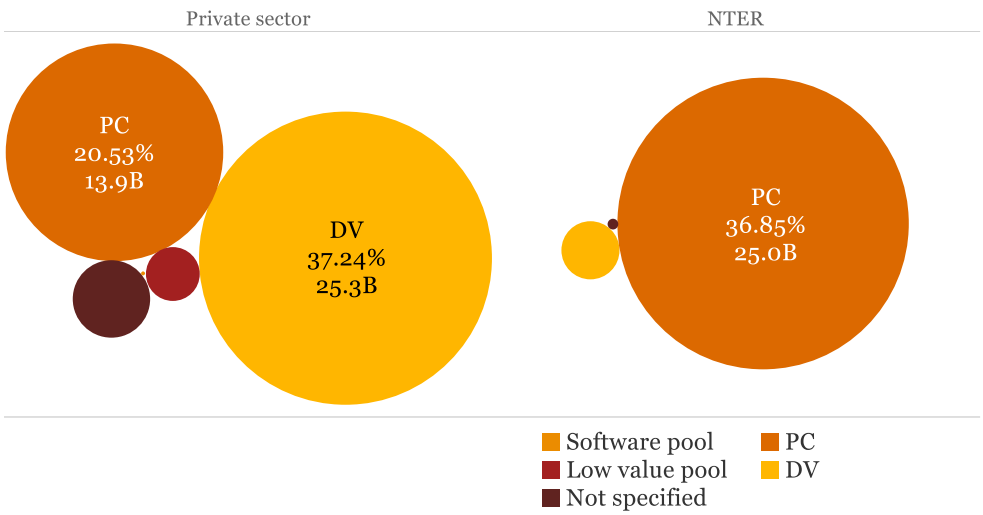
Figure 22 below illustrates the choice of depreciation method of all assets contained in the detailed depreciation register information from NSPs where the assets in those depreciation registers contained valid information relating choice of methodology (refer discussion above).

As previously highlighted above, the existing approach for determining the tax allowance assumes the prime cost method for determining depreciation in respect of the TAB in the latest determinations for all NSPs with one exception.[29] Accordingly, the adoption of the diminishing value method by industry participants for federal tax purposes (including under the NTER) is likely to result in a timing difference between actual tax payable and the estimated tax cost under the existing regulatory approach.

[28] Paragraph 16(d) Review of regulated tax asset base for regulated revenue purposes – addendum to the report of Vaughan Lindfield dated 21 November 2014.

[29] Jemena Gas Networks (NSW) Ltd Access Arrangement 2015-20

Figure 22: Depreciation method for all valid responses received from all participants



Overall (Electrical & Gas assets)

	TFAR CWDV (nearest available date as provided)	% of total CWDV
PC	38.97B	57.39%
DV	26.28B	38.70%
Not specified	1.80B	2.65%
Low value pool	0.85B	1.26%
Software pool	0.00B	0.01%
Grand Total	**67.90B**	**100.00%**

Notes relevant to interpretation of information:

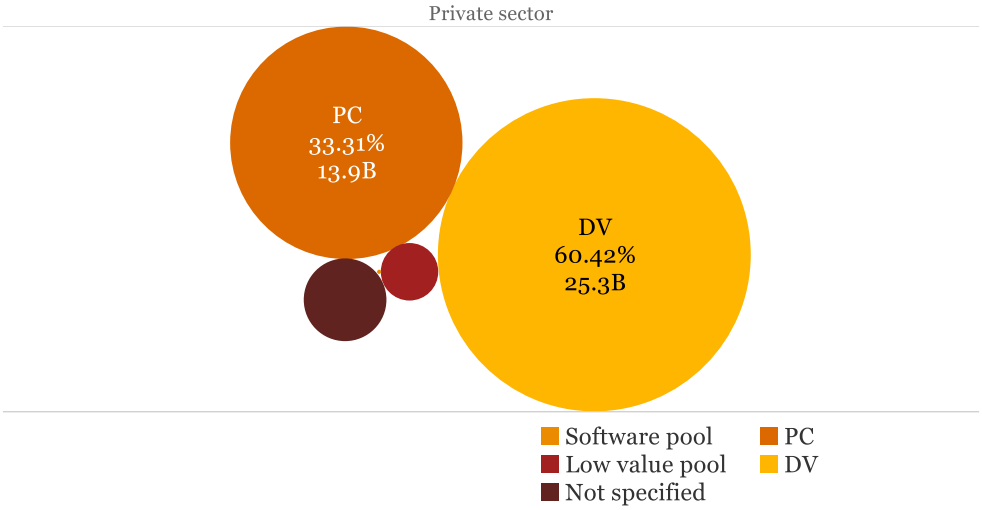
- The percentages displayed above relate to the TFAR balances at the latest reporting period, as provided by the NSPs on a voluntary basis.
- Non-depreciating assets (such as land) have been excluded from the TFARs provided by the NSPs.

The key observations that can be made from the data contained in Figure 22 include the following:

- The prime cost method has been adopted in respect of 57.39% of the total assets by value that are contained in TFARs where the choice of depreciation methodology is explicit.
- This data set of itself would prima facie suggest that a proposition that the diminishing value method would be the chosen methodology adopted by a benchmark efficient could not be supported.
- This was an unexpected outcome and is somewhat inconsistent with the ATO Note. We have therefore undertaken further analysis of this data set to determine whether there are any other trends that would provide further clarity or explanation of this outcome. Specifically, we have also analysed the choice of methodology adopted by private sector entities and compared this to the choice of methodology adopted by NTER entities (refer Figures 22 and 23 and associated discussion below).

- For completeness, we note that whilst low value pool assets made up 1.28% of the data population we do not have sufficient comfort that all assets allocated to a low value cost pool were included in the detailed depreciation registers (i.e. that the low value asset population is complete). Further, as noted in section 3.3.4 under the heading "Summary of our observations and conclusions - Capex Investigation Matter One" there is a divergence of policy in respect of the treatment of low cost items which are expensed immediately ranging from $1,000 to $20,000, some of which may not have been included in either the detailed depreciation registers or a low value pool (i.e. they were written off as immediate deductions). However, based on our experience, the percentage of low value assets as a subset of the total asset base held by NSPs is likely to be immaterial and accordingly is unlikely to be a key factor in any difference between actual tax paid and the estimated cost of tax for regulatory purposes.

Figure 23: Depreciation method adopted by private sector entities



Overall (Electrical & Gas assets)

	TFAR CWDV (nearest available date as provided)	% of total CWDV
PC	13.94B	33.31%
DV	25.29B	60.42%
Not specified	1.76B	4.22%
Low value pool	0.85B	2.04%
Software pool	0.00B	0.01%
Grand Total	**41.85B**	**100.00%**

Notes relevant to interpretation of information:

- The percentages displayed above relate to the TFAR balances at the latest reporting period, as provided by the NSPs on a voluntary basis.
- Non-depreciating assets (such as land) have been excluded from the TFARs provided by the NSPs.

Figure 23 above shows that the diminishing value method is the dominant methodology adopted when NTER entities are excluded from the total data set. Specifically, the diminishing value method is chosen by private sector entities in respect of more than 60.42% of assets by value ignoring assets where methodology is unspecified.

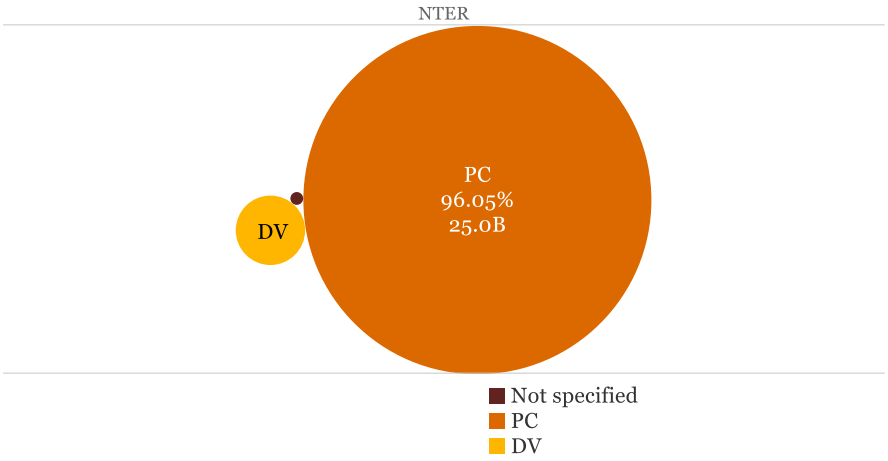
We note that this percentage may be understated given it is based on the written down value of assets for tax purposes at a point in time and typically the depreciation profile associated with the diminishing value method outpaces the prime cost method until the later years of an assets life. As is also evident in Figure 23, private sector entities are still adopting the prime cost method is respect of 33.31% of the assets held by this subset of NSPs, however based on the same rationale discussed above the prime cost method may be potentially overstated for the same reason noted above that the diminishing value method may be understated.

In contrast, Figure 24 below illustrates that the choice of methodology adopted by NTER entities is materially skewed to the prime cost method. Specifically, NTER entities have adopted the prime cost method in respect of 96.05% of assets by value with the diminishing value being adopted in respect of the residual 3.82%.

There is a reasonable support from a tax perspective to argue that the NTER entities are not 'efficient' from a tax perspective in the context of:

- their economic ownership (i.e. the indifference from the ultimate State and Territory owners between the payment of dividends or NTER tax payments); and
- the specific limitations on their ability to challenge ATO positions relating to technical interpretation of the tax legislation.

Figure 24: Depreciation method adopted by NTER entities



Overall

	TFAR CWDV (nearest available date as provided)	% of total CWDV
PC	25.03B	96.05%
DV	0.99B	3.82%
Not specified	0.03B	0.13%
Grand Total	**26.05B**	**100.00%**

Notes relevant to interpretation of information:

- The percentages displayed above relate to the TFAR balances at the latest reporting period, as provided by the NSPs on a voluntary basis.
- Non-depreciating assets (such as land) have been excluded from the TFARs provided by the NSPs.

In this regard, even if the methodologies chosen by NTER entities (which skew the data set in favour of being predominately prime cost) were dismissed on the basis that this is not reflective of the choice that a benchmark efficient entity would make, there is still a question as to whether on balance the remaining data supports an objective conclusion that a benchmark efficient entity would chose to adopt the diminished value method. When the unspecified data and low value data is excluded from this data population this effectively results in the diminishing value method accounting for approximately 64.5% of the remaining data set with the prime cost method accounting for 35.5%. In our view, this supports an objective conclusion that a benchmark efficient entity would prima facie adopt the diminishing value method.

Has the adoption of the diminishing value method caused a historical misalignment?

Whilst in reality a substantial portion of the assets are currently being depreciated using the prime cost method, it is likely that the adoption of the diminishing value method (largely by the private sector) is likely to result in a divergence between actual tax paid and the amount calculated under the regulatory allowance going forward. While this difference would be timing in nature there is likely a cost in net present value terms.

However, whether the prevalence of the diminishing value method by the private sector is a key driver in the historical discrepancy between tax paid and the forecast of tax costs for regulatory purposes for the period referred to in the ATO Note is less clear for the following reasons:

a) During the period covered by the ATO Note (2013- 2016), a not insignificant portion of the private sector entities were actually adopting the diminishing value method for regulatory purposes. This is not addressed by the ATO based on their terms of reference. As noted above, this continued to be the case until the most recent regulatory determinations for all NSPs other than Jemena as noted above.

b) Further, during the period considered in the ATO Note it also needs to be acknowledged that the NSW electricity assets were owned by the NSW State Government for some or all of the period. We do not have any data confirming the methodology adopted in respect of the NSW assets whilst these assets were owned by the NSW State Government which would have included the period from 2013 to 2016.

Accordingly, whilst the adoption of the diminishing value method by the private sector is expected to be a current factor that is likely to cause a misalignment between income tax paid and the forecast of tax for regulatory purposes, it is difficult to objectively conclude that this was a key factor for any historical difference between tax paid and the forecast of tax for regulatory purposes during the period referred to in the ATO Note.

Part A – Recommendations – Choice of Depreciation methodology

Having regard to the relevant data that we have investigated, we make the following key recommendations:

- As noted above, in our view the data would suggest that the diminishing value method would be adopted by a benchmark efficient entity. Accordingly, we consider that the diminishing value method should be applied to all new assets (except in respect of an intangible assets or capital works expenditure captured by Division 43 of the ITAA 1997 that are required to be deducted for tax purposes on a straight line basis) rather than the straight line method which is currently being applied in all but one instance for regulatory purposes.

- We caution that this change in approach with respect to depreciation methodology is unlikely to have a material impact in the initial years of itself unless it is implemented in tandem with our recommendation that the regulatory model also be amended to recognised Capex that is being treated as immediately deductible for tax purposes. This is because of the determination of the 'composite depreciating asset' for the purposes of

Division 40 whereby a lot of the Capex being incurred by NSPs may relate to existing depreciable asset (such as distribution lines) as opposed to being treated as a new depreciating asset for the purposes of Division 40.

- We are recommending that this change only be applied on a prospective basis (i.e. only to new depreciable assets that are acquired or constructed by the energy network not existing assets) because there is no technical basis to retrospectively change the depreciation methodology to existing assets. Specifically, as noted above once the depreciation methodology is chosen it is irrevocable pursuant to section 40-130. Accordingly, from a legislative perspective there is no ability to change the depreciation method that has been applied to existing assets for regulatory purposes.

  Notwithstanding that there is no technical basis to change methodologies for existing assets, we refer to the fact that the AER has previously transitioned existing assets from the diminishing value method to the prime cost method in determining the forecast tax cost for regulatory purposes when some networks were transition from State based regulators. Accordingly, we note that this is a policy choice that has been historically made by the AER which we cannot comment on given it is inconsistent with the application of the tax legislation.

- Even if the choice of methodology for existing assets could be retrospectively changed, that is the historical choice of the prime cost methodology could be put to one side for the purposes of determining the tax allowance for regulatory purposes, this in our view would require the opening TAB to be recalculated on the basis that the diminishing value method had always applied to these assets. This approach is supported by the manner in which the legislation requires balancing adjustments to be determine under the tax legislation which is relevant in calculating gains and losses arising on the disposal of a depreciating asset.

  Such an approach would not only result in the potential for there to be winners and losers based on the age and profile of the individual network assets, but it also introduces other integrity issues. Specifically, any changes to the opening TAB starting base in this manner would likely give rise to permanent differences as opposed to timing differences which is discussed immediately below.

  A substantial exercise would need to be undertaken to determine whether on aggregate there was an overall step up or step down in the opening written down value of the network assets where the diminishing value method is applied to existing assets. Where there was an overall step down in the opening depreciable balance this would mean that more tax would actually be paid as compared to the tax allowance calculated under the existing regulatory model through the remaining life of the existing assets resulting in a permanent difference as opposed to a timing difference.

  Accordingly, any requirement to change the choice of depreciation methodology should only be applied prospectively to new depreciating assets acquired.

- However, notwithstanding our comments above, this technical limitation was again ignored when certain entities transitioned from State based regulators as the closing written down value (determined using the diminishing value method) was adopted as the opening value in the subsequent tariff determinations for those entities and then depreciated using the straight line method.

  The ability of the AER to ignore the application of the tax legislation is a policy decision on which we cannot comment, but we acknowledge that the forecast of the tax cost is in fact applied to a hypothetical taxpayer and introduces a fiction not accommodated in the tax legislation.

  Whilst arguments can be made that choice of depreciation method represents a timing difference and therefore could create inter-generational issues, this may not necessarily

be the case where continuing expenditure profiles mean that accelerated deductions will continue to be recognised for regulatory purposes in future years. Refer section 3.4.2 for a case study whereby this issue was considered by the US Supreme Court in relation to the relevant regulatory tax allowance, and it was determined that adoption of an accelerated basis of depreciation was more akin to a permanent saving due to ongoing expenditure profiles.

Part B – Choice of Effective Life

For income tax purposes, the effective lives of depreciable assets can either be based on the Commissioner's effective life for that asset, or the effective life can be self-assessed by the taxpayer. The ATO issues an annual Taxation Ruling setting out the Commissioner's determination of the effective life for a range of assets by industry. The latest ruling issued by the ATO is TR 2018/4 which applies from 1 July 2018 and replaces TR 2017/2 . This Ruling explains the methodology used by the Commissioner to make a determination of the effective life of depreciating assets under section 40-100 of the ITAA 1997.

A taxpayer also has the ability to self-assess effective lives for depreciating assets where the effective lives suggested by the Commissioner do not reflect the decline in value of those assets as used by the taxpayer.

Capping for Gas Transmission and Distribution assets

The Government decided to place statutory caps on the effective lives of certain assets, in recognition of broader policy considerations including attracting foreign investment into certain specified industries. Specifically, in introducing the statutory caps as part of the 2002 Federal Budget, the then Federal Government recognised that:[30]

> *..the measure to cap statutory effective lives for certain depreciating assets is the most efficient and transparent method of achieving the desired policy outcome. The measure provides for the most appropriate 'balance of interest' between meeting the needs of the specific industries and maintaining the integrity of the Governments effective life capital allowance system*

The capped effective lives apply to various assets but relevant to this review is that gas transmission and distribution assets attract a capped effective life of 20 years pursuant to subsection 40-102(5) of the ITAA 1997 which in general terms would be materially lower that the economic lives of such assets.

This section was inserted into the ITAA 1997 by *Taxation Laws Amendment Act (No. 4) 2002* (Cth). The Explanatory Memorandum to this Act confirms the effective life of such assets prior to the insertion of section 40-102 was also 20 years. Accordingly, the adoption of an effective life of 20 years for gas transmission and distribution assets capitalised prior to 2002 is also supported by legislation.

Recalculating effective life

A taxpayer may choose to determine a new effective life for a depreciating asset where the way the asset is used or other circumstances relating to the nature of its use have changed, and the change means the effective life the taxpayer is using is no longer accurate pursuant to subsection 40-110(1). Some examples of a change in circumstance that may result in a taxpayer wanting to choose to recalculate the effective life of an asset include:

- Use of the asset turns out to be more rigorous than expected (or was anticipated by the Commissioner's determination of effective life)
- Legislation prevents the asset's continued use

[30] Explanatory Memorandum to tax Laws Amendment Bell (no.4) 2002 para 4.79.

- Changes in technology make the asset redundant

The application of subsection 40-110(1) is limited to cases where the basis used by the taxpayer in most recently estimating the effective life of the asset has changed. It does not extend to situations where the basis of the effective life estimate used in the calculations is incorrect due to a mistake of fact or error made by the taxpayer. In these cases, the taxpayer may apply to the Commissioner for an amendment of prior assessments.

In contrast, a taxpayer must recalculate the effective life of a depreciating asset pursuant to subsection 40-110(2) in the following circumstances:

- the taxpayer has self-assessed the effective life and its cost increased by at least 10% in that year;

- the taxpayer uses the Commissioner's determination of effective life, uses the prime cost method and the depreciating asset's cost increased by at least 10% in that year; or

- the taxpayer uses an effective life because of subsection 40-95(4) and (5) and the depreciating asset's cost increased by at least 10% in that year. Subsection 40-95(4) and (5) related to certain circumstances where you acquired the depreciable asset from a former associate.

Accordingly, for each income year in which improvements have been made to a depreciating asset, a taxpayer *must* consider the effect of these additions on the asset's effective life. This allows for an appropriate allocation of the cost of these improvements over the effective life of the asset.

Without the requirement to reassess when using the Commissioner's determination and the prime cost method, second element costs incurred late in the asset's effective life could be deducted almost immediately even though these costs relate to future activities over a substantial period.

We understand that there is no reassessment of effective life of assets for the purposes of determining the estimated cost of taxation for regulatory purposes. We have not undertaken any procedures to determine whether a NSP has been required to re-assess or has voluntarily reassessed the effective life of any asset contained in the depreciation registers that were provided to determine whether this is a relevant consideration. Our expectation is that this would not be a widespread practice based on our knowledge and experience with the industry.

Part B - Summary of our Observations and Conclusions - Choice of Effective Life

Figure 25 below illustrates the effective life spread of all assets contained in the detailed depreciation register information from NSPs where the assets in those depreciation registers contained valid effective life information as discussed above.

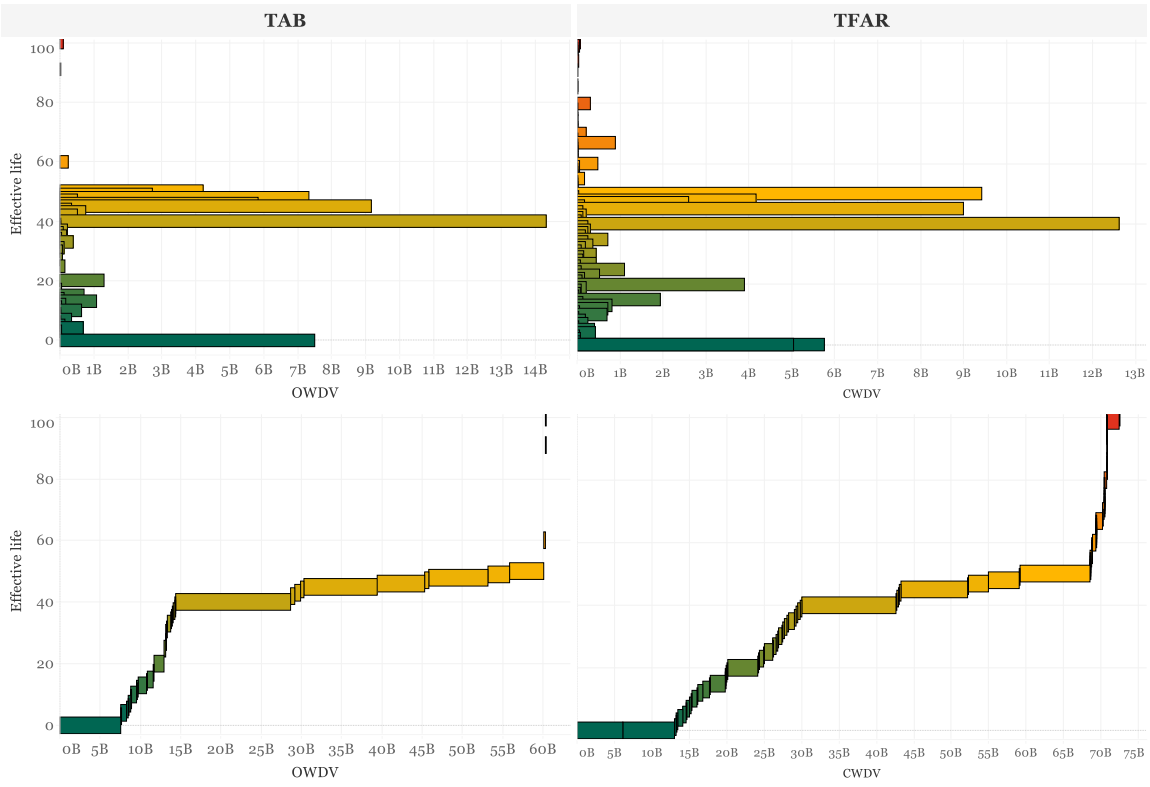
The effective life spread is allocated by the value of the depreciating assets and then compared against the effective life of all associated TAB assets by value. We make the following observations in respect of the data set contained in Figure 25:

- The average effective life of assets contained in the TFARs (by value) being 38.98 years is lower than the average effective life applied to assets in the TAB. This would indicate that tax depreciation is being claimed at a faster rate in determining actual tax paid as compared to the tax allowance determined existing regulatory approach.

- As noted above, the opening written down value of assets in the TFARs are likely to contain non regulated assets given 40.5% of assets were classified as unspecified (that is neither regulated nor unregulated). Accordingly, trying to draw any direct inference between the difference in the opening written down values in the TAB which total $59.85

billion and the opening written down values contained in the TFAR totalling $67.91 billion is likely to be unreliable and potentially misleading.

Figure 25: Effective life spread by value for all participants by value



TAB opening value (all respondents)	$59.85B	TFAR CWDV (nearest available date as provided)	67.91B
TAB average effective life by value	41.15 years	TFAR average effective life by value	38.98 years

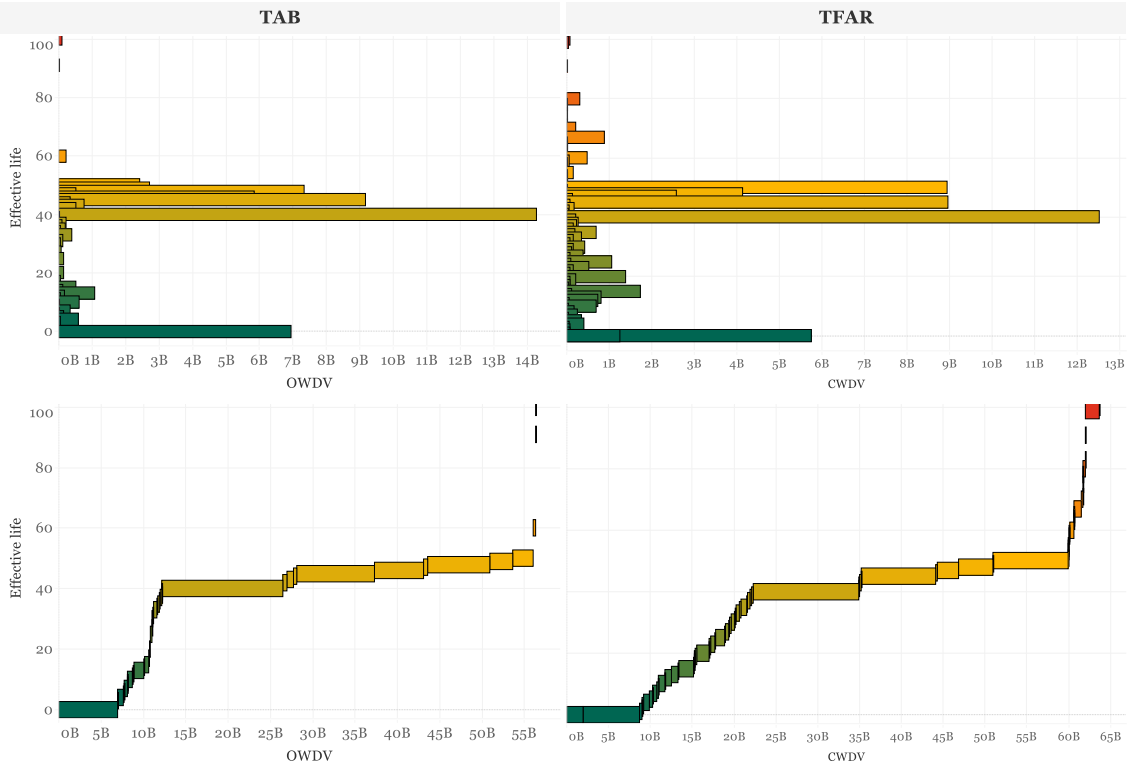
Notes relevant to interpretation of information:

- TFAR asset values only include those assets for which depreciation was claimed during the period as disclosed by the respondents.
- An effective life of zero indicates asset value where no effective life was specified. These assets were not included in effective life calculations.
- TFAR information was requested as at 30 June 2018, however some entities have provided the information for the nearest possible date to 30 June 2018 for which the information has been prepared. All values related to closing balances within the asset register within the FY17 and FY18 years.
- TAB information (effective lives and values) has been taken from the opening TAB value for the latest available post tax revenue model (which supports the most recent determination) for each NSP. As some opening TAB balances relate to earlier years (such as FY14, 15 and 16), where this is the case, we have separately considered the average effective life application to capex additions included in the relevant post tax revenue models for those later periods (e.g. the periods not reflected in the data above). The average effective life applicable to Capex incurred after the opening TAB date for electricity and gas assets for all entities (NTER and non-NTER), which is not reflected in the Figure above is **37.84 years**. Inclusion of this information would decrease the average effective life of 41.15 years outlines for TAB purposes above.

Importantly, Figure 25 above is representative of all industry participants that have provided a TFAR and therefore incorporates both electricity and gas participation. As noted above, a statutory cap of 20 years applies to the effective life of gas distribution and transmission

assets. This statutory cap has not been applied uniformly for all gas participants. Specifically, the statutory cap has only been applied to six out of the 11 gas participants. This statutory cap therefore has the potential to skew the overall average effective lives of assets contained in the TFAR as set out in Figure 25. Accordingly, we have set out in Figures 26 and 27 respectively the average effective life of assets contained in the TFARs by electricity industry participation and gas industry participation to illustrate the potential skewing impact of the 20 year statutory cap applying to the gas industry assets.

Figure 26: Effective life of Electricity Assets



TAB opening value (all respondents)	$55.85B	TFAR CWDV (nearest available date as provided)	59.62B
TAB average effective life by value	41.56 years	TFAR average effective life by value	39.94 years

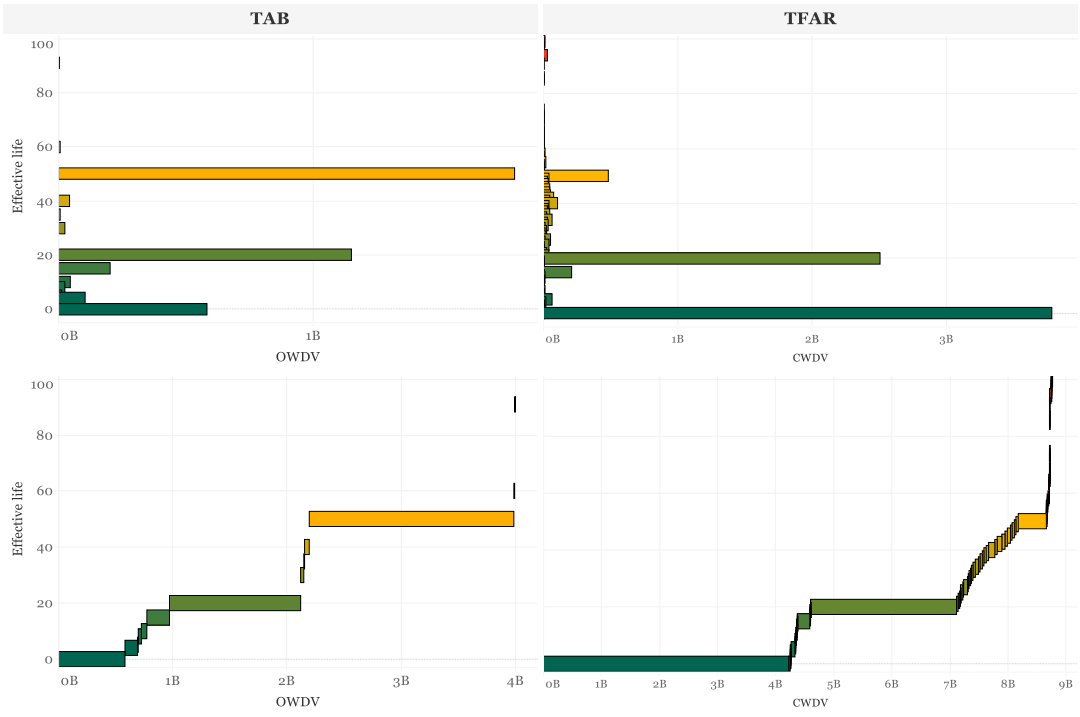
Notes relevant to interpretation of information:

- TFAR asset values only include those assets for which depreciation was claimed during the period as disclosed by the respondents.
- An effective life of zero indicates asset value where no effective life was specified. These assets were not included in effective life calculations.
- TFAR information was requested as at 30 June 2018, however some entities have provided the information for the nearest possible date to 30 June 2018 for which the information has been prepared. All values related to closing balances within the asset register within the FY17 and FY18 years.
- TAB information (effective lives and values) has been taken from the opening TAB value for the latest available post tax revenue model (which supports the most recent determination) for each NSP. As some opening TAB balances relate to earlier years (such as FY14, 15 and 16), where this is the case, we have separately considered the average effective life application to capex additions included in the relevant post tax revenue models for those later periods (e.g. the periods not reflected in the data above). The average effective life applicable to Capex incurred after the opening TAB date for electricity assets only, for all entities (NTER and non-NTER), which is not reflected in the Figure above is **39.58 years**. Inclusion of this information would decrease the average effective life of 41.56 years outlines for TAB purposes above.

Figure 26 above, shows that the average effective life of electricity assets contained in the relevant TFAR being 39.94 years, for electricity participants is marginally lower than the average effective life of electricity assets in the TAB, being 41.56 years. This would indicate a marginal timing difference in the depreciation being claimed by electricity sector participants in determining actual tax paid as compared to the tax allowance.

In contrast, the average effective life of assets in the TFAR for the gas industry participants being 27.83 years as outlined in Figure 27 below is substantially lower than the average effective life of gas assets in the TAB. This is reflective of the 20 year effective life statutory cap applying to gas network assets that is not uniformly being taken into account for the purposes of determining the depreciation on assets contained in the TAB for the purposes of calculating the tax allowance. This would indicate depreciation is being claimed by some gas sector participants (i.e. the five gas participants where capping is not being applied) at a faster rate in determining actual tax paid as compared to the tax allowance determined existing regulatory approach.

Figure 27: Effective life Gas Assets



TAB opening value (all respondents)	$3.99B	TFAR CWDV (nearest available date as provided)	8.29B
TAB average effective life by value	35.12 years	TFAR average effective life by value	27.83 years

- TFAR asset values only include those assets for which depreciation was claimed during the period as disclosed by the respondents.
- An effective life of zero indicates asset value where no effective life was specified. These assets were not included in effective life calculations.
- TFAR information was requested as at 30 June 2018, however some entities have provided the information for the nearest possible date to 30 June 2018 for which the information has been prepared. All values related to closing balances within the asset register within the FY17 and FY18 years.
- TAB information (effective lives and values) has been taken from the opening TAB value for the latest available post tax revenue model (which supports the most recent determination) for each NSP. As some opening TAB balances relate to earlier years (such as FY14, 15 and 16), where this is the case, we have separately considered the average effective life application to capex additions included in the relevant post tax revenue models for those later periods (e.g. the periods not reflected in the data above). The average effective life applicable to Capex incurred after the opening TAB date for gas assets only, for all entities (NTER and non-NTER), which is not reflected in the Figure above is **29.77 years**. Inclusion of this information would decrease the average effective life of 35.12 years outlines for TAB purposes above.

Part B – Recommendations Choice of Effective Life

Based on our investigations into whether the choice of effective life is a key driver between the amount of tax actually paid and the tax allowance calculated under the existing regulatory approach we make the following recommendations:

- We recommend that the 20 year effective life statutory capping applying to gas assets should be applied uniformly to all gas participants.

- We have not sighted an objective evidence that the existing regulatory approach to determining the tax allowance should be amended for effective life choices made by electricity industry participants.

Certain submissions were made indicating that the allocation of low value assets to a low value pool was a potential driver between actual tax paid and the tax allowance calculated under the existing regulatory approach. Based on our experience, the percentage of low value assets as a subset of the total asset base held by NSPs is likely to be immaterial and accordingly is unlikely to be a key factor in any difference between actual tax paid and the tax allowance.

3.3.6 Capex Investigation Matter Three – cost base of depreciable assets

In the context of tax depreciation, the other variable outside the choice of depreciation methodology and effective life is the cost of the 'depreciable asset' as identified under Division 40.

Importantly, as noted above, trying to draw any direct inference between the difference in the opening written down values in the TAB which total $59.85 billion and the opening written down values contained in the TFAR totalling $67.91 billion is likely to be unreliable and potentially misleading. This is for the following reasons:

- There are amounts being capitalised in the TAB that are being treated as immediately deductible for tax purposes as discussed above. This will likely mean that the opening written down value of the TAB is overstated as compared to the opening written down value in the TFARs. We have recommended changes in the treatment of these amounts on a prospective basis as noted above, subject to the commercial considerations raised in various submissions which need to be considered by the AER.

- Amounts included in the TFARs are likely to include unregulated assets (this may in some instances include historical gifted assets not taken into account for TAB) that have not been recognised for determining the tax allowance. This is highlighted by the fact that 40.5% of the assets included in the detailed TFARs received from the NSPs were not specified as being regulated or unregulated. This is likely to mean that the opening written down value of assets in the TFARs are overstated as compared to the opening balance of the TAB.

- There will be differences resulting from the choice of depreciating method adopted and choice of effective lives (including the statutory capping applying to gas assets) given we have compared the TAB and tax written down values contained in the TFARs at a point in time. This is further complicated by the fact that some participants were adopting the diminishing value method and then transitioned to the straight line method without adjustment to the written down value (i.e. the closing written down value used to determine the closing balance was then adopted without adjustment and deducted using the prime cost method when these entities were transitioned).

- For tax purposes, there can be a step up in the tax cost base of depreciable assets that arise as a consequence of third party acquisitions of the regulated assets (direct and

indirectly) which are not recognised in the TAB which create permanent differences. This can include taking into account indirect costs associated with the acquisition (for example stamp duty and legal costs).

Our discussion below focuses on the following matters:

- The tax treatment of gifted assets for determining the tax allowance for regulatory purposes.
- The technical explanation of how the step up in the tax cost base of depreciable assets arise as a consequence of third party transactions and our opinion as to whether any such step ups should be included in the TAB.

Overview of legislation - Cost of a depreciating asset

Broadly the cost of a depreciating asset is comprised of two elements. The first element is the amount paid, or taken to have been paid, to commence holding the asset. The second element generally includes amounts paid, or taken to be paid, after you start to hold the asset and represent costs which contributed to bringing the asset to its present location and condition. This generally includes costs such as relocating an asset and improvements to an asset.

Further, the cost base of an asset can include the sum of the amounts that would have been included in a taxpayer's assessable income because they started to hold the asset or received the benefit, or because they gave something to start holding the asset or receive the benefit, ignoring the value of anything they gave that reduced the amount actually included. This would typically be relevant where a taxpayer receives a capital contribution or what is commonly referred to as a gifted asset.

Gifted assets

Where enhancements to existing infrastructure are funded by third party users and then gifted to a taxpayer, the ordinary income provisions and the non-cash business benefit valuation rules in the income tax law potentially combine to bring an arm's length fair value amount to taxation. This is relevant both where the recipient is a private sector taxpayer, and where the recipient is a NTER taxpayer. Relevantly, the application of the income tax law in respect to the gifting of assets is currently subject to dispute between the ATO and an NSP, and so there is some uncertainty in respect of the application of these rules.[31]

Where an amount is required to be bought to account as assessable income in respect of gifted assets this amount is then included in the cost of the gifted asset that the recipient taxpayer starts to hold for tax depreciation purposes pursuant to subsection 40-185(1) of the ITAA 1997 and deducted over the effective life of the gifted asset. This tax treatment typically results in adverse tax timing outcomes for the recipient of the gifted asset given the market value of the gifted asset is treated as assessable income when the benefit is received whilst depreciation is only available over the effective life of the asset. This has led to some electricity and gas utilities implementing policies to gross up the contributions required to augment network assets to compensate them for the adverse tax timing implications associated with gifted assets.

It is also worth noting that the non-cash business benefit is brought to account at its arm's length value disregarding the conditions preventing its conversion to cash. Difficult questions of valuation can arise for certain gifted assets that do not directly result in the

[31] ASX announcement, Spark Infrastructure, 21 September 2018: ATO Deed of Settlement – Capitalised Labour and Other Costs for Victoria Power Networks.

recipient deriving a benefit, for example where the asset is not included in a regulated asset base.

The existing regulatory approach to determining the tax allowance of a benchmark efficient includes the value of gifted assets in the calculation of the forecast tax cost for regulatory purposes.

In this regard the arm's length fair value of the gifted assets received by the relevant NSP has been included in assessable income notwithstanding our understanding that the gifted asset is of itself included in the RAB at nil value and therefore the NSP does not receive a return on the gifted asset (i.e. because the NSP has not incurred efficient expenditure) outside the return attributable to the tax allowance. Consistent with the application of section 40-185 the associated tax depreciation in respect of the gifted asset in these circumstances is also included in determining the tax allowance on the basis that an amount of assessable income has been brought to account for tax purposes.

We would generally agree that tax depreciation on gifted assets should only be taken into account in determining the tax allowance for regulatory purposes where an amount is also included in assessable income in respect of the gifted assets for the purposes of the regulated tax allowance to ensure an appropriate application of the tax law, specifically subsection 40-185(1).

We have not considered the appropriateness of only recognising gifted assets for the purposes of determining the tax allowance given the gifted asset is ascribed a nil value for the RAB as we understand this is a policy position that has previously been considered and accepted by the AER. We note that matters relevant to this particular matter are currently scheduled to be heard by the Federal court in December 2018.[32]

Step up in the tax cost of a depreciating asset

The matters discussed above relating to the immediate deductibility of capex, and the choices made in respect of depreciation methodology and effective life generally give rise to timing differences only.

In contrast, there can also be permanent differences between actual tax paid and the amount determined under the regulatory allowance where there is a 'step up' (or for that matter 'step down') in the tax cost base of depreciable assets as a consequence of changes in ownership of the regulated assets. That is, the tax cost base of depreciable assets can change as a consequence of a change in either direct or indirect ownership of the assets for tax purposes. Such changes in the tax cost base as a consequence of M&A activity are not taken into account for the purposes of determining the regulatory tax allowance. In the first instance, this should be expected given the regulatory business is deemed to be a 'standalone' benchmark efficient entity because the assumption is that it largely ignores changes in the control and/or ownership of these assets.

Outlined below is a summary of the tax implications arising to a seller and buyer of a depreciating asset followed by a simplified example showing how a step up in the tax cost base of depreciable assets occurs. The example ignores the potential application of Division 58 which is discussed in more detail below and the application of the tax consolidation rules which adds further complexity to the concepts contained in the example considered.

As noted above, the cost base of a depreciable asset is the amount paid or taken to be paid to commence holding the asset. Where a depreciable asset is subsequently sold, a balancing adjustment event will arise. Where the consideration received is greater than the adjustable value of the asset (being the cost established under Division 40 less any tax depreciation

[32] Ibid.

claimed in respect of the asset up to the date of sale) a taxable gain will arise to the taxpayer. Where the consideration is less than the adjustable value of the asset a balancing adjustment loss would be immediately deductible.

Importantly, the acquirer would then have a cost in the asset equal to the amount paid for the asset (including any incidental costs incurred which may include stamp duty or legal fees).

Example 1 below illustrates in very simplistic terms the broad tax outcomes for a seller and an acquirer in respect of the sale of a depreciable asset noting that the actual tax implications of a sale will also depend on the precise sale structure and tax profiles of the relevant taxpayers.

Example 1

Taxpayer A originally constructs an electricity distribution line which is considered a single composite asset for a cost of $1 billion which was first installed ready for use on 1 July 2010. The taxpayer has a 30 June year end for tax purposes and elects the diminishing value method in respect of the asset and adopts the Commissioner's effective life of 45 years.

Taxpayer A sells the electricity distribution line to Taxpayer B on 30 June 2018 for cash consideration of $900 million. Taxpayer B incurs additional incidental costs including stamp duty of $50 million in respect of the acquisition of the distribution line.

Taxpayer A will make a taxable gain of $138.735m being the consideration received of $900 million less the adjustable value of the electricity distribution line at the date of disposal totalling $761.265m. The gain would be subject to tax in the hands of Taxpayer A.

Taxpayer B would have a an initial tax cost base of $950 million in the distribution line which will form the basis for determining tax depreciation on the distribution line going forward.

The above example in very simplistic terms (prior to taking into account the interaction of Division 58 and the tax consolidation rules to privatised assets) illustrates the origins of an uplift in tax book values referred to in the Martin Lally Report.

More specifically, whilst there is an uplift in the tax cost of the asset in the hands of taxpayer B as at 30 June 2018 (when compared to the adjustable value of the asset in the hands of Taxpayer A at that same date), there has also been a taxable gain arising to Taxpayer A which has recaptured a substantial amount of the previous depreciation claimed by Taxpayer A.

In our opinion, taking into account the uplift in the tax cost of assets in the TAB for the purposes of determining the tax allowance would be inequitable as it would specifically ignore the detrimental tax outcomes to the Taxpayer A (being the recapture of depreciation previously claimed and factored into the TAB). It would essentially amount to sitting on both sides of a transaction, but only taking the benefits of both sides which is not commercially realistic.

If the existing approach to determining the regulatory tax allowance were amended to recognise both the reset of the tax base in the hands of the buyer whilst recognising the tax implications to the seller, this may have the potential to create intergenerational issues. Specifically, the actual tax paid by the seller may in some instances be borne by consumers who have not benefited from the depreciation claimed by the seller for the purposes of determining the historical tax allowance over the time it held the assets.

Application of Division 58 to Privatised Assets

The above analysis is made slightly more complex in the context of depreciable assets that are privatised. Specifically, when depreciating assets owned by a tax exempt State entity are privatised (either via a sale of an entity or assets, the latter including the grant of a long term lease in respect of the assets), specific integrity rules contained in Division 58 of the ITAA 1997 (which was re-written and replaced parts of Schedule 2D of the ITAA 1936) apply to cap the opening tax written down value of those assets when they first enter the federal tax regime.

In accordance with Division 58, the taxable entity has a choice of two methods that may be used to determine the capped amount (or opening written-down value) of a depreciating asset that is transferred to it from a tax exempt entity which are discussed in more detail below. This would generally serve to cap the asset's opening tax bases at something less than their market value. The cost base determined under Division 58 of the ITAA 1997 is then used to determine the ongoing depreciation deductions and balancing adjustments for, depreciating assets previously owned by, or purchased from, a tax-exempt entity.

The rationale for capping the cost ascribed to depreciable assets when they first become subject to income tax was first highlighted in the Explanatory Memorandum to the Taxation Laws Amendment Bill (No 4) 1998 (Act No 93 of 1999), which broadly noted that failure to implement Division 58 would "pose a significant threat to the revenue due to larger potential depreciation deductions being available to purchasers of exempt entity assets" (para 990-646, p 121). Specifically, the concern identified by the ATO related to an asset sale technique that was in use in the late 1980s which "provided scope for parties to the sales to structure arrangements to gain tax advantages at the cost to Commonwealth revenue".[33]

In more general terms it was said that in an asset acquisition "there exists some potential or opportunity for shifting value from the non-depreciable assets including intangibles into the depreciating assets". This risk may be increased where the vendor is, from a taxation perspective, disinterested in the proportion of the total business price which is attributed to the cost or terminating value of the depreciating assets as it is of no tax consequence for the exempt vendor in terms of a balancing adjustment or capital gains tax.[34] Accordingly Division 58 (as amended) sought to provide consistency of treatment between an entity sale and an asset sale.

The two choices under Division 58 for determining the opening written down value of depreciable assets when they first become subject to income tax are:

- The *notional written-down value* (**NWDV**) of the asset at the time it is acquired / transferred by the taxable entity; or

- The *undeducted pre-existing audited book value* of the asset at the time it is acquired / transferred by the taxable entity.

For completeness, we note that where the assets are privatised by way of an asset sale (including by way of long term lease) as opposed to being acquired under an equity transaction, the acquirer can adopt a different depreciation method going forward to calculate the depreciation deductions to the method used to determine the opening starting base under the NWDV method. Specifically, the acquirer could use the prime cost method to determine the opening starting base under Division 58 and then switch to the diminishing value method going forward.

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[33] Page 105 of the Explanatory Memorandum to the Tax Laws Amendment Act (No2) 1999.

[34] Example under paragraph 3.8 of the Explanatory Memorandum to the Tax laws Amendment Act (No2) 1999.

However, the taxable entity must use the same depreciation method (i.e. prime cost or diminishing value) to determine the tax depreciation deductions available where the privatisation occurs by way of an equity transaction.

Division 58 is silent in respect of determining the effective life of an asset which has been acquired / transferred from a tax exempt entity, for the purpose of determining the decline in value of the asset for tax purposes after the acquisition / transfer time. In this regard, the taxable entity is required to determine the effective life of all transferred assets in accordance with Division 40 of the ITAA 1997, similar to the way the effective life of the taxable entity's other depreciating assets are determined. Thus, the taxable entity has the choice of either self-assessing the effective life of the asset or using the relevant effective life determined by the Commissioner.

Notional Written-down Value

The NWDV of an asset is essentially the deemed adjustable value of the asset in the hands of the tax exempt entity just before the acquisition / transfer time. The adjustable value of an asset is determined under Division 40 of the ITAA 1997, which involves ascertaining the original cost of the asset to the tax exempt entity and deducting from this the decline in value (or tax depreciation) of the asset up until the asset is acquired by / transferred to the taxable entity. In calculating the NWDV, the taxpayer has a choice between adopting the prime cost method and the diminishing value method on an asset by asset basis.

For the purposes of determining the notional written-down value of an asset, Division 58 requires the taxable entity to assume that the asset had always been used by the tax exempt entity for a taxable purpose and that the effective life of the asset for tax purposes is in accordance with the Commissioner's determination of the effective life of such an asset as at the acquisition / transfer time.

Of note is that the application of the assumptions in Division 58 does not require the taxpayer to have regard to the tax position adopted by a tax exempt entity that was subject to the NTER whilst it was the owner/holder of the depreciating assets. Specifically, whilst a tax exempt entity may have sought to comply with the income tax law's requirements, including making decisions, elections and choices in respect of those assets and may have also obtained tax advice or rulings on how the income tax law ought to apply in respect of those depreciating assets the purchaser of the exempt entity or exempt entity's assets is not bound by this when applying Division 58.

Undeducted Pre-existing Audited Book Value

The undeducted pre-existing audited book value of an asset is specified by Division 58 as the audited value given in respect of an asset (as at the end of an accounting period) which was prepared as part of the final accounts of the tax exempt entity. Under this approach, a qualified independent auditor must have prepared and signed an unqualified final audit report on the tax exempt entity's final accounts before 4 August 1997. This will generally limit the timeframe for this method to assets existing at 30 June 1996 (or 30 June 1997 where the 30 June 1997 audit was completed by 4 August 1997).

In the circumstances where the final accounts of the tax exempt entity do not specify a specific value for a particular asset, but rather provide a total value for a number of assets, Division 58 requires that the taxable entity apply a reasonable attribution method to the total value, to determine the book value of each individual asset.

Once the audited value of the asset, as per the final accounts of the tax exempt entity, is determined, this value is then adjusted by notionally depreciating the asset to the date that the asset was acquired by / transferred to the taxable entity. Similar to the notional written-down value method, for the purposes of determining the notional depreciation of the asset, Division 58 requires the taxable entity to assume that the asset had always been used by the tax exempt entity for a taxable purpose and that the effective life of the asset for tax purposes is in accordance with the Commissioner's determination of the effective life of such an asset as at the acquisition / transfer time.

Post 30 June 1996 Assets

Where an asset which was acquired / transferred to the taxable entity, was acquired / constructed by the tax exempt entity after the time which qualifies for measurement under this method, the undeducted pre-existing audited book value method cannot be used to determine the opening written-down value of the asset. Rather, the taxable entity will be required to use the notional written-down value method.

In a privatisation context a purchaser will typically make elections using the two methods available to effectively maximise the opening tax cost base of the privatised assets when the assets first enter into the Federal tax regime. Whilst the tax base determined under Division 58 is likely to be higher than the tax base held by the tax exempt entity that was subject to the NTER, this is not an uplift in the tax cost base of the assets per-se but a redetermination of the tax base using the assumptions contained in Division 58 generally based on the original cost of those assets incurred by the NTER entity.

Subsequent balancing adjustment events on acquired privatised assets

Where an entity sells the privatised assets by way of an asset sale a balancing adjustment event would occur and a taxable gain would arise to the seller to the extent the consideration received is greater than the adjustable value of the assets at the time of sale (being the cost base initially determined under Division 58 less any depreciation deductions claimed by the Seller up to the date of sale). A balancing adjustment loss would arise to the extent the adjustable value was greater than the consideration received for the sale of the assets.

As set out in Example 1 above, the new purchaser would obtain a tax cost base in the assets equal to the amount paid for the assets. That is, Division 58 would not apply to cap the tax cost base of the assets on a subsequent acquisition of the assets.

Where Division 58 capped the opening depreciable asset base well below market value, there is a natural deterrent in selling the assets directly as this is likely to give rise to substantial taxable gains which can be contrast to a sale of the equity in the entity that holds the assets where the cost base held in the equity would reflect the amount paid.

Interaction between tax consolidation and Division 58

Australia introduced the ability for Australian corporate groups to consolidate for tax purposes with effect from 1 July 2002. In order to form a consolidated group there needs to be a head company and at least one wholly owned Australian subsidiary member. The head company must be a company that has all or some of its taxable income (if any) taxed at a rate that equals the corporate tax rate but specifically excludes certain entities referred to in section 703-10 of the ITAA 1997. This exclusion section refers to any entity whose total ordinary income and statutory income is exempt from tax under Division 50 which for example would include municipal corporations and a public authority constituted under Australian law.

Pursuant to section 713-130 of the ITAA 1997 certain corporate unit trusts (**CUTs**) and public trading trusts (**PTTs**) that are taxed as companies can also be head companies and elect to form a tax consolidated group provided certain conditions are met. We have identified one instance where a PTT is the head company of a tax consolidated group that holds network assets based on our investigations to date.

For completeness, we also note that legislative changes in 2016 resulted in some PTTs and CUTs ceasing to be treated as corporate tax entities for income years on or after 1 July 2016. Notwithstanding, entities impacted by these changes were still able to make an election to continue to be treated as corporate tax entities if they had made a valid choice to be the head company of an income tax consolidated group.

One of the outcomes of income tax consolidation is the reset of the tax values of certain underlying assets of a subsidiary entity including any depreciable assets. Whilst the reset of the underlying assets of subsidiary members is a complex process which may contain up to 7

steps and take into account the existence of tax losses referred to as the Allocated Cost Allocation method or ACA method in its most simplistic form it requires the cost of the equity including any incidental costs that the head company has in the subsidiary member to be added to the subsidiary entity's liabilities (with certain adjustments) with this aggregate amount then push down to reset the underlying assets held by the subsidiary relative to the assets market value. Where there are multiple layers of companies in a group a top down approach is required and the process becomes more complex.

The interaction between the tax consolidation regime and Division 58 can also have implications for the tax cost of regulated depreciable assets. Section 705-47 of the ITAA 1997 was introduced to ensure the appropriate interaction of Division 58 of the ITAA 1997 with the consolidation provisions of that Act. Where a company holds a privatised asset at the time of consolidation, the cost allocated to that asset is restricted, for depreciation purposes, by reference to the Division 58 capped amount. Where the cost setting amount under consolidation is lower than the Division 58 amount the tax consolidation rules will apply to limit the reset amount of the asset to the lower amount.

Section 705-47 also applies to limit the cost of a privatised asset held by a consolidated group which joins another consolidated group unless the specific requirements in section 705-47(3) apply. Section 705-47(3) applies where the purchasing entity is not an associate of the former head company that has held the asset for more than 24 months. In these circumstances the asset would no longer be treated as an asset to which Division 58 previously applied for the purposes of subsequent application of the cost setting rules. That is, subsequent acquisitions of the asset via equity will not attract the Division 58 cap and the tax cost of the assets can be reset based on their market value.

In the situation that this initial reset of the tax base is achieved, the tax consolidation rules contain a mechanism in Division 711 of the ITAA 1997 (which relates to resetting the tax cost base of the shares of an exiting group member) to prevent adverse tax outcomes arising to the seller (as a consequence of the capping it had to originally apply to the depreciable assets under Division 58). This is an example of where the reset of the tax base of the regulated depreciation assets can be achieved without a detrimental outcome to the seller referred to in Example 1. However, Division 711 would not apply again in this way on subsequent transactions involving the change of ownership in the regulated assets.

A reset of the tax depreciable assets under 705-47(3) can also be achieved without adverse tax implications to the seller (as noted in Example 1) in circumstances where the seller is a non-resident and sells its shares in the Australian holding company which are not considered indirect interests in Australian real property to another Australian tax consolidated group. Foreign residents are only taxed on the sale of shares in an Australian company where the underlying real property assets held by the company (or its subsidiaries) comprise more than 50% of the total assets of that company by value. It is worth noting that there are additional complexities that present with this scenario in the context of the regulated assets including:

1. Whether foreign investors may have entered into any agreements, deeds or otherwise with the ATO which deem assets to be real property interest when otherwise this wouldn't be the case.

2. Whether non regulated assets (including foreign assets) held by an Australian holding company (or its subsidiaries) skew the total percentage of real property interests to be above or below the 50% threshold to bring the sale of the shares into or outside of the Australian tax net (i.e. because the shares are or are not considered to be indirect interests in Australian real property).

3. Whether the sale of the shares are considered to be on revenue account and the profits from the sale of the shares are considered to have an Australian source. In this case the profits could be subject to Australian tax even if they are not considered to be an indirect interest in Australian real property (subject to the application of any Double Tax Treaties entered into).

However, there are additional technical and commercial complications associated with trying to take into account any step up in the tax cost of regulated depreciable assets that arise as a consequence of acquisition activity involving tax consolidated groups which include the following:

- The step up in the tax base of the depreciable assets arising from M&A activity are unrelated to the efficient operation of the regulatory business and therefore is outside the regulatory framework ring-fence.

- The current regulatory approach being to treat the regulated business as a standalone efficient business held by a single company would not technically meet the requirements to enable tax consolidation (i.e. the currently regulatory approach would need to be amended to acknowledge/recognise the head company of the tax consolidated group). Specifically, as noted above to form a tax consolidated group you need an Australian head company and at least one wholly owned Australian resident subsidiary.

- This amendment would necessitate the regulatory approach more broadly being amended to recognise all holding structures adopted by investors in respect of regulated assets which we would not recommend given the complexity that this introduces.

- If the existing regulatory model were amended to recognise investor holding structures, including the head company of a tax consolidated group in attempt to recognise the step up's that can occur in the tax cost base of depreciable assets this would likely to introduce substantial integrity issues. Specifically, the existence of liabilities and the cost of equity referable to non-regulated assets would be taken into account in resetting the cost base of the regulated assets. This introduces substantial integrity risks as liabilities associated with non performing unregulated business assets could inappropriately skew value into the regulated depreciable assets and vice versa which would be not be acceptable.

- Consistent with the point immediately above, the tax cost resetting rules can also potentially give rise to substantial step downs in the tax cost of depreciable assets. This could arise for example where the regulated income was reduced resulting in an impairment of the regulated assets which were then sold to a third party tax consolidated group.

- The income tax consolidation rules were introduced to treat groups of wholly owned Australian resident companies as a single entity for the purposes of determining income tax liability. In context of this review some regulated assets are held within tax consolidated groups where the tax affairs are attributed to the head company of the tax consolidated group and comingled with other regulated and unregulated business operations.

- The context of the introduction of the consolidation rules is broadly contained in paragraphs 1.7 to 1.10 of the Explanatory Memorandum to the *New Business Tax System (Consolidation Bill) No 1* which can be broadly summarised as:

    a To promote business efficiency, by permitting groups of wholly-owned entities to choose to be taxed as a single entity rather than on an entity by entity basis.

    b To address both efficiency and integrity problems existing in the taxation of wholly-owned entity groups, many of which arise from this inconsistent treatment.

- It was considered therefore that the consolidation regime would assist in simplifying the tax system, reduce both the cost of compliance and tax revenue costs associated with existing tax treatment of company groups, improve the efficiency of business restructuring and strengthen the integrity of the income tax system.

- If the existing regulatory approach to determining tax allowance were to be amended to take into account holding structures in order to recognise the uplift in tax cost of depreciation for regulated assets, there would be an inconsistency with the spirit of the tax consolidation regime if the other aspects of the tax consolidation rules were not also adhered too. The adoption of the tax consolidation rules appear totally inconsistent with treating the regulated business as a standalone business efficient entity. In this regard we make the following observations:

    a Reducing compliance costs associated with treating all the tax affairs of the tax consolidated group as a single taxpayer would be in direct contradiction to the regulated approach to treat the regulated assets as a standalone business efficient entity.

    b Taking into account the ability to offset the tax outcomes of all business activities within the tax consolidated group again is inconsistent with treating the regulated business as a stand-alone business.

3.4 Comparisons: International case studies

3.4.1 Summary of our investigation process

In considering the appropriateness of the corporate benchmark entity approach, we have performed high level research into models applied by regulators in comparable industries across the globe. In particular, we have sought to identify any jurisdictions where network service operators have differing ownership structures, which may result in differing income tax profiles.

We have relied on publicly available information regarding the international electricity and gas transmission and distribution regulatory regimes, and the approaches adopted by local jurisdictions. We have also raised queries and attended teleconferences with PwC specialists in the relevant jurisdictions where further information was required. We note that our scope in respect of this aspect of the review was limited. Accordingly, our review was focused on countries which have experienced substantial privatisation of electricity and gas networks, as the practices applied by regulators in those jurisdictions will have greater relevance.

Jurisdictions which have been subject to our enquiries include the United States, the United Kingdom, New Zealand, Canada, Japan, and other European and Asian countries. To a very large extent, the foreign regulatory regimes identified seek to provide the utilities with a tax allowance having regarding to the expected tax profile of the local operators (e.g. a benchmark entity approach as opposed to an actual or pass through approach), subject to intricacies relating to each country's unique regulatory system and tax regime. From our enquiries, we have identified the following practices or considerations as relevant to our Report. Due to limitations in the scope and timeframe for our review, this is not intended to be an exhaustive analysis of the foreign regimes, but rather provide a high level indication of approaches taken in respect of similar issues at an international level. The practices identified for further consideration include:

- The approach taken within the **United States** to the **normalisation** of tax expense within the regulatory tax allowance;
- The approach taken within the **United States** to the treatment of returns to **flow-through entities**, including recent proposed changes to this;
- The approach taken within the **United States** to the recognition of tax expense relating to regulated activities of a provider within a **tax consolidated group**; and
- The approach taken within the **United Kingdom** to claw back any notional **interest expense** included in the tax allowance which is in excess of the interest deductions claimed by the entity on subsequent lodgement of their tax filing.

Each of these practices is discussed in further detail below.

3.4.2 United States – Normalisation of tax expense

Our initial research indicates that the issue of inconsistencies between actual tax depreciation methodologies and that applied in the regulatory tax allowances has been subject to continual debate in the United States over the last 60 years. This is complicated by the fact that while the Federal Energy Regulatory Commission (**FERC**) publishes rules and determinations relating to regulatory allowances for gas pipelines and transmission activities, rates applicable to distribution of electricity and gas are regulated by Public Service Commissions on a state by state basis across the country. Further, the tax regulator (the Internal Revenue Service) may also make rulings in respect of individual firms which will impact the methodology applied in the relevant tax allowances. Accordingly, practices adopted over time have differed and inconsistent rulings have been applied across various industries and utility providers. That said, it appears the debate regarding the appropriateness of the depreciation methodology to be included in tax allowance in the

United States is now largely settled, in that the benefit of accelerated depreciation is largely passed on to consumers.[35] In assessing the various decisions and debates applied in the United States, we have noted the following developments.

The interaction of accelerated depreciation methods and the regulatory tax allowances was considered through FERC regulations and changes to the United States income tax law in the 1960s and 1970s. The history of this matter was addressed by the United States Supreme Court in the matter of *FPC v Memphis Light, gas & Water Div.,* (1973) as follows:

> *Initially, the Commission required utilities to compute their cost of service, which includes federal income taxes, as if they were using straight-line depreciation. This method, referred to as "normalization," was designed to avoid giving the present customers of a utility the benefits of tax deferral attributable to accelerated depreciation. If a utility used accelerated depreciation in determining its actual tax liability, the difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes was required to be placed in a deferred tax reserve account. See Amere Gas Utilities Co., 15 F.P.C. 760.*
>
> *It soon became apparent that accelerated depreciation, in practice, resulted in permanent tax savings. Because most utilities had growing or at least stable plant investments, the depreciation allowances from additional and replacement equipment offset the declining depreciation allowance on existing property. Accordingly, the Commission required utilities using accelerated depreciation for tax purposes to use the same method for calculating their cost of service, and, thus, to "flow through" any tax savings to their customers. Alabama-Tennessee Natural Gas Co., 31 F.P.C. 208, aff'd sub nom. Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (CA5). Subsequently, the Commission decided that it would impute the use of accelerated depreciation for ratemaking purposes regardless of the method used for computing actual taxes. Midwestern Gas Transmission Co., 36*
>
> *When the House and Senate considered tax reform legislation in 1969, both were concerned with the loss of tax revenues that stemmed from the combined effect of accelerated depreciation for computing federal taxes (leading to higher deductions) and flow-through for fixing rates (leading to lower rates and thus lower gross revenues). [Footnote 3] Section 441 of the Tax Reform Act, which added § 167(l) to the Internal Revenue Code, was designed in general to "freeze" existing depreciation practices.*

Debate regarding the recognition of accelerated depreciation in the regulated tax allowance has centred on who should be the beneficiary of the tax incentive (e.g. the ability to accelerate depreciation). On one hand, arguments can be made that the origins of policy intention relating to accelerated depreciation methods often relate to the incentivising of businesses to invest in capital infrastructure (and therefore benefit the wider economy) through greater tax write offs.[36] This has often been referred to in the United States as an “interest free loan” from the government to the taxpayer by way of deferral of tax liabilities.[37] In the event this tax benefit is immediately passed through to consumers through adjustment to the tax allowance, the incentive for capital expansion may be reduced. On the other hand, the retention of that benefit can be seen as inconsistent with the broader ratemaking principles

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[35] United States of America Federal Energy Regulatory Commission, Order Instituting Section 206 Proceedings, Commencing Paper Hearing Procedures, and Establishing Refund Effective Date, 163 FERC ¶ 61,200 (June 21, 2018).

[36] Deloitte, 2014, *Determining whether a utility's ratemaking treatment of an NOL carry forward complies with the normalization requirements* ; Brazell, Dworin and Walsh, May 1989, *A History of Federal Tax Depreciation Policy*, Depreciation Analysis Staff Office of Tax Analysis, OTA Paper 64; Ronald Reagan, White House Report on the Program for Economic Recovery, 18 February 1981.

[37] See for example, Public Utility Commission of Oregon Staff, February 2005, *Treatment of Income Taxes in Utility* Ratemaking, A White Paper Prepared for the Oregon Legislative Assembly; *Deferred Taxes in Utility Rate-Making,* ‘Cincinnati Gas & Electric Co. v. Public Utilities Commission of Ohio 173 Ohio St 473, 184 N.E.2d 84 (1962), Ohio State Law Journal [vol. 24 1963] 218.

that the utility provider should be limited to fair and reasonable return on equity after recovering expenses.

Under FERC requirements, the difference between the straight line method of depreciation included in the regulatory allowance and any acceleration of depreciation applied by the regulated entity for actual tax purposes is recognised through the maintenance of an Accumulated Deferred Income Taxes (**ADIT**) account.[38] In accordance with generally accepted accounting principles, the maintenance of a deferred tax account will give rise to a deferred tax expense which must be considered in addressing the recoverable expenses.

Arguments have been made that the inclusion of deferred tax expenses / benefits in the tax allowance will result in the "smoothing" of the tax effect[39] of the relevant capital expenditure such that consumers will not be subject to fluctuations in prices, or lead to inter-generational pricing issues whereby relative tax expenses increase in the later years of an asset's effective life as depreciation deductions are more limited. On the other hand, and as referred to in the Supreme Court judgement above, practice in the United States has indicated that due to increasing expenditure profiles, the acceleration can often take the form of a more permanent tax saving rather than a timing difference.

This debate was settled by FERC through a number of determinations and subsequent publishing of FERC Order 144 in May 1981 in which it ordered:

> *"a public utility making a rate filing under the Federal Power Act or an interstate pipeline making a rate filing under the Natural Gas Act to use tax normalization for miscellaneous timing differences to compute the income tax component of its cost of service."*
>
> *"[t]he rule also codifies the existing Commission practice of adjusting rate base for accumulated deferred income taxes" to require "the applicant to apply tax normalization for all 'miscellaneous' timing differences" and include related ADIT in the adjustment to rate base.*

In accordance with this order, while normalisation requires the recognition of an ADIT account to reflect the deferred tax expense associated with acceleration depreciation, this ADIT balance is then applied to reduce to the rate base applied and pass the benefit of the accelerated deduction on to consumers.

The normalisation requirements within the FERC rules are further complicated by the requirement for the applications to seek to eliminate any excesses or deficiencies in the ADIT over time to reach full normalisation.[40] In addition, there may be instances where it is not deemed appropriate to include certain items in ADIT balances (e.g. tax losses in certain circumstances) which can lead to rate adjustments on a case by case basis.

3.4.3 United States – returns to flow through entities

Consistent with the investment management framework in Australia and many other sophisticated countries around the world, the United States facilitates investments in utility assets via the use of flow through (or tax transparent) entities. This requires consideration of tax paid at the investor level rather than the business level.

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[38] Federal Energy Regulatory Commission, To All Jurisdictional Public Utilities, Licences, and Natural Gas Companies *'Subject: Accounting for Income Taxes'* (April 23, 1993).

[39] Scott Madden Management Consultants, May 2016, Primer on Bonus Depreciation: *Making the Most of the Bonus Depreciation Extension*.

[40] The National Archives of the United States, *Regulations Implementing Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes*, Order No. 144, 18 CFR Part 2, Federal Register 5-14-81 Vol.46 No.93, ¶ 26613; State of New York Public Service Commission, 26 June 2018, *Proceedings on Motion of the Commission on Changes in law that May Affect Rates*, Case 17-M-0815.

This issue appears to have been considered in detail by FERC, leading to the release of a policy statement regarding the tax allowance for flow through vehicles in May 2005.[41] In this statement, FERC considered the arguments for and against adjustment of the tax allowance in respect of flow through entities, and determined that a tax allowance should be provided to the business to the extent that the investors are expected to have a tax liability. Comments provided in this respect include:

> *31. The issue is under what circumstances, if any, an income tax allowance should be permitted on the public utility income earned by various public utilities regulated by the Commission. As stated earlier, while the court's decision in BP West Coast only addressed the particulars of a certain oil pipeline, the numerous comments submitted here indicate that partnerships or other pass-through entities are used pervasively in the gas pipeline and electric industries as well. Upon review of the comments, there appear to be four possible choices: (1) provide an income tax allowance only to corporations, but not partnerships; (2) give an income tax allowance to both corporations and partnerships; (3) permit an allowance for partnerships owned only by corporations; and (4) eliminate all income tax allowances and set rates based on a pre-tax rate of return.*
>
> *32. Given these options, the Commission concludes that it should return to its pre-Lakehead policy and* ***permit an income tax allowance for all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets****. Thus a taxpaying corporation, a partnership, a limited liability corporation, or other pass-through entity would be permitted an income tax allowance on the income imputed to the corporation, or to the partners or the members of pass-through entities, provided that the corporation or the partners or the members, have an actual or potential income tax liability on that public utility income. Given this important qualification, any pass-through entity seeking an income tax allowance in a specific rate proceeding* ***must establish that its partners or members have an actual or potential income tax obligation on the entity's public utility income****. To the extent that any of the partners or members do not have such an actual or potential income tax obligation, the amount of any income tax allowance will be reduced accordingly to reflect the weighted income tax liability of the entity's partners or members.*

This policy statement appears to have resulted historically in the requirement for flow through utilities to apply a "blended" tax rate in determining the tax allowance, taking into account the tax profile of each relevant partner. This creates a question as to how the return relating to the tax allowance is returned to the partners. Without any adjustment to the partnership distribution process, an issue would arise whereby the non-tax paying partners would benefit from the tax allowance attributable to the tax paying entities, and likewise, the taxpaying entities would receive less of the proportionate tax allowance than what has actually been paid. FERC acknowledges this issue will need to be dealt with through the relevant partnership agreement, stating:

> *The court was concerned that the income tax allowance granted for corporate partners would increase the cash available for distribution to all partners, thus providing an increased return to the individual partners that the Lakehead doctrine was intended to prevent.* ***Adjustments within the partnership agreement should assure that this does not result while preserving the incentives to establish flexible investment vehicles****.*

Accordingly, the historic system applied by FERC appears to have been to apply a blended rate based on specifically reported tax profiles, and then require the partners to re-allocate the appropriate distributions using the mechanics of their partnership agreements. Given that our scope has been limited to a high level analysis, we are not aware of how this has been

[41] United States of America Federal Energy Regulatory Commission, Inquiry regarding Income Tax Allowances, Policy Statement on Income Tax Allowances, 111 FERC ¶ 61,139 (May 4, 2005).

implemented in practice, and also note that the regulatory approach in relation to distribution providers may differ on a state by state basis due under the powers of the various public service commissions.

This issue has recently generated further attention in the United States, resulting in FERC releasing a proposed revised Statement of Policy[42] in March 2018 which would deny any tax allowance to certain flow through vehicles known as Master Limited Partnerships (**MLP**). The Commission issued this proposed policy following a United States Court of Appeals decision whereby it was determined that a service provider was unable to demonstrate that it was not receiving a double recovery of income tax costs, where it received both a tax allowance and a return on equity based on specific discounted cash flow methodology.

The reasoning provided by FERC in this instance was as follows: [43]

> *As the Commission explains in the Remand Order, a double recovery results from granting an MLP an income tax allowance and a DCF ROE:*
>
> - *MLPs and similar pass-through entities do not incur income taxes at the entity level. Instead, the partners are individually responsible for paying taxes on their allocated share of the partnership's taxable income.*
> - *The DCF methodology estimates the returns a regulated entity must provide to investors in order to attract capital.*
> - *To attract capital, entities in the market must provide investors a pre-tax return, i.e., a return that covers investor-level taxes and leaves sufficient remaining income to earn investors' required after-tax return. In other words, because investors must pay taxes from any earnings received from the partnership, the DCF return must be sufficient both to cover the investor's tax costs and to provide the investor a sufficient after-tax ROE.*
> - *The DCF methodology "determines the pre-tax investor return required to attract investment."*
>
> *Given that the DCF return is a "pre-tax return," permitting an MLP to recover both an income tax allowance and a DCF ROE leads to a double recovery of the MLP's income tax costs.*

On this basis, FERC has proposed an order whereby MLPs will receive no tax allowance. The proposed Policy Statement notes that other types of flow through vehicles will be considered at a later point.

Following lobbying from the industry, FERC has since softened its position in an Order released in July 2018[44] which states that a tax allowance will be provided to an MLP in respect of any returns which flow to corporate partners where tax will be paid on receipt of that return by the corporate partner. The Order also confirms that to the extent a business has accumulated a deferred tax reserve which has not been passed to consumers through a rate reduction, the business would be able to retain that deferred tax reserve.

3.4.4 United States – approach to tax consolidation

The United States implements a similar tax consolidation regime to Australia, whereby tax attributes relating different members of the same corporate group can be offset against each other to determine a consolidated income tax position. Similar to the current review, this has previously raised questions regarding the appropriateness of the regulatory model as actual

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[42] United States of America Federal Energy Regulatory Commission, Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs, 162 FERC ¶ 61,227, (March 15, 2018).

[43] United States of America Federal Energy Regulatory Commission, Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs, 162 FERC ¶ 61,227, (March 15, 2018).

[44] United States of America Federal Energy Regulatory Commission, Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs, Order on Rehearing, 164 FERC ¶ 61,030, (July 18, 2018).

tax liabilities may differ from estimated stand-alone tax positions, due to the mechanics of the tax consolidation regime.

The appropriate approach to assess the tax allowance of entities within a tax consolidated group was considered in the United States by FERC in *Columbia Gulf Transmission Company, Opinion No. 173*: *Opinion and Order Establishing Proper Cost of Service Treatment of Tax Liability Arising from the Filing of a Consolidated Tax Return,* 23 FERC ¶61,396 (22 June 1983).

FERC considered three approaches: the "stand-alone method" which takes into account the stand-alone position of the entity within the tax consolidated group and analyses each of the deductions used to reduce the group's tax liability to determine the deductions for which each company is responsible; the "separate return policy" which ignores the consolidated tax return and assumes that the tax allowance should be equal to the tax each member company would pay if it filed a separate tax return; and a third approach which starts with each member company's pro-rata share of consolidated tax liability and ignores each member company's individual income and deductions.

FERC endorsed the "stand-alone method" and relevantly referred to the earlier decision *Florida Gas Transmission Company, Opinion No. 611, 47 FPC 341, 363 (1972)* in which FERC concluded:

> *"that a pipeline's tax allowance should not be based on the "activities of others in the affiliated group" but instead, like other costs, should be based on the activities of the pipeline itself. Thus, Commission rejected methods of determining the tax allowance by allocating a pro rata share of the consolidated tax liability and then adjusting that amount by excluding the losses of certain affiliates. In place of these methods the Commission installed the stand-alone method which determines the tax allowance on the basis of the pipeline's own revenue and expenses."*

In *Columbia Gulf*, FERC agreed with the decision in *Florida Gas* on the basis the stand-alone method is consistent with the principles used to allocate other costs and produces a tax allowance which is cost-based. It was concluded that the stand-alone method was the administratively proper method to adopt, as although it was not the only method that could be adopted to resolve the problems posed by diversification, it was viewed as less time-consuming and administratively burdensome.

3.4.5 United Kingdom – approach to notional interest expense

The United Kingdom applies a similar benchmark efficient entity incentive based approach to regulation of electricity and gas providers as Australia, as administered by Office of Gas and Electricity Markets (**OFGEM**).

Largely, the estimates of the tax allowance appear to be based on a similar benchmark efficient entity process having regard to the various elements of tax expense, in line with the existing Australian model. Relevantly however, a specific claw back mechanism is included in the framework where the actual debt gearing or interest costs of a regulated business exceeds the notional gearing or interest costs modelled at the relevant price control (notional / benchmark level of 65%). When both of these conditions are satisfied, the OFGEM will clawback the tax benefit which results from the difference between actual and modelled (notional) interest costs in a year, through updating the tax liability of that business. It should be noted that there is no provision to give additional tax allowances to the licensee if it chooses to operate at a level of gearing lower than the modelled one.

The relevance of this approach will be considered further in the Addendum to our Report which considers the impact of financing deductions on the forecast cost of tax for regulatory purposes.

3.5 Regulatory activity

3.5.1 Global shift in tax policy and administration

To understand the scope and purpose of current ATO regulatory activity, it is important to appreciate the context of the significant changes in global tax policy and administration that have developed since 2012.

From June 2012, when the G20 met for their annual summit in Los Cabos and launched the Base Erosion and Profit Shifting (**BEPS**) project,[45] there has been a significant shift the approach to tax policy and administration which has been embodied by the BEPS project.

The focus of the BEPS project undertaken by the OECD, as evidenced by the executive summary in the initial BEPS report was released in February 2013 was, and is, as follows (at page 5):

> *While there is a clear tax compliance aspect, as shown by a number of high profile cases, there is a more fundamental policy issue: the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment…*
>
> …
>
> *The interaction of domestic tax systems (including rules adopted in accordance with international standards to relieve double taxation), however, can also lead to tax gaps that provide opportunities to eliminate or significantly reduce taxation on income in a manner that is inconsistent with the policy objectives of such domestic tax rules and international standards.*

A number of tax administrations, including the ATO in Australia, have echoed the concerns framed in the BEPS project in the context of the ramifications of falling corporate tax receipts, particularly given the reliance by the Australian government on corporate income tax as a source of consolidated revenue.[46]

The BEPS project focused on 15 action items that, broadly, canvassed the potential compliance and policy options to reduce or eliminate profit shifting. Australia has moved to adopt or implement a number of the BEPS action items following the release of the final OECD report in October 2015.[47] The implementation of the BEPS action items in Australia can be categorised, with relevant examples, as follows:

Type of action	Sub-type	Example
Multilateral	Policy	Australia ratified the Multilateral Instrument (**MLI**) which resulted in the automatic modification of Australia's double tax treaties with other countries that have ratified the MLI.
Multilateral	Compliance	Implementation of *The Multilateral Convention on Mutual Administrative Assistance in Tax Matters*[48]

[45] See also OECD paper released February 2013; *Addressing Base Erosion and Profit Shifting* available at: https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1.

[46] See https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/General-statistics/Australia-in-the-global-economy/?page=2.

[47] See https://www.ato.gov.au/business/international-tax-for-business/in-detail/base-erosion-and-profit-shifting/.

[48] https://read.oecd-ilibrary.org/taxation/the-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters_9789264115606-en#page10.

Type of action	Sub-type	Example
		which provides for mutual assistance between tax administrations in different jurisdictions.
Unilateral	Policy	Introduction of legislative measures to address BEPS related issues, for example the Diverted Profits Tax.[49]
Unilateral	Compliance	Programs to ensure that the ATO can be confident that taxpayers in Australia are paying the correct amount of tax.[50]

3.5.2 Recent approach to administration by the ATO

In the context of multilateral and unilateral actions to address changes in tax policy and administration, the ATO has taken action to ensure that the appropriate amount of tax is being paid by large and key taxpayers in Australia.

This more proactive approach adopted in recent times is in contrast with the historic compliance approach adopted by ATO. For example, the ATO approach to tax compliance for large business can be summarised as follows:

- The risks that taxpayers posed to tax collection were rated using a risk differentiation framework;
- Higher risk or key taxpayers were subject to significant levels of compliance action and lower risk taxpayers were, broadly, not subject to significant compliance action; and
- Compliance action was generally focused on specific issues.

More recently, in an effort to address the questions as to whether taxpayers are paying the correct amount of tax, the ATO has adopted a "Justified Trust" approach to compliance activity. The ATO is now seeking evidence based positive assurance that taxpayers have paid the right amount of tax rather than assuming that taxpayers are being honest. This approach is being implemented using compliance products such as the Top 1,000 Tax Performance Program.

As an example of the focus of Justified Trust programs, below are the key pillars that the ATO are focusing on under the Top 1,000 Tax Performance Program:

- that appropriate tax risk and governance frameworks exist and are applied in practice;
- that none of the specific tax risks that the ATO have identified and communicated to the market are present;
- the tax outcomes of atypical, new or large transactions are appropriate; and

[49] https://www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected.

[50] For example, see https://www.ato.gov.au/business/large-business/justified-trust/.

- any misalignment between tax and accounting results is explainable and appropriate and the right amount of tax on profit from Australia-linked business is being recognised in Australia.[51]

Using the above as an example, the current compliance approach by the ATO may be viewed in some ways as a shift back towards a full assessment regime, being a system where the administrator undertakes some level of risk-based review of positions adopted by the taxpayer contemporaneously with (or soon after) lodgement of the tax return. This is in contrast to the current legislative regime of self-assessment, being a system where the position adopted by a taxpayer is accepted by the administrator but subject to limited period of review and amendment.

Relevantly for NSPs, the ATO has also formed a specialist infrastructure team which is focused on considering issues relevant to infrastructure projects. The team has taken an active role in privatisation transactions since 2015, including providing input into the Foreign Investment Review Board review process for foreign acquirers of privatised assets. The specialist team has also been active in reviewing the tax positions of taxpayers in the infrastructure industry, which is reflected in the ATO compliance and assurance activity to which the NSPs have been subject – see section 3.5.

3.5.3 Nature of the self-assessment system and amendment periods

Tax legislation is complex, constantly changing and subject to differing interpretations. As a result of these factors, administrators and taxpayers may form differing views in relation to the appropriate interpretation of legislative provisions and judicial decisions.

This environment of potentially divergent interpretation broadly creates two different types of outcomes, being:

- Judicial clarification - where legal issues are opined on by Courts that results in a change in the administration of legislative provisions. A recent example of this was the *Chevron* decisions[52] that clarified the application of transfer pricing provisions in Australian tax legislation. This has also resulted in the ATO adopting a modified approach to compliance with related party loan arrangements;[53] and

- Settlement of potential disputes - resolution of matters between taxpayers and administrators on a "without admission" basis. For example, a number of potential disputes that would ordinarily require litigation to resolve are settled to provide certainty to both taxpayers and the administrator.[54]

In this context, in any group of taxpayers, it is axiomatic that there will be areas of contention between administrators and taxpayers in relation to the interpretation of legislation. This is particularly relevant where judicial clarification results in the requirement that historical positions adopted by taxpayers need to be amended to ensure that these positions are compliant with the law.

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[51] See https://www.ato.gov.au/Business/Large-business/Top-1,000-Tax-Performance-Program/

[52] See; *Chevron Australia Holdings Pty Ltd (No.4) v Commissioner of Taxation* [2015] FCA 1092, and *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation*[2017] FCAFC 62

[53] See PCG 2017/4; *ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions* available at https://www.ato.gov.au/law/view/document?DocID=COG/PCG20174/NAT/ATO/00001

[54] See https://www.ato.gov.au/General/Tax-and-Corporate-Australia/In-detail/Managing-disputes-with-large-corporate-groups/

This interaction between taxpayers and the ATO is conducted in the context of the self-assessment system, where taxpayers adopt positions that the ATO and taxpayers subsequently have the opportunity to review and amend within limited amendment periods.

For additional context, a self-assessment tax system is built on the following premises:

- The administrator does not have the resources to ensure that every taxpayer is reporting and remitting the correct amount of income tax;
- Taxpayers have access to intermediaries that provide advice on the operation of tax law and can assist with compliance requirements, such as lodgement of returns;
- Statements made by taxpayers to the administrator are accepted on face value and subsequently form the basis of the assessment of tax;[55] and
- The administrator has a limited period of review to, if required, confirm that the statements made by taxpayers are, in fact, correct.[56]

A self-assessment system encourages taxpayers to behave in a way that avoids further compliance action by the administrator as, if the statements made to the administrator are correct, there should be limited risk of a further compliance burden as a result of a review or audit.

This type of system also provides taxpayers and administrators with comfort that there is an opportunity to amend previous positions adopted in the event that the law is clarified through a Court decision or the factual circumstances of a taxpayer having not been accurately recorded. Further integrity is provided through certain types of issues that have either unlimited or lengthy amendment periods, such as adjustments in relation to transfer pricing.

A self-assessment system also reflects the reality of tax calculation in that at any given point in time, the actual amount of tax being collected from a taxpayer does not accurately reflect the overall tax attributes of the taxpayer. For example, a taxpayer involved in a project that spans multiple years and that ultimately results in a loss may return taxable income in the earlier years of the project that would need to be refunded once the entire economic reality of the project becomes clear.

An example where this may result in an acutely anomalous outcome is where judicial clarification results in adjustments to tax positions that have a significant legacy. Using the result of the *Chevron* decisions as an example where there was no amendment period limitation for transfer pricing adjustments, amendments that relate to a number of years ultimately modify the tax profile of a taxpayer. In this situation, the actual tax paid by a taxpayer cannot be accurately determined using a single year of assessment.

The example provided above may create further uncertainty where there is a change in ownership of a taxpayer, which may result in the economic benefit of a legacy position being wholly attributable to a former owner with the economic detriment being borne only by the new owner. It is in this scenario that the issues associated with measuring tax performance on a yearly tax paid basis become particularly evident.

[55] See, for example, section 169A of the ITAA 1936.

[56] See section 170 of the ITAA 1936.

3.5.4 Application to NSPs

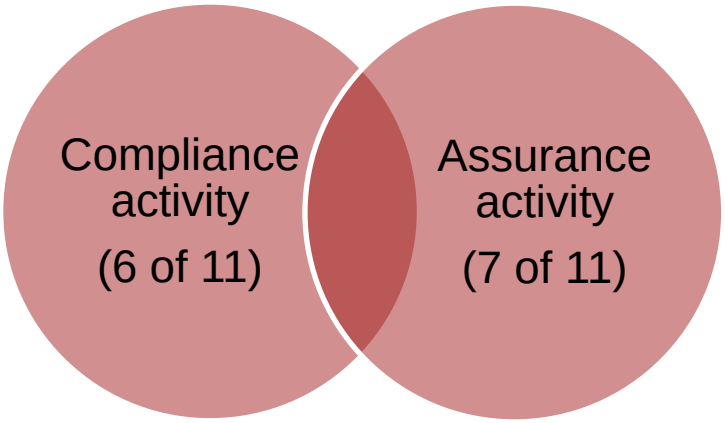
The operation of the self-assessment system and regulatory background outlined above is reflected in the population of NSPs that are the subject of this report.

Of the NSPs that responded to the request for the voluntary provision of tax information, 100% of respondents reported as being subject to some form of ATO review during the preceding five years.

The form of the ATO review undertaken can be classified into the following two categories:

- Compliance activity, such as audits or reviews of specific issues or general reviews of lodged returns; and
- Assurance activity, either initiated by the ATO or an NSP, such as requests for private binding rulings, entering into tax deeds, pre-lodgement compliance reviews and/or justified trust reviews.

There was also some overlap in activity conducted by the ATO where a number of the NSPs that responded were subject to both compliance and assurance activity during the five year period. This is demonstrated by the diagram below.



It is noted that the Martin Lally Report recommends against "capping" on the basis that it implicitly and wrongly attributes all tax shortfalls to tax minimisation behaviour. The Martin Lally Report also recommends against targeting tax minimisation activities as this would replicate the efforts of the ATO. ATO activity around the NSPs would tend to suggest any areas of technical uncertainty associated with the positions adopted by the NSPs are already being reviewed and addressed by the ATO such that there should be limited or minimal tax shortfall attributable to such matters.

3.6 Other considerations

3.6.1 Privatisations and M&A Activity

Privatisations and M&A activity may result in:

- uplifts in the depreciable asset base for tax purposes;
- the application of the tax consolidation regime which allows the sharing of tax attributes; and
- significant stamp duty costs (refer discussion below).

We note that the current regulatory approach to determining tax allowance does not take into account stamp duty paid by NSPs or the upstream investors.

As we have not received responses to the formal RINs, we are not currently able to quantify the impact of stamp duty on the tax differential. Our general observations are set out below.

Stamp duty payments typically arise as a consequence of transactions with third parties. Stamp duty paid by the NSPs in respect of the acquisition of assets as a consequence of third party transactions (like other costs associated with M&A activities) is typically not included in the RAB and therefore is not recoverable from consumers. In our view, any tax deductions arising from stamp duty (and indeed other M&A costs such as advisor costs) which have given rise to a difference between actual tax paid and the tax allowance is appropriate. In this regard, the stamp duty is no different than any other unregulated expenditure or inefficient cost that is not considered within the regulated ring-fence and appropriately excluded from the calculation of the tax allowance.

We set out below a high level overview of the tax treatment of stamp duty costs associated with acquisitions.

Acquisition of Assets

The transfer of dutiable assets (including chattels, business assets, business identities or licences, intellectual property, third party contracts and rights in respect of dutiable property) is prima facie subject to stamp duty in most States and Territories, albeit with some variations. The rate of stamp duty applied to dutiable transactions also varies between the different States and Territories.

Where stamp duty is paid on the acquisition of assets, it is normally allocated across the assets acquired for tax purposes and is part of the cost base of acquiring those assets. Where the asset is depreciable, the stamp duty should be deductible over the effective life of the asset (as with other costs incurred in acquiring those assets). If the stamp duty is not included in the RAB and therefore not recoverable from consumers, it should be excluded from the TAB, consistent with other expenditure outside the regulated ring-fence.

The difference in the treatment of stamp duty gives rise to a difference in the costs included in the TFAR as compared with the TAB. However, it is our view that this difference is an appropriate outcome and therefore does not require any change to be made to the tax allowance determination.

For completeness, it is noted that where the asset is not depreciable, stamp duty costs would typically form a part of the cost base of a capital gains asset and be taken into account in determining whether a capital gain or capital loss arises on the disposal of that asset.

Acquisition of equity interests

Stamp duty can also be payable on the acquisition of equity interests in a landholding entity (e.g. a company or trust) where certain thresholds (typically $2 million or less) are met in

relation to the unencumbered value of the underlying land interests held by the entity at the date of acquisition.

If the stamp duty is included in the cost base of shares in an entity that is consolidated, the stamp duty costs would be part of the Allocable Cost Amount calculation and used to reset the cost base of the underlying assets of the company, including any depreciable assets. However for privatised assets, Division 58 may apply to cap the cost depending on the circumstances.[57]

Long term leases

Recently, the privatisation of assets (including the New South Wales electricity distribution and transmission assets) has been undertaken by the grant of a long term lease over the assets by the State to the successful bidder in consideration for an upfront lease premium payment. The grant of a long term lease over such assets is typically subject to stamp duty on any lease premium paid (on a GST inclusive basis) in respect of the grant of the lease. Stamp duty paid in respect of a lease is deductible for income tax purposes pursuant to section 25-20 of the ITAA 1997.

Therefore, for recent NSP privatisations that have been structured as a long term lease, it is likely that the stamp duty costs resulted in substantial income tax deductions for the entity that paid the lease premium. It is expected that such deductions would give rise to carried forward tax losses in the initial years after the privatisation, which would then be available to shelter taxable income from regulated business activities.

In our view such costs should not be taken into account for the purposes of estimating the tax allowance for regulatory purposes. Any difference between actual tax paid and the estimated cost of tax relating to such costs is justifiable. It is our view that this is an appropriate outcome and consistent with the broader regulatory framework as the stamp duty costs are effectively borne at sole risk by the buyer and are not recovered from consumers.

3.6.2 R&D tax incentives

Overview

Division 355 of the ITAA 1997 and the *Industry Research and Development Act* 1986 (Cth) (**IR&D Act**) were amended in 2011 to allow a broader range of entities to access the R&D tax incentive in Australia.

The entities that can access the R&D tax incentive (**R&D Entity**) are restricted to:

- A body corporate that is tax resident of Australia;
- A body corporate that is not a tax resident of Australia but carries on business through a permanent establishment in Australia; and
- Entities that are not specifically excluded from being an R&D entity. [58]

To access the R&D tax incentive, an R&D Entity must register its eligible R&D activities pursuant to the IR&D Act. Once the activities are registered, the R&D Entity may elect to

[57] Section 705-47 of the ITAA 1997.

[58] Section 355-35 of the ITAA 1997.

claim eligible expenditure on those activities as a tax offset. If the R&D Entity elects to claim the tax offset, the eligible expenditure cannot be claimed as a deduction.[59]

Broadly, the level of tax offset available to an R&D Entity is determined by the turnover of the R&D Entity and the quantum of expenditure claimed. The table below outlines the tax offset available to different R&D Entities:

Turnover	Offset available	Expenditure limit
Income years ending 30 June 2012 to 30 June 2016		
Less than $20 million	45% refundable offset	None
More than $20 million	40% non-refundable carry forward offset	$100 million
Income years ending 30 June 2017 to 30 June 2018		
Less than $20 million	43.5% refundable offset	None
More than $20 million	38.5% non-refundable carry forward offset	$100 million

To demonstrate the effect of the R&D tax incentive for an R&D Entity with turnover greater than $20 million, the following simple calculation shows the tax reflex of electing to claim the tax offset as opposed to merely deducting the expenditure.

2016 income year	R&D	No R&D
Income	30,000,000	30,000,000
Expenses	20,000,000	20,000,000
Profit / (Loss)	10,000,000	10,000,000
Total add items	2,500,000[60]	500,000
Total subtract items	500,000	500,000
R&D expenditure	2,000,000	-
R&D offset at 40%	800,000	-
Taxable Income	12,000,000	10,000,000
Tax payable[61] / franking credits available	2,800,000	3,000,000

As demonstrated by the table above, in the context of the dividend imputation system in Australia, the effective result of entities with turnover greater than $20 million claiming the R&D tax incentive is a timing difference in tax collection as there are less franking credits available to pay franked dividends to shareholders.

This result arises from the R&D tax offset reducing the tax payable by the R&D Entity which subsequently results in less franking credits being available to distribute to shareholders, but no change to the underlying profits of the R&D Entity.

Observations

The AER's existing tax allowance model does not take into account the impact of R&D tax incentives. In this regard, any R&D tax offsets that are available in respect of efficient

[59] Section 355-715 of the ITAA 1997.

[60] R&D expenditure that is claimed as an R&D offset in not deductible (see section 355-715 of the ITAA 1997) is added back to determine taxable income.

[61] This is calculated as profit plus net add / subtract items less R&D offset.

expenditure included in the RAB will result in a difference between actual tax paid and the amount calculated under the tax allowance.

An NSP that is owned by a flow through entity (i.e. partnership or trust) will not entitled to claim R&D deductions because the entity will not qualify as a R&D entity. This is regardless of the fact that the flow through vehicle may ultimately be owned by corporate entities. In practice, only corporate entities subject to the corporate tax rate are entitled to register and therefore claim R&D tax incentives. Accordingly, the R&D tax incentive should only be a potential driver of any tax differential for 64.7% of the NSPs (11 of 17).

We have reviewed the FY17 income tax returns provided by the NSPs including the R&D schedule where provided. Of the 17 NSPs in total, four of the NSPs did not provide tax returns (albeit one of these was explainable and had valid reasons).

Of the remaining 13 NSPs that did provide tax return data for FY17 only nine NSPs were eligible to be registered as an R&D entity and therefore claim R&D tax incentives. Of the potential nine NSPs who were eligible to register as an R&D entity and provided income tax returns, only two actually claimed R&D tax incentives based on the tax return information reviewed. The aggregate R&D tax offset claimed by the two entities for FY17 was immaterial. The tax returns do not provide sufficient detail to delineate whether these R&D activities related to regulated or unregulated activities.

We note for completeness that tax return amendments are often made to claim R&D tax incentives as the R&D work to substantiate the claim may not be complete by the time the tax return is due to be lodged. Therefore, it is possible that the other NSPs entitled to register as R&D entities may have made an R&D claim, but we are not able to confirm this.

Based on the above, in our view it is unlikely that any R&D tax offsets have resulted in a material discrepancy between actual tax paid and the estimated cost of taxation for regulatory purposes.

Further, we consider that any discrepancy that arises because of R&D tax offsets is an appropriate outcome whether the R&D expenditure is not recoverable. This is because where the R&D tax offset relates to unregulated activities or amounts not included in the RAB (because it did not meet the efficiency criteria), the expenditure is at the sole risk of the NSP and not recoverable from customers. The exclusion of the R&D expenditure from the determination of tax allowance is consistent with the treatment of Capex that is not included in the RAB – that is, the expenditure is not taken into account in the depreciation deduction for the purposes of determining the tax allowance because it is not within the regulated ring-fence.

Changes to the R&D tax incentive

For completeness, it is noted that the 2018 budget announced changes to the R&D tax incentive to:

- improve the integrity of the R&D tax incentive by ensuring that ineligible claims are denied;
- continue to provide support to smaller companies that undertake R&D activities; and
- refocus the support for larger companies towards those undertaking R&D activities that is at an intensity level that is high compared to the overall activity of the company.

Relevantly, larger companies will now be subject to progressive access to different levels of the incentive, as illustrated by the following example:

> *A company with a 30 per cent tax rate that has $120 million of R&D expenditure for the year and $300 million of total expenditure will have an overall R&D intensity of 40 per cent. It claims R&D tax offsets at a rate of 34 per cent for the first $6 million of R&D expenditure,*

36.5 per cent for the next $9 million of R&D expenditure, 39 per cent for the next $15 million of R&D expenditure and 42.5 per cent for the final $90 million of its R&D expenditure. It also benefits from the increased $150 million R&D expenditure threshold as it can claim concessional R&D tax offsets for its R&D expenditure that exceeds $100 million, rather than claiming these offsets at the company tax rate.[62]

[62] This example is taken from https://www.budget.gov.au/2018-19/content/factsheets/6-tax-integrity.html

Appendices

Appendix A Glossary

Abbreviation	Term
ADIT	Accumulated Deferred Income Taxes
AER	Australian Energy Regulator
AER Initial Report	Initial report released by the AER on 28 June 2018 entitled "review of regulatory tax approach"[63]
AER Issues Paper	Issues Paper released by AER on 15 May 2018 which provided an overview to the current regulatory tax approach and summarised the findings from the ATO Note
ATO	Australian Tax Office
ATO Infrastructure Cell	Specialist infrastructure team formed by the ATO
ATO Note	Note issued by the ATO to the AER dated 10 April 2018 with the subject "Indicative comparative analysis of the AER electricity distribution tax allowance and tax payable"
BEPS	Base Erosion and Profit Shifting
Capex	Capital expenditure
CCIV	Corporate Collective Investment Vehicle
COT	Continuity of Ownership
CUTs	Corporate unit trusts
DPT	Diverted profits tax
DV	Diminishing value
Energy networks	Electricity networks and gas pipelines regulated by the AER
FERC	Federal Energy Regulatory Commission
Gamma	Assumed benefit which will be received by shareholders following distribution of franking credits to those investors
IR&D Act	*Industry Research and Development Act 1986* (Cth)
ITAA 1936	*Income Tax Assessment Act 1936* (Cth)
ITAA 1997	*Income Tax Assessment Act 1997* (Cth)
Martin Lally Report	Expert report by Dr Martin Lally, Capital Financial Consultants Ltd "*Tax Payments versus the AER's*

[63] The Martin Lally Report and the McGrathNicol Report are available online at www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018/consultation

Abbreviation	Term
	Allowances for Regulated Businesses" dated 16 June 2018[64]
McGrathNicol Report	Expert report by McGrathNicol "*Implications of ownership structures on tax paid by regulated entities*" dated 26 June 2018, on how the various corporate ownership structures of the gas and electricity businesses that the AER regulates may impact on the actual tax paid by the regulated entities
M&A	Mergers and acquisitions
MIS	Managed Investment Scheme
MIT	Managed Investment Trust
MLI	Multilateral Instrument
MLP	Master Limited Partnerships
NER	National Electricity Rules
NGR	National Gas Rules
NOL	Net operating losses
NSPs	Network Service Providers
NTER	National Tax Equivalent Regime
NWDV	Notional written-down value
OFGEM	Office of Gas and Electricity Markets
Order of Services	Our order of services with a commencement date of 9 July 2018
PTTs	Public trading trusts
R&D	Research and Development
R&D Entity	Entity that can access the R&D tax incentive
RAB	Regulated Asset Base
Report	This report by Vaughan Lindfield and Michael Davidson
RIN	Regulatory information notice
SBT	Similar Business Test
SGEs	Significant global entities
State Owned Enterprises	Corporate vehicles established under State law which hold assets owned by the public sector
TAB	Tax Asset Base
TFARs	Tax fixed asset registers

[64] The Martin Lally Report and the McGrathNicol Report are available online at www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-regulatory-tax-approach-2018/consultation.

Appendix B
Curricula Vitae

Vaughan Lindfield

Partner (Perth)

Infrastructure and Urban Renewal, Financial Advisory - Tax

Vaughan has over 25 years of tax advisory experience and will Co-Lead the Engagement on this Project. Vaughan is a partner in the firm's Taxation Services practice, providing corporate taxation advice across a range of industries but specialising in infrastructure. Vaughan spent five years in Sydney as part of the management team of Alinta Energy Limited before returning to Perth as a corporate tax partner specialising in infrastructure and private equity in 2011. Vaughan brings significant commercial experience with respect to large infrastructure projects including M&A and has also prepared several expert reports relating to the determination of tax for regulatory purposes.

Relevant experience

- Vaughan prepared expert witness statements' for Western Power Corporation (WPC) with respect to determining their post-tax WACC for regulatory pricing purposes in respect of their transmission and distribution businesses. Vaughan's work resulted in an increase in WPC's tariff of $98 million (NPV).
- Vaughan prepared expert witness statements' for ATCO Gas (ATCO) with respect to determining the post-tax WACC for regulatory pricing purposes in respect of ATCO's gas transmission and distribution business including supplementary addendums in response to AER's interim findings.
- ATCO - Vaughan provided various advice to ATCO in relation to the ongoing tax matters associated with owning its gas transmission and distribution business.
- Vaughan was the tax lead advisor to the WA Treasury in assisting it develop its asset sales pipeline. In this role Vaughan provided detailed tax advice on the various privatisation scenarios including preferred structures having regard to likely investor bid structures for assets including Western Power, Horizon Power, Fremantle Port, Utah Port and Water Corporation.
- WA Treasury – Vaughan was appointed as the tax lead advisor by the WA State Government in relation to the Sale of Utah Point Bulk handling facility.
- WA Office of Energy – Vaughan provided advice in relation to the disaggregation of Western Power.
- WA Office of Public Utilities - Vaughan provided tax advice on the implications of the Verve/Synergy merger including selection of preferred vehicle.
- Vaughan acted for Chow Tai Fook on the AUD$4 billion acquisition of Alinta Energy providing tax diligence, and structuring services.
- Alinta Energy / Babcock and Brown - Vaughan acted for Babcock & Brown Power (now Alinta Energy) in relation to acquisition and separation of Alinta Limited by Babcock and Brown Infrastructure, Singapore Power and BBP.
- TransAlta – Vaughan advised TransAlta in relation to the privatisation of the South Hedland Power Station and associated assets by Horizon Power (WA regional

transmission and distribution business).

- TransAlta - Vaughan provided tax structuring and due diligence assistance to TransAlta in relation to the recent sale of IFM's PacHydro assets.
- Fortescue Metals Group (FMG) - Vaughan prepared a vendor due diligence report on behalf of FMG in relation to the disposal of the Solomon Power Station. Vaughan also advised FMG on the Fortescue River Gas pipeline JV with TransAlta.

Michael Davidson

Partner (Sydney)

Infrastructure and Urban Renewal, Financial Advisory - Tax

Mike is a tax adviser with Australian and international experience in the infrastructure, utilities, alternative assets and resources industries. He has worked in both Melbourne and Sydney practices. Prior to moving to Australia in 1990, Mike was the Divisional Tax Manager of a large publicly listed company in London.

Mike is experienced in advising the public and private sectors on issues such as corporate acquisitions and re-organisations and structuring transactions with domestic and foreign entities. He has worked on a range of infrastructure, utility and related industry projects in recent years both in Australia and overseas and has considerable experience in cross border transactions. Mike also meets at least twice a year with the tax groups of the main Canadian funds that invest into Australia.

Mike is also the Deputy Chairman of the Infrastructure Partnerships Australia tax committee.

Relevant experience

- Advised bidders in the South Australian, Qld and recent NSW electricity privatisation processes, including the establishment or funding of the relevant bid vehicles.
- Assisted with the sales process for NSW Ports.
- Advised owners or bidders for various road and air transportation projects, including via the unsolicited bid process.
- Various PPP/PFI projects including social and economic infrastructure (including advising international consortium members) on both the government and private sector sides.
- Has acted for the NSW Auditor General in reviewing the tax balances in the statutory accounts of State Owned Corporations in the utilities industry.
- Advised the State and Territory Governments on the tax impacts of the proposed National Emissions Trading Scheme and then the Carbon Pollution Reduction Scheme.
- Whilst in Melbourne, provided advice to the State Government on the application of their Tax Equivalence Regime (noting this predates the NTER).

Appendix C
Pro forma voluntary information request and RIN

Questions from the voluntary request for the provision of tax information to the AER

General information – entity structure

Please provide the following information to help us confirm our understanding of the broad structures of industry participants.

1. Provide a diagram illustrating the group holding structure of the NSP (and any related stapled entities), its downstream associated entities[65] and any upstream equity participants[66] as at 30 June 2018, or its most recent financial year end. For completeness, the group structure diagram should indicate:
    a. The nature of the vehicle (e.g. trust, company, partnership)
    b. Where entities are stapled (contractually or otherwise)
    c. The existence of partnership arrangements including any Limited Partnerships
    d. The jurisdiction in which the entity is a resident for tax purposes
    e. Entities which are members of a Australian tax consolidated group (where relevant)
    f. In the case of trusts the Trustee entity
    g. Whether the entity is classified a Managed Investment Trust
    h. Where the entity is government owned confirmation that it is subject to the National Tax Equivalent Regime
    i. The existence of a special purpose finance company
2. Confirm whether there have been any changes to the group structure since 30 June 2018.

General information – tax returns and ATO reviews

Please provide the following information to help us confirm our understanding of the tax profiles of industry participants.

[65] For the purpose of this request, "downstream associated entities" refers to "associates" of the NSP as that term is defined in section 318 of the *Income Tax Assessment Act 1936*, however only to the extent that the NSP has a direct or indirect control interest in that entity of greater than 10%.

[66] For the purpose of this request, "upstream equity participants" includes any entities which have a direct or indirect equity interest in the NSP of greater than 10%. This would include a total participation interest as defined in section 960-180 of the *Income Tax Assessment Act 1997*, but only to the extent that the participation interest is greater than 10%. Direct and indirect interests held by a foreign entity in the NSP only need to be disclosed to the extent the foreign entity has a direct interest in an Australian resident vehicle. For the avoidance of doubt, an equity interest for these purposes would also include a partner's interest in a partnership.

3. Provide a copy of any income tax returns lodged by the NSP, whether Federal or NTER, in the last 5 years (or period of existence if less than 5 years).

4. Where the NSP is a member of a tax consolidated group please provide tax calculations for the NSP on a stand-alone basis to the extent these calculations have already been prepared (e.g. these calculations already exist), which support the latest income tax return lodged by the Head Company of the tax consolidated group in the last 5 years (or period of existence if less than 5 years).

5. Where the NSP is part of a stapled entity arrangement please also provide the income tax returns lodged for the other stapled entity(s) that hold direct interests in the network asset (i.e. the Asset Trust/Partnership) in the last 5 years (or period of existence if less than 5 years).[67]

Please provide the following information to help us assess the impact of recent ATO activity and proposed legislative changes on the tax profile of industry participants

6. Provide a summary[68] of any non-routine engagement between the ATO and the NSP (and any related stapled entities i.e. Asset Trust/Partnership)[69], any of its downstream associated entities, or any of its upstream equity participants (to the extent relevant to the financing of or investment in the NSP (and any related stapled entities)) during the last five years, including identifying whether the following is applicable:
    a. Review (for example streamlined review, Pre-Lodgement Compliance Review, Annual Compliance Agreement Review)
    b. Audit including details of the issue under audit
    c. NTER Lodgement Visits
    d. Other engagements (for example, Advanced Pricing Arrangement, Tailored Compliance Engagement, Private Binding Ruling or Tailored Advice)

7. Where ATO has provided a formal clearance letter or position paper in respect of any of the engagements noted in question 6, please provide a copy of this.

8. Has the NSP (and any related stapled entities i.e. Asset Trust/Partnership), any of its downstream associated entities, or any of its upstream equity participants entered into a Tax Deed with the ATO?

    Yes ❑
    No ❑

Fixed asset registers and policies

Please provide the following information to assist us perform general analytical investigations into the tax capitalisation practices made within the industry (e.g. depreciation method adopted, effectives lives applied, asset categorisation).

9. Provide the tax fixed asset register which supports the capital allowance balances reported in the last lodged tax return for the NSP (and any related stapled entities that

[67] For clarification, we are not requesting tax return information for upstream stapled entities (e.g. holding trusts).

[68] Note, we are not asking for any actual correspondence with the regulatory authorities to be provided, but rather a summary of the relevant ATO compliance engagements, reviews and audit activity.

[69] If the NSP is a member of a tax consolidated group, please provide this information only to the extent it is relevant to the tax calculations of the NSP.

hold direct interests in the network assets, e.g. the Asset Trust/Partnership).[70] This should include, without limiting the information to be provided:

a. Description of asset;
b. Effective life of asset;
c. Depreciation method applied;
d. Depreciation claimed; and
e. Original cost, including a starting cost determined under Division 58.

To the extent this information is already broken down by regulated versus non-regulated assets, please provide the information only for the regulated assets.

10. Provide existing documented capitalisation policies of the NSP (and any related stapled entities that hold direct interests in the network assets, e.g. the Asset Trust/Partnership) for tax purposes which provides guidelines for distinguishing when expenditure should be classified as capital or immediate deductible on revenue account (e.g. repairs and maintenance) and the identification of functional assets.

11. Provide a summary which identifies the total quantum of expenditure which is included in the regulatory fixed asset register (e.g. the regulatory capex allowance), but has been treated as immediately deductible for income tax purposes (e.g. refurbishment), in respect of income tax returns lodged in the past five years.

Additional optional question

This question is intended to provide an opportunity for those NSPs who would like to comment on the potential impact of upcoming changes to the tax landscape, including possible legislative changes. It is strictly optional.

12. Please briefly describe the likely positive or negative impact on the tax profile of the NSP, its downstream associates or its upstream equity investors, of upcoming changes to the tax legislative framework. This may include consideration of:

f. the proposed legislative measures contained in the Draft Treasury Laws Amendment (Making sure foreign investors pay their fair share of tax and other Measures) Bill 2018
g. any transitional measure associated with the above legislation
h. the anti-hybrid mismatch legislation contained in the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018
i. the reform of the R&D tax incentive claim announced in the 2018/19 Federal Budget (and as outlined in the draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018)
j. any other proposed tax landscape changes.

[70] If the NSP is a member of a tax consolidated group, please provide the tax fixed asset register which includes the NSP's assets, which has been reflected in the income tax return disclosures for the Head Company of that tax consolidated group.

Questions from the Regulatory Information Notice under Division 4 of Part 3 of the National Electricity (State) Law (Electricity RIN)

GENERAL REQUIREMENTS

1. GROUP STRUCTURE

1.1 Provide a diagram illustrating the group holding structure of the *[distribution/transmission] network service provider*, including:

(a) any related stapled entities;

(b) its *downstream associated entities*[71]; and

(c) *upstream equity participants*[72] (using a 'best endeavours' basis[73])

as at 30 June 2018, or its most recent financial year[74] end.

For completeness the group structure diagram should indicate:

- The nature of the vehicle (e.g. trust, company, partnership)
- Where entities are stapled (contractually or otherwise)
- The existence of partnership arrangements including any *Limited Partnerships*
- The jurisdiction in which the entity is a resident for tax purposes
- Entities which are members of an Australian *tax consolidated group* (where relevant)
- In the case of trusts, the Trustee entity:
- Whether the entity is classified as a *Managed Investment Trust (MIT)*
- Where the entity is government owned, confirmation that it is subject to the *National Tax Equivalent Regime (NTER)*.

1.2 Confirm whether there have been any changes to the group structure since 30 June 2018 or its most recent financial year end.

2. FINANCING ARRANGEMENTS

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71 For the purpose of this *notice*, "*downstream associated entities*" refers to "associates" of the [*distribution/transmission*] *network service provider* as that term is defined in section 318 of the *Income Tax Assessment Act 1936*, however only to the extent that the [*distribution/transmission*] *network service provider* has a direct or indirect controlling interest in that entity of greater than 10 per cent.

72 For the purpose of this *notice*, "*upstream equity participants*" includes any entities which have a direct or indirect equity interest in the [*distribution/transmission*] *network service provider* of greater than 10 per cent. This would include a total participation interest as defined in section 960–180 of the *Income Tax Assessment Act 1997*, but only to the extent that the participation interest is greater than 10 per cent. Direct and indirect interests held by a foreign entity in the [*distribution/transmission*] *network service provider* only need to be disclosed to the extent the foreign entity has a direct interest in an Australian resident vehicle. For the avoidance of doubt, an equity interest for these purposes would also include a partner's interest in a partnership.

73 Appendix C includes instructions on the use of a 'best endeavours' basis when responding to this *notice*. Further, if best endeavours are used when responding to this item and it is not possible to identify the names of upstream investors, the response should describe the type of investors in terms relevant to the assessment of tax (e.g. domestic/foreign, super fund).

74 The reference to financial year end includes financial years ending on a different basis to 30 June (i.e. 31 December and 31 March).

2.1 Provide the *debt to equity* ratio (including external and internal/related party debt) of the *[distribution/transmission] network service provider* and any related stapled entities holding direct interests in the network assets (e.g. Asset Trust and/or Partnership), any of its *downstream associated entities* or any of its *upstream equity participants* (the latter on a best endeavours basis) as at 30 June 2018 (or its most recent financial year end).

2.2 Provide the following details for all financing arrangements (except those classified as equity for income tax purposes) of the *[distribution/transmission] network service provider* and any related stapled entities that hold direct interests in the network assets, e.g. the Asset Trust/Partnership) and any of its *downstream associated entities* which were in place in at 30 June 2018 (or its most recent financial year end):

(a) Outstanding principal in respect of each arrangement and the interest rate as set out in the agreement(s) for the arrangement thereon, and

(b) Counterparties to the arrangement where they are associates as defined in section 318 of the Income Tax Assessment Act 1936 (*ITAA 1936*).

2.3 To the extent the *[distribution/transmission] network service provider* and any related stapled entities that hold a direct interest in the network assets (e.g. the Asset Trust/Partnership) are treated as a transparent vehicle for tax purposes (e.g. partnership or flow through trust) provide details requested in item 2.2 of this schedule, where practically possible on a best endeavours basis, of all financing arrangements (except those classified as equity for income tax purposes) for *upstream equity participants* in those vehicles.

2.4 Identify and list those entities in the group structure referred to in item 1.1 of this schedule that were inward or outward investors for the purpose of the thin capitalisation regime in Division 820 of the Income Tax Assessment Act 1997 (*ITAA 1997*), as at the end of the latest income year for which a tax return has been lodged.

2.5 For those entities listed in response to item 2.4 of this schedule, confirm the following to the extent the information is not already disclosed in the latest tax return (including international dealings schedule) lodged as provided in response to item 3.1 of this schedule:

(a) Whether any exemption from the thin capitalisation rules apply in respect of the latest lodged tax return.

(b) What method was chosen in determining *maximum allowable debt* (e.g. safe harbour, arms-length debt or worldwide gearing) in the latest lodged tax return?

(c) The *maximum allowable debt* amount and *adjusted average debt amount* as defined under Division 820 of the *ITAA 1997* and as disclosed in the latest lodged tax return.

3. INCOME TAX RETURNS, PAYMENTS AND CALCULATIONS

3.1 Provide a copy of any income tax returns lodged (including schedules) by the *[distribution/transmission] network service provider*, whether Federal or *NTER*, in the last five (5) years or period of existence if less than 5 years.

3.2 Where the *[distribution/transmission] network service provider* is a member of a *tax consolidated group*:

(a) provide tax calculations for the *[distribution/transmission] network service provider* on a stand-alone basis to the extent these calculations have already been prepared (e.g. these calculations already exist), which reconcile to the *network service provider's* net profit before tax and support the latest income tax return lodged by the *head company* of the *tax consolidated group* in the last 5 years or period of existence if less than 5 years.

(b) Where (a) does not apply because these calculations have not already been prepared, prepare and provide tax calculations for the [*distribution/transmission*] *network service provider* on a stand-alone basis, which reconcile to the *network service provider*'s net profit before tax and support the latest income tax return lodged by the *head company* of the *tax consolidated group*, in respect of the latest income tax return lodged only.

3.3 Where the *[distribution/transmission] network service provider* is part of a stapled entity arrangement also provide the income tax returns lodged for the other stapled entities that hold direct interests in the network asset (i.e. the Asset Trust/Partnership) in the last 5 years or period of existence if less than 5 years.[75]

3.4 Provide the following information in respect of the last 5 years (or period of existence if less than 5 years):[76]

(a) If the *[distribution/transmission] network service provider* is held in a company structure, or taxed as a company under Division 6C of the *ITAA 1936*, provide income tax paid (including any withholding tax on interest, dividends and royalties, but excluding PAYG withholding and foreign contractor withholding tax) to the Australian Tax Office (*ATO*) by the *[distribution/transmission] network service provider*.

(b) If the *[distribution/transmission] network service provider* is held in a flow through vehicle (e.g. trust or partnership), please provide details of income tax paid (including withholding tax) to the ATO by the *[distribution/transmission] network service provider* (and any related stapled entities that hold direct interests in the network assets, e.g. the Asset Trust/Partnership), any of its *downstream associated entities*, or any of its *upstream equity participants* (the latter on a best endeavour basis).

(c) If the *network service provider* is held by an entity which is subject to the *NTER*, provide tax equivalent payments made to the Treasury or Revenue Office of the State or Territory to which the *NTER* entity belongs.

3.5 Where item 3.2 does not apply because the *[distribution/transmission] network service provider* is not a member of a *tax consolidated group*, provide a statement of taxable income which shows all permanent and temporary tax adjustments including, opening and closing balances of those tax adjustments (e.g. provisions and accruals), and any working papers supporting the adjustments made with respect to capital expenditure for accounting or tax purposes, that reconciles taxable income to net

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75 For clarification, we are not requesting tax return information for upstream stapled entities (e.g. holding trusts).

76 For clarification, this period should align with the period for tax returns referred to in item 3.1 of this schedule, and yearly figures should be provided.

profit before tax for the *[distribution/transmission] network service provider* (and any related stapled entities that hold a direct interest in the network assets) and any of its *downstream associated entities*, in respect of the latest income tax return lodged only.

3.6 Provide details of any Research & Development (R&D) tax incentive claims made by the *[distribution/transmission] network service provider* and any related stapled entities in respect of expenditure incurred in respect of *regulated assets* for the last 5 years (or period of existence if less than 5 years),[77] including a summary of the quantum of expenditure for each of the registered R&D activities, and a description of that activity.

4. ASSET BASES

4.1 Confirm the amount of assessable income which has been recognised by the *[distribution/transmission] network service provider* (and any related stapled entities, e.g. the Asset Trust/Partnership) for income tax purposes in respect of customer contributions and gifted assets in respect of tax returns lodged during the last 5 years, or period of existence if less than 5 years.

4.2 If the *[distribution/transmission] network service provider* is a member of a *tax consolidated group* confirm whether there has been any reset of the tax cost base of *regulated assets* as a consequence of the tax consolidation rules during the last 10 years. Please state if either and/or both of the following has occurred:

(a) Step up in tax value of assets

(b) Step down in tax value of assets

4.3 If either a step up and/or down in the tax value of *regulated assets* has occurred and is noted in response to item 4.2 of this schedule, quantify the total gross increase or decrease in the tax cost base of depreciable assets (where possible, split between regulated and unregulated assets). If there has been more than one event resulting in a resetting of the tax cost bases, please provide the total gross increase or decrease attributable to each separate event.

5. TAX DEPRECIATION

5.1 Provide the tax fixed asset register which supports the capital allowance balances reported in the last lodged tax return for the *[distribution/transmission] network service provider* and any related stapled entities that hold a direct interest in the network assets (e.g. the Asset Trust/Partnership).[78] This should include without limiting the information to be provided:

(a) Description of the asset;

(b) *Effective life* of the asset;

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77 For clarification, this period should align with the period for tax returns referred to in item 3.1 of this schedule, and yearly figures should be provided.

78 If the *[distribution/transmission] network service provider* is a member of a *tax consolidated group*, provide the tax fixed asset register which includes the *[distribution/transmission] network service provider's* assets, which has been reflected in the income tax return disclosures for the *head company* of that *tax consolidated group*.

(c) Depreciation method applied;

(d) Depreciation claimed; and

(e) Starting cost, including the starting cost determined under Division 58.

To the extent this information can be separated into regulated and non-regulated assets operated by the *[distribution/transmission] network service provider* provide the information only for the *regulated assets* in an excel template.

5.2 Provide the balance of any low value pools carried forward by the *[distribution/transmission] network service provider* and any related stapled entities that hold direct interests in the network assets (e.g. the Asset Trust/Partnership) as at the end of the income year for which the latest tax return has been lodged.

5.3 Provide existing documentation of capitalisation policies of the *[distribution/transmission] network service provider* and any related stapled entities that hold direct interests in the network assets (e.g. Asset Trust/Partnership) for tax purposes which provides guidelines for distinguishing when expenditure should be classified as capital or immediate deductible on revenue account (e.g. repairs and maintenance) and the identification of functional assets.

5.4 Provide a summary which identifies the total quantum of expenditure which is included in the regulatory fixed asset register (e.g. reported actual capex for regulatory purposes), but has been treated as immediately deductible for income tax purposes (e.g. refurbishments, overheads), in respect of income in the past 5 years, or period of existence if less than 5 years.[79]

6. STAMP DUTY ON ASSET PRIVATISATIONS AND ASSET SALES

6.1 To the extent the *[distribution/transmission] network service provider* (and any related stapled entities) holds assets that have been privatised, please confirm the tax treatment of any stamp duty payable as a consequence of the privatisation (and the quantum of duty paid) by the *[distribution/transmission] network service provider* (and any related stapled entities that acquired a direct interest in the network assets) including but not limited to circumstances where any stamp duty payments have been:

(a) treated as immediately deductible pursuant to section 25-20 of the *ITAA 1997*, or

(b) added to the cost base of depreciable assets (directly or through application of the Allocable Cost Amount (ACA) calculation and allocation methodology).

Where privatisation occurred more than 10 years ago, the stamp duty tax treatment may be described on a best endeavours basis.

[79] For clarification, this period should align with the period for tax returns referred to in item 3.1 of this schedule, and yearly figures should be provided.

7. ATO ENGAGEMENT, REVIEWS AND AUDITS

7.1 Provide a summary[80] of any non-routine engagement between the *ATO* and the *[distribution/transmission] network service provider* and any related stapled entities (e.g. Asset Trust/Partnership),[81] any of its *downstream associated entities*, or any of its *upstream equity participants* (the latter on a best endeavour basis) during the last 5 years (or period of existence if less than 5 years), including identifying whether the following is applicable:

(a) Reviews such as streamlined review, pre-lodgement compliance review, annual compliance agreement review.

(b) Audits.

(c) *NTER* lodgement visits.

(d) Other engagements such as, advanced pricing arrangement, tailored compliance engagement, private binding ruling or tailored advice.

7.2 Where *ATO* has provided a formal clearance letter, outcomes letter or position paper in respect of any of the engagements noted in item 7.1 of this schedule, provide a copy of this.

7.3 Please state whether the *[distribution/transmission] network service provider* and any related stapled entities (e.g. the Asset Trust/Partnership), any of its *downstream associated entities*, or any of its *upstream equity participants* has entered into a Tax Deed with the *ATO* (excluding any tax debt deed).

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80 Note, we are not asking for any actual correspondence with the regulatory authorities to be provided, but a summary of the relevant ATO compliance engagements, reviews, and audit activity.

81 If the *[distribution/transmission] network service provider* is a member of a *tax consolidated group*, please provide this information only to the extent it is relevant to the tax calculations of the *[distribution/transmission] network service provider*.

Questions from the Regulatory Information Notice under Division 4 of Part 1 of Chapter 2 of the National Gas (State) Law (Gas RIN)

GENERAL REQUIREMENTS

1. GROUP STRUCTURE

1.1 Provide a diagram illustrating the group holding structure of the *scheme pipeline service provider*, including:

(a) any related stapled entities;

(b) its *downstream associated entities*[82]; and

(c) *upstream equity participants*[83] (using a 'best endeavours' basis[84])

as at 30 June 2018, or its most recent financial year[85] end.

For completeness the group structure diagram should indicate:

(d) The nature of the vehicle (e.g. trust, company, partnership)

(e) Where entities are stapled (contractually or otherwise)

(f) The existence of partnership arrangements including any *Limited Partnerships*

(g) The jurisdiction in which the entity is a resident for tax purposes

(h) Entities which are members of an Australian *Tax Consolidated Group* (where relevant)

(i) In the case of trusts, the Trustee entity

(j) Whether the entity is classified as a *Managed Investment Trust* (MIT)

(k) Where the entity is government owned, confirmation that it is subject to the *National Tax Equivalent Regime (NTER)*.

1.2 Confirm whether there have been any changes to the group structure since 30 June 2018 or its most recent financial year end.

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82 For the purpose of this *notice*, "*downstream associated entities*" refers to "associates" of the *scheme pipeline service provider* as that term is defined in section 318 of the *Income Tax Assessment Act 1936*, however only to the extent that the *scheme pipeline service provider* has a direct or indirect controlling interest in that entity of greater than 10 per cent.

83 For the purpose of this *notice*, "*upstream equity participants*" includes any entities which have a direct or indirect equity interest in the *scheme pipeline service provider* of greater than 10 per cent. This would include a total participation interest as defined in section 960–180 of the *Income Tax Assessment Act 1997*, but only to the extent that the participation interest is greater than 10 per cent. Direct and indirect interests held by a foreign entity in the *scheme pipeline service provider* only need to be disclosed to the extent the foreign entity has a direct interest in an Australian resident vehicle. For the avoidance of doubt, an equity interest for these purposes would also include a partner's interest in a partnership.

84 Appendix C includes instructions on the use of a 'best endeavours' basis when responding to this *notice*. Further, if best endeavours are used when responding to this item and it is not possible to identify the names of upstream investors, the response should describe the type of investors in terms relevant to the assessment of tax (e.g. domestic/foreign, super fund).

85 The reference to financial year end includes financial years ending on a different basis to 30 June (i.e. 31 December and 31 March).

2. FINANCING ARRANGEMENTS

2.1 Provide the *debt to equity ratio* (including external and internal/related party debt) of the *scheme pipeline service provider* and any related stapled entities holding direct interests in the network assets (e.g. Asset Trust and/or Partnership), any of its *downstream associated entities* or any of its *upstream equity participants* (the latter on a best endeavours basis) as at 30 June 2018 (or its most recent financial year end).

2.2 Provide the following details for all financing arrangements (except those classified as equity for income tax purposes) of the *scheme pipeline service provider* and any related stapled entities that hold direct interests in the network assets, e.g. the Asset Trust/Partnership) and any of its *downstream associated entities* which were in place in at 30 June 2018 (or its most recent financial year end):

(k) Outstanding principal in respect of each arrangement and the interest rate as set out in the agreement(s) for the arrangement thereon, and

(l) Counterparties to the arrangement where they are associates as defined in section 318 of the Income Tax Assessment Act 1936 *(ITAA 1936)*.

2.3 To the extent the *scheme pipeline service provider* and any related stapled entities that hold a direct interest in the *covered pipeline* (e.g. the Asset Trust/Partnership) are treated as a transparent vehicle for tax purposes (e.g. partnership or flow through trust) provide details requested in item 2.2 of this schedule, where practically possible on a best endeavours basis, of all financing arrangements (except those classified as equity for income tax purposes) for *upstream equity participants* in those vehicles.

2.4 Identify and list those entities in the group structure referred to in item 1.1 of this schedule that were inward or outward investors for the purpose of the thin capitalisation regime in Division 820 of the Income Tax Assessment Act 1997 (*ITAA 1997*), as at the end of the latest income year for which a tax return has been lodged.

2.5 For those entities listed in response to item 2.4 of this schedule , confirm the following to the extent the information is not already disclosed in the latest tax return (including international dealings schedule) lodged as provided in response to item 3.1 of this schedule:

(a) Whether any exemption from the thin capitalisation rules apply in respect of the latest lodged tax return.

(b) What method was chosen in determining *maximum allowable debt* (e.g. safe harbour, arms-length debt or worldwide gearing) in the latest lodged tax return?

(c) The *maximum allowable debt* amount and *adjusted average debt amount* as defined under Division 820 of the *ITAA 1997* and as disclosed in the latest lodged tax return.

3. INCOME TAX RETURNS, PAYMENTS AND CALCULATIONS

3.1 Provide a copy of any income tax returns lodged (including schedules) by the *scheme pipeline service provider*, whether Federal or *NTER*, in the last five (5) years or period of existence if less than 5 years.

3.2 Where the *scheme pipeline service provider* is a member of a *tax consolidated group*:

(a) provide tax calculations for the *scheme pipeline service provider* on a stand-alone basis to the extent these calculations have already been prepared (e.g. these calculations already exist), which reconcile to the *scheme pipeline service provider*'s net profit before tax and support the latest income tax return lodged by the *head company* of the tax consolidated group in the last 5 years or period of existence if less than 5 years.

(b) Where (a) does not apply because these calculations have not already been prepared, prepare and provide tax calculations for the *scheme pipeline service provider* on a stand-alone basis, which reconcile to the *scheme pipeline service provider*'s net profit before tax and support the latest income tax return lodged by the *head company* of the *tax consolidated group*, in respect of the latest income tax return lodged only

3.3 Where the *scheme pipeline service provider* is part of a stapled entity arrangement also provide the income tax returns lodged for the other stapled entities that hold direct interests in the network asset (i.e. the Asset Trust/Partnership) in the last 5 years or period of existence if less than 5 years.[86]

3.4 Provide the following information in respect of the last 5 years (or period of existence if less than 5 years):[87]

(a) If the *scheme pipeline service provider* is held in a company structure, or taxed as a company under Division 6C of the *ITAA 1936*, provide income tax paid (including any withholding tax on interest, dividends and royalties, but excluding PAYG withholding and foreign contractor withholding tax) to the Australian Tax Office *(ATO)* by the *scheme pipeline service provider*.

(b) If the *scheme pipeline service provider* is held in a flow through vehicle (e.g. *trust* or partnership), please provide details of income tax paid (including *withholding tax*) to the *ATO* by the *scheme pipeline service provider* (and any related stapled entities that hold direct interests in the network assets, e.g. the Asset Trust/Partnership), any of its *downstream associated entities*, or any of its *upstream equity participants* (the latter on a best endeavours basis).

(c) If the *scheme pipeline service provider* is held by an entity which is subject to the *NTER*, provide tax equivalent payments made to the Treasury or Revenue Office of the State or Territory to which the *NTER* entity belongs.

3.5 Where item 3.2 does not apply because the *scheme pipeline service provider* is not a member of a *tax consolidated group*, provide a statement of taxable income which shows all permanent and temporary tax adjustments including opening and closing balances of those tax adjustments (e.g. provisions and accruals), and any working papers supporting the adjustments made with respect to capital expenditure for accounting or tax purposes, that reconciles taxable income to net *profit before tax* for the *scheme pipeline service provider* (and any related stapled entities that hold a direct interest in the network assets), and any of its *downstream associated entities*, in respect of the latest income tax return lodged only.

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86 For clarification, we are not requesting tax return information for upstream stapled entities (e.g. holding trusts).

87 For clarification, this period should align with the period for tax returns referred to in item 3.1 of this schedule, and yearly figures should be provided.

3.6 Provide details of any Research & Development (R&D) tax incentive claims made by the *scheme pipeline service provider* and any related stapled entities in respect of expenditure incurred in respect of *regulated assets* for the last 5 years (or period of existence if less than 5 years),[88] including a summary of the quantum of the expenditure per each of the registered R&D activities, and a description of that activity.

4. ASSET BASES

4.1 Confirm the amount of assessable income which has been recognised by the *scheme pipeline service provider* (and any related stapled entities, e.g. the Asset Trust/Partnership) for income tax purposes in respect of *customer contributions* and gifted assets in respect of tax returns lodged during the last 5 years, or period of existence if less than 5 years.

4.2 If the *scheme pipeline service provider* is a member of a *tax consolidated group* confirm whether there has been any reset of the tax cost base of *regulated assets* as a consequence of the tax consolidation rules during the last 10 years. Please state if either and/or both of the following has occurred:

(a) Step up in tax value of assets

(b) Step down in tax value of assets

4.3 If either a step up and/or down in the tax value of *regulated assets* has occurred and is noted in response to item 4.2 of this schedule , quantify the total gross increase or decrease in the tax cost base of depreciable assets (where possible, split between regulated and unregulated assets). If there has been more than one event resulting in a resetting of the tax cost bases, please provide the total gross increase or decrease attributable to each separate event.

5. TAX DEPRECIATION

5.1 Provide the tax fixed asset register which supports the capital allowance balances reported in the last lodged tax return for the *scheme pipeline service provider* and any related stapled entities that hold a direct interest in the network assets (e.g. the Asset Trust/Partnership).[89] This should include without limiting the information to be provided:

(a) Description of the asset;

(b) *Effective life* of the asset;

(c) Depreciation method applied;

(d) Depreciation claimed; and

(e) Starting cost, including the starting cost determined under Division 58.

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88 For clarification, this period should align with the period for tax returns referred to in item 3.1 of this schedule, and yearly figures should be provided.

89 If the *scheme pipeline service provider* is a member of a *tax consolidated group*, provide the tax fixed asset register which includes the *scheme pipeline service provider*'s assets, which has been reflected in the income tax return disclosures for the *head company* of that tax consolidated group.

To the extent this information can be separated into regulated and non-regulated assets operated by the *scheme pipeline service provider* provide the information only for the *regulated assets* in an excel template.

5.2 Provide the balance of any low value pools carried forward by the *scheme pipeline service provider* and any related stapled entities that hold direct interests in the network assets (e.g. the Asset Trust/Partnership) as at the end of the income year for which the latest tax return has been lodged.

5.3 Provide existing documentation of *capitalisation policies* of the *scheme pipeline service provider* and any related stapled entities that hold direct interests in the network assets (e.g. Asset Trust/Partnership) for tax purposes which provides guidelines for distinguishing when expenditure should be classified as capital, or immediate deductible on revenue account (e.g. repairs and maintenance), and the identification of functional assets.

5.4 Provide a summary which identifies the total quantum of expenditure which is included in the regulatory fixed asset register (e.g. reported actual capex for regulatory purposes), but has been treated as immediately deductible for income tax purposes (e.g. refurbishments, overheads), in respect of income in the past 5 years, or period of existence if less than 5 years.[90]

6. STAMP DUTY ON ASSET PRIVATISATIONS AND ASSET SALES

6.1 To the extent the *scheme pipeline service provider* (and any related stapled entities) holds assets that have been privatised, please confirm the tax treatment of any stamp duty payable as a consequence of the privatisation (and the quantum of duty paid) by the *scheme pipeline service provider* (and any related stapled entities that acquired a direct interest in the scheme pipeline) including but not limited to circumstances where any stamp duty payments have been:

(a) treated as immediately deductible pursuant to section 25-20 of the *ITAA 1997*, or

(b) added to the cost base of depreciable assets (directly or through application of the Allocable Cost Amount (ACA) calculation and allocation methodology).

Where privatisation occurred more than 10 years ago, the stamp duty tax treatment may be described on a best endeavours basis.

7. ATO ENGAGEMENT, REVIEWS AND AUDITS

7.1 Provide a summary[91] of any non-routine engagement between the *ATO* and the *scheme pipeline service provider* and any related stapled entities (e.g. Asset Trust/Partnership),[92] any of its *downstream associated entities*, or any of its *upstream equity participants* (the latter on a best endeavours basis) during the last 5

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90 For clarification, this period should align with the period for tax returns referred to in item 3.1 of this schedule, and yearly figures should be provided.

91 Note, we are not asking for any actual correspondence with the regulatory authorities to be provided, but a summary of the relevant *ATO* compliance engagements, reviews, and audit activity.

92 If the *scheme pipeline service provider* is a member of a *tax consolidated group*, please provide this information only to the extent it is relevant to the tax calculations of the *scheme pipeline service provider*.

years (or period of existence if less than 5 years), including identifying whether the following is applicable:

(a) Reviews such as streamlined review, pre-lodgement compliance review, annual compliance agreement review.

(b) Audits.

(c) *NTER* lodgement visits.

(d) Other engagements such as, advanced pricing arrangement, tailored compliance engagement, private binding ruling or tailored advice.

7.2 Where *ATO* has provided a formal clearance letter, outcomes letter, or position paper in respect of any of the engagements noted in item 7.1 of this schedule, provide a copy of this.

7.3 State whether the *scheme pipeline service provider* and any related stapled entities (e.g. the Asset Trust/Partnership), any of its *downstream associated entities*, or any of its *upstream equity participants* has entered into a Tax Deed with the *ATO* (excluding any tax debt deed).

Appendix D Summary of responses received

	Electricity Private			Electricity NTER			Gas		
No. businesses information requested	14			7			15		
Total responses received	12			7			14		
	Yes	**N/A**	**No**	**Yes**	**N/A**	**No**	**Yes**	**N/A**	**No**
Covering Letter	11	0	3	7	0	0	9	0	6
Question 1	12	0	2	7	0	0	9	0	6
Question 2	12	0	2	5	0	2	9	0	6
Question 3	10	0	4	7	0	0	9	0	6
Question 4[a]	6	4	4	2	3	2	8	1	6
Question 5[b]	2	8	4	0	5	2	0	9	6
Question 6	8	0	6	7	0	0	8	0	7
Question 7[c]	5	3	6	6	1	0	1	1	13
Question 8	6	2	6	5	0	2	0	2	13
Question 9	11	0	3	7	0	0	9	0	6
Question 10[d]	3	0	11	6	0	1	1	0	14
Question 11	8	1	5	5	0	2	2	0	13
Question 12[e]	4	1	9	2	2	3	0	1	14

[a] Question 4 is applicable to entities that have formed a tax consolidated group.
[b] Question 5 is applicable to entities with stapled arrangements.
[c] Question 7 is applicable in respect of any ATO engagements noted in question 6.
[d] Some entities are currently in the process of formalising tax capitalisation policies or utilise accounting policies in place of tax policies – these have been denoted with a 'NO' response.
[e] Question 12 is strictly an optional question intended to provide an opportunity for NSP's to comment on the potential impact of upcoming changes to the tax landscape, including legislative changes.

Appendix E Depreciating Asset

As noted in section 3.3.2 of this Report, identification of a particular depreciating assets is a critical factor when determining the income tax treatment of any associated expenditure. Depending on how an assets is defined, the expenditure may be either attributed to the cost or that asset (with the resulting income tax treatment determined by the nature of the asset to which the cost is attributed to), or potentially treated as deductible as ancillary expenditure which does not improve or replace that asset. This Appendix discusses the income tax concepts which are relevant in identifying a depreciable asset for these purposes in further detail.

Paragraph 1.15 of the Explanatory Memorandum to the *New Business Tax System (Capital Allowances) Act 2001* indicates that taxpayers can adopt the 'functionality test', used as a basis of identifying a 'unit of plant' in the predecessor plant depreciation rules, to determine whether a particular item or component is a depreciating asset.

The functionality test has been applied in a number of judicial decisions and the factors considered by the courts provide guidance in determining whether a composite item constitutes a separate depreciating asset.

Taxation ruling (**TR**) 94/11, entitled "Income tax: general investment allowance - what is a unit of property?" deals with the issue of a unit of property albeit for investment allowance purposes.

Paragraph 20 of TR 94/11 states:

> *"The Commissioner accepts that the term 'unit of property ' is to be construed in a broad and non-technical way (Monier Colourtile). Therefore, each case needs to be looked at on its own particular facts."*

Lockhart J in FCT v *Tully Co-op*[93] also came to a similar conclusion. This case involved the availability of the investment allowance for expenditure on extensive alterations and additions to plant used at various stages in the process of milling sugar cane and refining sugar.

Thomas J of the Federal Court, who was the trial judge, analysed the operation of the process in these terms (13 ATR 410 at 411):

> *"The system involves the processing and reprocessing of cane through the various mills. Juice is thereby extracted which finds its way into the various juice tanks. Ultimately the clarified juice is pumped to two effect sets, which operate in parallel with one another. The effect station increases the sugar content of the juice by evaporating water from the solution. The product from the effect station, now called liquor or syrup, is pumped to storage tanks. There is then a process of crystallisation of sugars and the production of other products at the pan station. The overall scheme of things is much more complex than the primary course which I have described. It includes a re-processing of by-products which are collected along the way. These include recovery of the eventual fibres which are used to fuel*

[93] *FCT v Tully Co-operative Sugar Milling Association Ltd* (1983) 14 ATR 495; 83 ATC 4495

the mill itself; and the collection of 'mud' which is then reprocessed so as to extract sugar bearing liquids which it still contains."

Having analysed the overall process in this way, Thomas J then discussed whether a mixed juice pumping station was a unit of property (the taxpayer's contention) or whether the components making up the mixed juice pumping station were the units of property (the Commissioner's contention). He described the components of the mixed juice pumping station as follows:

> *"The foundations were necessary for the functioning of two Kelly and Lewis pumps acquired and installed at the mixed juice pumping station. The relevant equipment included two starters and two electric motors to start and drive the Kelly and Lewis pumps...*
>
> *"It is first necessary to identify what is the 'new unit of eligible property' with respect to which the taxpayer incurred expenditure. The appellant [taxpayer] submits that the mixed juice pumping station itself comprises the relevant unit. Whilst it is plain that an electric motor, or a starter may in appropriate circumstances itself be a unit, the evidence here shows that each of these components has become an integral part of the pumping station. It may be noted that the Kelly and Lewis pumps (in respect of which expenditure has apparently been allowed) were delivered to the site with the relevant motors (in respect of which expenditure has not been allowed) attached to them. The station obviously would not function without the pumps, and the pumps obviously could not function without the motors or the starters. Two pumps are necessary because during the crushing season the milling must continue on a 24-hour basis."*

Thomas J then referred to evidence of one of the taxpayer's expert witnesses regarding the function of the mixed juice pumping station (13 ATR at 413):

> *"Mr Miskin regarded this station as a separate item within the overall process of the mill. He described it as being dedicated to withdrawing juice from the mixed juice tank, pressurising it through the pumps and then pumping that juice under pressure through the primary juice heads through to the incubator. He pointed out that it has no other function."*

Thomas J had previously commented (13 ATR at 412): "I accept the evidence of Mr Miskin and Mr Lewis without reservation."

Thomas J then held:

> *"On this evidence, I am prepared to hold that the mixed juice pumping station... is a ' unit of eligible property' under s 82AB(1). It is an item which performs a discrete function in the milling process."*

He compared the Commissioner's submission which was to treat "relatively minor components as units" with the taxpayer's "identification of relatively large components within the milling process as comprising the relevant units." He was of the view that (13 ATR at 414):

> *"In my opinion a component may be a unit of property... in the context of a manufacturing system, if it can be shown to perform a discrete function, or if it can be shown to vary the performance of that system."*

His findings were similar in relation to other items. He upheld the taxpayer's contention that relatively large units were the relevant units and found that two crushing mills (costing $866,649 and $998,658 respectively) were each units of property, although they comprised a number of components. A mud filter station, two juice heaters and an effect vessel were also

held to be the relevant units. The units of property identified by Thomas J each had a discrete function to perform in the overall process which he had previously analysed. The findings by Thomas J regarding the relevant units of property were upheld on appeal to the Full Federal Court.

Fox J of the Federal Court made these comments (14 ATR at 500):

> *"The learned judge took the view that the whole pumping station comprised a unit, and that the items in question were part of it, indeed an essential part. He was looking at the larger whole, of which the items had become an integral part. This was essentially a finding of fact, and I see no reason to disturb it."*

Lockhart J of the Full Federal Court made a similar finding (14 ATR at 505):

> *"The difficulty of identifying a 'unit of property' for the purposes of the Assessment Act is that sometimes an item may be correctly described as a 'unit ' when it is one of a number of parts which upon assembly perform a subsidiary function. Sometimes each part may be correctly described as a unit before assembly and at other times after assembly. On other occasions there may not be a unit until a number of parts have been integrated into a complete system. Then the whole may answer the description of a unit. The possibilities and combinations are numerous. But purpose or function must generally be a useful guide to the ide1ltification of an item as answering the description of a unit of property in particular cases."*

In essence, what the judges did in this case was to identify the various production stages of the refinery as a whole and identify as units of property those items that had a "purpose or function" in the totality of the overall production process. On the basis of this analysis, a motor was too small a component to have an identifiable function or process. The motor only had a function as part of the mixed juice pumping station.

Case M98 80 ATC 689; 24 CTBR (NS) (***Case 69***) involved a tractor and two items of equipment used with it, being a carry-all and a soil ripper. The Board treated these three items as separate units, as they performed entirely different functions. This decision was referred to with approval by Lee J in *Monier Colourtile*. The Board emphasised the function test.

TR 94/11 also contains several practical examples. The ruling was of the view that a new system of storage racks for use in a warehouse would qualify as a separate unit of property if it were an integrated system intended to be used as a single entity, although the system was capable of being dismantled and reassembled. Each component was not a separate unit of property. Plant items such as stacker cranes, forklifts and computer control models used in conjunction with the racking systems were each separate units as were individual pallets.

A mainframe computer purchased together with 50 terminals was considered to be a single unit of property, as the terminals were not personal computers and did not have a separate function. The terminals were integral to the operation of the new mainframe. If 20 additional terminals were purchased some time later, these would each qualify as a separate unit of property, as each constituted an improvement of the existing unit. In this example the 20 terminals were considered to be similar to the individual pallets considered in *Monier Colourtile*.

Where a PC "package" was purchased which consisted of a base unit, monitor, keyboard and computer mouse, these items would be regarded as a single overall unit of property, even where they were purchased from different retailers, if the intention was to create a new, single, integrated system which functioned as a whole. However, a printer would be a separate unit of property, as it was capable of independent existence, even if it were acquired at the same time as the PC package.

The decision of the House of Lords in *IRC v Barclay, Curle & Co Ltd* discussed previously also provides support for the view that the stockyard extension as a whole is a unit of plant. Lords Reid, Guest and Donovan all emphasised that the dry dock and its equipment were to be treated as a unit of plant and that a "piecemeal" approach was not appropriate. This UK case arose in relation to depreciation provisions, but is referred to with approval in TR92/16 and the dicta provides support for the view that the entire stockyard extension including equipment is a unit of plant.

Finally, the following ATO Interpretative Decisions provide some more recent insights into the identification of a 'depreciating asset' for Division 40 purposes:

- ATO ID 2003/489 - in which rail transport trackwork (inclusive of rails, sleepers, ballast and their associated earthworks, and integral bridges, girders, culverts and tunnels) was held to be a composite depreciating asset. Its function of allowing travel between two points could only be performed by combining the relevant components in a particular integrated or interdependent way.

- ATO ID 2007/11 - in which a mine haulage road (comprised on ramps, switchbacks, intersections, drains and roadway berms) was accepted as a composite item that is itself a depreciating asset. According to the tax determination "…components including drains and roadway berms are integral to the use and integrity of the formed roadway and are physically and functionally integrated with the roadway itself to form the composite item 'a haulage road'."

Appendix F Tax Loss Integrity Rules

The utilisation of carried forward tax losses is subject to certain tax loss integrity measures. The rules applicable to the utilisation of carried forward tax losses by companies are set out below.

Australia's tax loss integrity measures ensure that tax losses may only be carried forward by a corporate taxpaying entities subject to satisfaction of the Continuity of Ownership Test (**COT**) and Similar Business Test (formerly the Same Business Test) (**SBT**), and tax consolidation related loss integrity measures (e.g. the available fraction rules).

Broadly, the COT and SBT rules ensure that a corporate group may only carry forward tax losses to be offset against future assessable income where there has been a continual ultimate beneficial ownership interest in the company which carries forward the losses of 50% or more from the beginning of the income year in which the tax loss was incurred, until the end of the income year in which it is to be utilised, or failing that, a continuity of the nature of the business and transactions carried on by the relevant taxpayer, broadly having regard to the business carried on by the taxpayer immediately prior to the COT failure (e.g. the change of greater than 50% of the ultimate beneficial ownership of the taxpayer) and the business carried on by the taxpayer during the income year in which the loss is to be utilised (noting various amendments may be made to these tests in a tax consolidation environment). These rules ensure there is consistency in either the same ultimate economic owners of the company which incurred and utilised the loss (e.g. greater than 50%), or a consistency in the nature of the business which incurred and utilised the loss. The COT is an objective test which involves substantiation of shareholding percentages through a corporate group, and therefore is relatively straight-forward test to apply. The SBT requires a detailed analysis of all relevant aspects of the business carried on at the various testing point, and is somewhat subjective in nature, and therefore in practice is more difficult to apply and substantiate.

As noted above, the tax consolidation regime involves the sharing of tax losses between different entities within a tax consolidation environment. Accordingly, the tax law applies additional integrity measures to prevent inappropriate allocation of tax losses between entities (e.g. loss "shopping"). This includes additional COT and SBT testing requirements to determine whether or not tax losses may be "transferred" into a tax consolidated group on acquisition of an entity which has carried forward losses, and also the available fraction rules which ensure that rate of the utilisation of any tax losses which are "transferred" to a tax consolidation group following acquisition of the loss making entity is restricted to the economic value which that joining entity contributes to the acquiring group (e.g. the rate at which losses can be utilised is broadly determined by reference to the market value of the joining entity, divided by the market value of the tax consolidated group following acquisition of the entity).

It is noted that trusts are subject to similar rules, except that they are not able to access the SBT unless they are listed. Partnerships which are taxed on a flow through basis will not have tax losses trapped at the partnership level, but rather the partnership will distribute any tax losses incurred to its investors (e.g. the partners) in the income year those losses are incurred. The ability to carry forward those tax losses would then be subject to the tax profile of the relevant investor.

The effect of the above rules is that Australian taxpayers are generally prevented from utilisation of losses except to the extent they satisfy the relevant requirements relating to

continuity of ownership, business and attributed value (in a tax consolidated environment) relating to those losses.

Different loss integrity rules apply in respect of tax losses which are carried forward by trusts (as outlined in the trust loss provisions in Schedule 2F to the ITAA 1936). The trust loss tests apply to two types of arrangements under which the tax benefit of trust losses and debt deductions could otherwise be transferred to other entities:

- a change in the ownership or control of the trust; and
- use of an income injection scheme.

The change in ownership test is similar to the COT as outlined above, in that a change in beneficial ownership of greater than 50% will lead to a failure of the test. In the case of trusts however, a failure of the change of ownership test will lead to forfeiture of the tax losses – as noted above, there is no SBT as a secondary measure.

The income injection test is an anti-avoidance measure and applies, broadly, where income is injected into trusts with tax losses or other deductions to reduce the trust's net income under subsection 95(1) of the ITAA 1936, reducing the amount that is included in the assessable income of the trust's beneficiaries.