HERBERT SMITH FREEHILLS

INFRASTRUCTURE TRENDS - #10: AN ACTIVIST ATO

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Legal Briefings – By **Aldrin de Zilva and Nicholas Rouse**

In this series of short articles we look at the current trends affecting infrastructure investment in Australia. This article considers trend #10 – An activist ATO

The Australian Tax Office is becoming more active in its consideration of infrastructure investments and investor structuring. This includes the ATO's heavy involvement in decisions by the Foreign Investment Review Board during the foreign investment approval process (where the ATO's taxation conditions and structuring requirements are becoming a normal part of most infrastructure approvals).

The ATO has also been busy reviewing the use of stapled structures, related party debt and concepts of investor 'control' (in particular whether investor minority protections constitute 'negative control'). In 2017 the ATO released Taxpayer Alert TA 2017/1, the draft Privatisation and Infrastructure Framework and updated draft positions on 'control' for the purposes of Division 6C and the pricing of cross-border related party debt. Some two months after the release of TA 2017/1, the Federal Treasury released a consultation paper on stapled structures (presumably to address the uncertainty brought about by TA 2017/1).

While many of the ATO's positions are not overly contentious, there are some key issues where the views of the ATO and industry diverge materially. The ATO's stated position on the types of veto rights that will give rise to 'control' of a trading business for the purposes of Division 6C and the managed investment trust (**MIT**) rules is particularly concerning to industry, not least because since 2015 the ATO has released multiple draft guidance notes on the issue, each adopting a progressively harsher view.

This article focuses on the interpretations on ‘control’ being taken by the ATO for the purposes of Division 6C and the MIT rules. If the ATO’s views on control are fully implemented, they will significantly impact the structuring and tax treatment of both new and existing infrastructure investments in Australia. The changes will likely require the re-opening of existing investment structures, and the development of alternative investment structures and minority investor protections. They may also affect the attractiveness of Australian infrastructure investments to offshore investors.

ISSUES OF CONTROL

Stapled structures are one of a number of issues in the cross-hairs with the ATO and Treasury expressing concern that stapled structures are being used to inappropriately convert active income into concessionally taxed passive income. In that regard, passive income can be taxed on a flow through basis and, for foreign investors, at concessional withholding rates including under the MIT regime.

Notwithstanding the ATO’s acknowledgment that matters which go to the capital structure and distribution policy of an entity do not relate to the carrying on of a trading business, the ATO’s list of veto rights that it considers give rise to ‘control’ of a trading business appears at odds with this principle. The listed veto/control rights include a number of customary shareholder protections for minority investors which do not, in any commercial sense, give the minority investor an ability to ‘control’ the affairs or operations of a trading business. For example, the ATO indicates that veto rights in relation to the entry into new indebtedness or any kind or the restructuring of loans may give rise to ‘control’ for the purpose of Division 6C. However, the use of debt funding (vs equity funding) is generally regarded as being within the broader domain of capital structure and optimising shareholder value, rather than being in respect of a trading business carried on by the downstream entity.

Section 102N determines whether or not an investment is passive for the purposes of Division 6C, and therefore the effectiveness of most of the flow through trust structures commonly used in infrastructure investment in Australia which hold minority interests in trading businesses. In our view ‘control’ in the context of section 102N of the ITAA 1936 should be interpreted in a similar manner to the control test in section 50AA of the Corporations Act, but the ATO’s views on ‘negative control’ in the context of section 102N of the ITAA 1936 do not align with the control test in section 50AA of the Corporations Act 2000 (Cth).

If the ATO view, as expressed, was adopted it would probably give rise to many minority investor trusts being regarded as having ’control’ and being considered as trading trusts. As a consequence the investor trusts may cease to qualify as a MIT (removing access to the 15% withholding tax for distributions of other income to non-resident investors in information exchange countries) or may commence to be a public trading trust (losing their flow-through status and being taxed at the corporate tax rate). To rectify the ‘negative control’ issue would require a re-write of relevant shareholders, unitholders and joint venture agreements and a consequent loss of legitimate minority protections.

There are a range of views on this topic - some commentators suggest that ‘control’ requires a positive ability to direct and no veto can ever constitute ‘control’. Our view is that a veto right does not, of itself, constitute a ‘control’ right. A veto right might constitute ‘control’ in some limited circumstances, but the veto right would have to amount to an ability to effectively direct the operation and management of the business. This needs to be considered in the context of a range of factors, including:

1. whether the veto right protects the nature of the business and investment;
2. the extent to which the management and operation of the business are left to management; and
3. the regularity with which management must come to the directors or investors (as relevant) for the approval of matters for which the investor, or its board nominee, has the relevant veto right.

The right to direct the management and operation of an entity's trading business is fundamentally different from a veto right to protect the nature of the relevant business and therefore the nature and risk profile of the shareholder's investment. Minority shareholders need the ability to prevent the nature of the business from changing without their agreement. This could include selling the business or its major asset, venturing into a new industry or sector, materially changing the risk profile of the business, or undertaking activities that required the contribution of additional capital etc.

It is possible that the outcome of Treasury’s consultation on stapled structures and a further update to the ATO Infrastructure Framework document are released before the end of 2017. In the meantime, we recommend that infrastructure investors:

1. monitor these developments carefully;
2. ensure that they express their views on these matters to the ATO and Treasury; and
3. review their existing structural and governance arrangements, particularly for any veto rights that may create a ‘control’ issue under the ATO’s interpretation.

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