



TD 2014/D8 - Income tax: can the exemption in section 820-39 of the Income Tax Assessment Act 1997 apply to the special purpose finance entity established as part of the 'securitised licence structure' used in some social infrastructure Public Private Partnerships?

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This document has been finalised by TD 2014/18.

 There is a Compendium for this document: **TD 2014/18EC** .



Draft Taxation Determination

Income tax: can the exemption in section 820-39 of the *Income Tax Assessment Act 1997* apply to the special purpose finance entity established as part of the ‘securitised licence structure’ used in some social infrastructure Public Private Partnerships?

❶ This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner’s preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don’t have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. Yes. The exemption in section 820-39 of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ can apply to the special purpose entity (**SPE**) that seeks finance for the project which is established as part of the securitised licence structure used in some social infrastructure Public Private Partnerships (**PPPs**) provided the SPE satisfies the conditions in subsection 820-39(3) of the ITAA 1997.

2. In the securitised licence structures recently examined by the Commissioner (described below), the conditions in subsection 820-39(3) have been satisfied.

Date of effect

3. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination 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 Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

¹ All legislative references are to the ITAA 1997 unless otherwise indicated.

TD 2014/D8

Commissioner of Taxation

12 March 2014

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

Explanation

The securitised licence structure employed in social infrastructure PPPs

4. A PPP is an arrangement between the public sector (the Commonwealth, State or Territory Government) and the private sector pursuant to which the private sector is contracted to finance, design, construct, operate and maintain a public infrastructure asset. Broadly speaking, public infrastructure is divided into:

- 'social' infrastructure such as schools, hospitals, prisons; or
- 'economic' infrastructure such as transportation facilities, for example roads, bridges, tunnels.

5. Social infrastructure PPPs typically involve the Government paying the private sector for the provision of the infrastructure whilst economic infrastructure PPPs typically involve a 'user-pays' structure where the public pays the private sector for the provision of the infrastructure.

6. The predominant legal/contractual structure adopted by the private sector to deliver social infrastructure PPPs is known as the 'securitised licence' structure.² Some of the key features of the securitised licence structure are as follows:

- the project sponsors³ establish a special purpose project entity (the **Project Vehicle**) which enters into the project deed/concession with the Government to carry out the financing, design, construction, operation and maintenance of the relevant infrastructure asset.
- the project sponsors establish a separate SPE (**Fin Co**) to obtain the senior debt for the project.
- the Government grants a licence to the Project Vehicle to allow the Project Vehicle to access the relevant Crown land to construct and then operate the asset during the concession period. The Project Vehicle is required to pay licence fees to the Government in respect of the operating phase of the licence.⁴
- the majority of the external debt is used by Fin Co to pay a lump sum or series of progressive 'securitisation' payments to the Government to secure the licence fees payable by the Project Vehicle to the Government.

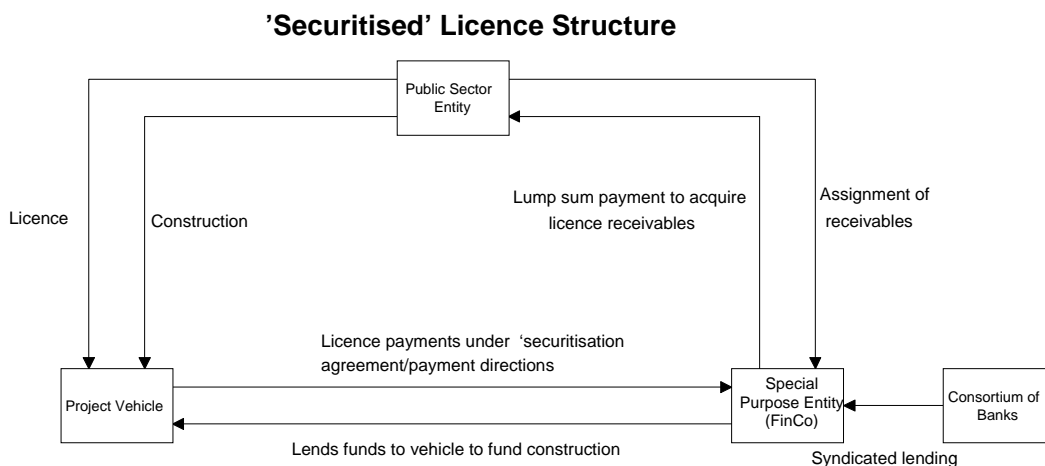
² Sometimes referred to as the securitised 'lease' structure.

³ A consortium of private sector operators.

⁴ Only a nominal fee is payable by the Project Vehicle during the construction phase.

- Fin Co enters into a Receivables Purchase Deed with the Government pursuant to which Fin Co agrees to pay the Government the 'Receivables Purchase Price' in consideration for the assignment by the Government of the licence fees payable to the Government by the Project Vehicle. The Receivables Purchase Price is payable in instalments (the **Receivables Purchase Payments**) during the construction phase. Fin Co funds the Receivables Purchase Payments by drawing down on the senior debt.
- the Government uses the Receivables Purchase Payments to fund the construction payments payable by the Government to the Project Vehicle during the construction phase.⁵
- Fin Co uses the licence fees assigned to it by the Government to repay the senior debt.
- Fin Co also enters into Intercompany Loan Agreements with the Project Vehicle. The funds provided under these loans are used to pay for project expenses including construction costs.
- once the PPP moves into the operational phase (post-construction), the Government commences to pay Quarterly Service Payments (**QSPs**) to the Project Vehicle. The QSPs are the sole cash flows in the project and are calculated to satisfy all of the costs of delivering the PPP including the payment of the licence fees.

Diagram of securitised licence structure



Application of section 820-39

7. Section 820-39 exempts certain special purpose entities from the application of the thin capitalisation rules in Division 820.

8. Subsection 820-39(1) provides that the exemption applies:

for an income year if the entity meets the conditions in subsection (3) throughout the income year.

⁵ The Receivables Purchase Payments are subject to a 'Payment Directions Deed' pursuant to which the Government directs Fin Co to make the Receivables Purchase Payments to the Project Vehicle in satisfaction of the Government's obligation to make the construction payments to the Project Vehicle.

9. The three conditions in subsection 820-39(3) that must be satisfied are:
- (a) the entity is one established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself); and
 - (b) the total value of debt interests in the entity is at least 50% of the total value of the entity's assets; and
 - (c) the entity is an insolvency-remote special purpose entity according to the criteria of an internationally recognised rating agency that are applicable to the entity's circumstances.
10. By virtue of subsection 820-39(4), the condition in paragraph 820-39(3)(c) can be met without the rating agency determining that the entity meets those criteria.

Paragraph 820-39(3)(a)

11. Paragraph 820-39(3)(a) states:
- the entity is one established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself).
12. In *Brookton Co-operative Society v. FCT*,⁶ the High Court was required to consider whether the appellant company was a 'co-operative company' within the meaning of subsection 117(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). In broad terms, a 'co-operative company' within the meaning of subsection 117(1) was '... a company which ... is established for the purpose of carrying on any business ...'. The High Court held that in ascertaining the purpose for which a company 'is established' it is necessary to look not only to the circumstances existing at the time of its incorporation, but also the activities carried on by the company at the time its status as a co-operative company is to be determined.⁷
13. Since the three conditions in subsection 820-39(3) must be satisfied throughout an income year if the entity is to satisfy section 820-39 in that income year,⁸ paragraph 820-39(3)(a) should be interpreted in a similar fashion to the phrase considered in *Brookton Co-operative Society*. Therefore, in determining whether an entity satisfies paragraph 820-39(3)(a), it is relevant to look at both the objects or purposes for which the body was incorporated including the clauses in the entity's memorandum of association or constitution,⁹ in addition to the enquiry required to be made in each income year about the purposes for which the entity was 'established'. Thus, it is possible that an entity will satisfy paragraph 820-39(3)(a) for the requisite purpose at one particular time (for example at the time of its establishment) but not another.

⁶ (1981) 11 ATR 880.

⁷ The Full Federal Court in *FCT v. Wentworth District Capital Ltd* 2011 ATC 20-253 reached the same conclusion as the High Court in *Brookton Co-operative Society* in respect of the phrase 'established for community service purposes' as found in Item 2.1 of section 50-10 of the ITAA 1997.

⁸ See subsection 820-39(1).

⁹ *Cronulla Sutherland Leagues Club Limited v. Commissioner of Taxation* 90 ATC 4215; (1990) 23 FCR 82 at 89-90 and 116-117 (*Cronulla*) (which considered s 23(g)(iii) of the *Income Tax Assessment Act 1936* (Cth), the predecessor to Item 2.1 of section 50-10 of the ITAA 1997).

14. The next issue is one of characterisation of the purpose or purposes for which the entity is established. Paragraph 820-39(3)(a) requires that the relevant SPE is one established for the identifiable 'purpose' of managing some or all of the economic risk associated with the assets, liabilities or investments (whether the entity assumes that risk from another entity or creates the risk itself).

15. The Explanatory Memorandum (**EM**) of the *Taxation Laws Amendment Act (No.5) 2003*, the Act which introduced section 820-39, notes at paragraph 1.8 that paragraph 820-39(3)(a) is intended to be an exclusionary definition. It seeks to exclude entities that are established with an identifiable purpose other than that relating to 'managing some or all of the economic risk associated with the assets, liabilities or investments'.

16. Where the entity is established for multiple purposes, the entity must have the requisite purpose in the context of the statutory provision as its main or dominant purpose. This is to be ascertained by examining the 'true character and nature of' the body in question.¹⁰

17. Having regard to the context in which paragraph 820-39(3)(a) appears, requiring the entity to be a 'special purpose entity',¹¹ an entity will satisfy paragraph 820-39(3)(a) if it is established for the main or dominant purpose of performing the activities required by the paragraph. If the entity is established for some other main or dominant purpose it will not satisfy paragraph 820-39(3)(a).

18. In the securitised licence structures which have been examined by the Commissioner, Fin Co is an SPE that is established to procure project finance for the project and manage the risks associated with this role. It is established to perform this role throughout the period of the PPP, firstly by obtaining senior debt to make the Receivables Purchase Payments to the Government during the construction phase of the PPP and secondly by acquiring and securitising the licence fees payable by Project Vehicle during the operational phase. Thus, on one hand, the existence of the Fin Co SPE is illustrative of the relevant purpose required by paragraph 820-39(3)(a), in that it is established to manage the risks associated with project financing the PPP infrastructure.

19. In terms of the economic risk associated with assets and liabilities of the PPP that Fin Co is established to assume and manage, that risk includes:

- assuming and managing the risk associated with the payment of the licence fees;
- assuming and managing the risk associated with the repayment of the senior debt since the SPE's return is contingent on the recoverability of the licence fee receivable;
- assuming and managing the risk associated with the Government's credit rating given the primary source of the cash flows in the Project stems from the Government in the form of the QSPs; and
- managing the interest rate risk associated with any floating rate interest on the senior debt.

20. Accordingly, Fin Co is an entity that will satisfy paragraph 820-39(3)(a).

¹⁰ *Federal Commissioner of Taxation v. Wentworth District Capital Ltd* 2011 ATC 20-253 and *Cronulla* at FCR 93-96.

¹¹ An SPE is generally understood as being an entity that is established to fulfil a limited, narrow or specific objective, a 'special purpose' of doing something.

Paragraph 820-39(3)(b)

21. Paragraph 820-39(3)(b) states:
- the total value of debt interests in the entity is at least 50% of the total value of the entity's assets.
22. There are two elements to paragraph 820-39(3)(b):
- there are debt interests in the entity; and
 - the debt interests are at least 50% of the total value of the entity's assets.
23. Division 974 sets out the tests that determine whether an interest is characterised as a 'debt interest'.
24. Subsection 974-15(1) provides that a 'scheme' gives rise to a **debt interest** in an entity if the scheme, when it comes into existence, satisfies the debt test in subsection 974-20(1) in relation to the entity.
25. Provided the relevant SPE satisfies the conditions in Division 974, then the relevant interests, which generally constitute the funds received from the third party lenders will be classified as debt.
26. If the relevant debt interests are at least 50% of the total value of the SPE's assets, then it will satisfy paragraph 820-39(3)(b).

Paragraph 820-39(3)(c)

27. Paragraph 820-39(3)(c) states:
- the entity is an insolvency-remote special purpose entity according to criteria of an internationally recognised rating agency that are applicable to the entity's circumstances.
28. In determining whether an entity satisfies paragraph 820-39(3)(c), the entity can self-assess whether it is 'insolvency-remote' according to criteria of an internationally recognised rating agency that are applicable to the entity's circumstances. Pursuant to subsection 820-39(4), the entity is not required to obtain an actual rating from an internationally recognised rating agency.
29. Paragraph 820-39(3)(c) does not require the entity be considered an insolvency-remote SPE exclusively by reference to one set of criteria (that is, more than one set of criteria may be applicable to the entity's circumstances). However, the insolvency-remote criteria sought to be applied must be *applicable* to the entity's circumstances if it is to satisfy paragraph 820-39(3)(c). If a particular set of criteria sought to be relied upon is not applicable to the entity's circumstances, the entity will not satisfy the paragraph unless some other set of criteria is applicable.
30. Whether a particular set of criteria that addresses the insolvency-remoteness of an SPE is applicable to the entity's circumstances is a question of fact and degree that depends on the nature of the commercial activity undertaken by the SPE. Further, it is not sufficient for the entity to rely on the different factors or criterion found in separate set of criteria to demonstrate that it is insolvency remote. The rating agency set of criteria (not criterion) applicable to the entity's circumstances should be employed to demonstrate that the entity is insolvency remote.

31. A number of rating agencies have published criteria outlining the characteristics that must be satisfied in order for a SPE to be classified as ‘insolvency-remote’ or ‘bankruptcy-remote’. For example, Standard & Poor’s (S&P) has published two criteria, *‘Criteria for Special-Purpose Entities in Project Finance Transactions’*¹² and *‘Legal: Guide to Legal Issues in Rating Australian Securitisation’*¹³ which sets out the characteristics of insolvency-remoteness¹⁴ in relation to SPEs in the context of project finance and securitisation transactions respectively.¹⁵

The characteristics of insolvency-remoteness

32. In assessing whether an SPE is insolvency-remote, the internationally recognised rating agencies outline some core tenets which must be considered. For example, S&P’s insolvency-remote criteria for project finance transactions require a consideration of the following characteristics:¹⁶

- Restrictions on objects and powers;
- Debt Limitations;
- Independent director;
- No merger or reorganisation;
- Non-petition language in contracts to which the SPE is a party; and
- Separateness.

33. Despite the slight differences in purpose and expression between each of the relevant set of criteria published by the various internationally recognised rating agencies dealing with insolvency-remoteness, the same fundamental principles underlie the analysis of whether an SPE is to be considered insolvency-remote.

34. S&P elaborate on each of the characteristics in greater detail and state that an SPE will achieve the state of insolvency-remoteness by adopting some form of each of the characteristics.¹⁷

35. Whilst it is not necessary that the entity strictly satisfy every criterion in order to demonstrate that the relevant SPE is insolvency remote, the appropriate weight to be given to each criterion is a matter of judgment having regard to the facts of each arrangement and the commentary provided by the relevant rating agency in respect of each criterion. For example, in determining whether Fin Co satisfies paragraph 820-39(3)(c), the Commissioner may give weight to a legal opinion addressing whether Fin Co is an insolvency-remote SPE according to the applicable criteria of an internationally recognised rating agency.

36. Provided an entity satisfies what are explicitly set out as the ‘characteristics’ of insolvency remoteness in the applicable criteria of an internationally recognised rating agency, then it will satisfy the requirements of paragraph 820-39(3)(c).

¹² Dated 20 November 2000 and republished on March 4, 2011.

¹³ Dated 1 March 2005.

¹⁴ Or ‘bankruptcy-remoteness’.

¹⁵ Also relevant is Fitch Ratings *‘Criteria for Special-Purpose Vehicles in Structured Finance Transactions’* published May 2012.

¹⁶ Page 4 of S&P’s Project Finance criteria

Appendix 2 – Your comments

37. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

38. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 11 April 2014
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¹⁷ See page 4.

References

Related Rulings/Determinations:

TR 2006/10

Previous Rulings/Determinations:

TD 2012/D11

Subject references:

- debt deductions
- thin capitalisation

Legislative references:

- ITAA 1997
- ITAA 1997 50-10
- ITAA 1997 Div 820
- ITAA 1997 820-39
- ITAA 1997 820-39(1)
- ITAA 1997 820-39(3)
- ITAA 1997 820-39(3)(a)
- ITAA 1997 820-39(3)(b)
- ITAA 1997 820-39(3)(c)
- ITAA 1997 820-39(4)
- ITAA 1997 Div 974
- ITAA 1997 974-15(1)
- ITAA 1997 974-20(1)
- ITAA 1936 23(g)(iii)
- ITAA 1936 112(1)

Case references:

- *FCT v. Wentworth District Capital Ltd* [2011] FCAFC 42 2011; 191 FCR 151; ATC 20-253; (2011) 82 ATR 894
- *Cronulla Sutherland Leagues Club Limited v. Commissioner of Taxation* (1990) 23 FCR 82; 90 ATC 4215; (1989) 21 ATR 300
- *Brookton Co-operative Society v. FCT* (1981) 147 CLR 441; (1981) 11 ATR 880; 81 ATC 4346

Other references:

- Standard & Poor's *Criteria for Special-Purpose Entities in Project Finance Transactions*, issued 20 November 2000 and revised 4 March 2011
- Fitch Ratings 'Criteria for Special-Purpose Vehicles in Structured Finance Transactions' published May 2012
- Standard & Poor's *Legal: Guide to Legal Issues in Rating Australian Securitisation* published 1 March 2005
- Explanatory Memorandum to the Taxation Laws Amendment Act (No.5) 2003

ATO references

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