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Committee Secretary
Senate Standing Committee on Economics
Department of the Senate
PO Box 6100
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CANBERRA ACT 2600
AUSTRALIA

11 October 2018

SUBMISSION TO SENATE STANDING COMMITTEE ON ECONOMICS - Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018; Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2018; Income Tax Rates Amendment (Sovereign Entities) Bill 2018

Global Infrastructure Partners (**GIP**) welcomes the opportunity to make a submission to the committee in relation to the proposed changes to taxation of stapled securities, foreign superannuation funds and sovereign wealth funds.

<u>About GIP</u>

GIP is one of the world's largest independent infrastructure fund managers. GIP [redacted] manages high-profile infrastructure investments across many OECD and emerging market geographies.

GIP's client base is largely made up of global pension and sovereign wealth funds, including many from Australia [redacted].

Some of GIP's current and former investments include:

- Port of Melbourne
- Port of Brisbane
- Pacific National

[redacted]

- Gatwick Airport
- Edinburgh Airport
- London City Airport
- Naturgy
- Freeport LNG
- Hess Midstream Partners
- Vena Energy

GIP established an on the ground presence in Australia during 2008 and [redacted]. GIP has led some of the largest and most complex transactions in the Australian

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infrastructure space in recent years including the 50-year lease of the Port of Melbourne from the State of Victoria and the break-up of Asciano Limited into its constituent rail (Pacific National) and ports (Patricks and Linx) businesses.

GIP has also raised one of the largest ever funds dedicated solely to investment in Australian infrastructure [redacted]. Port of Melbourne was the first investment through this fund.

Since 2010, GIP (on behalf of itself and managed clients) has invested [redacted] in the Australian infrastructure market (much of which flowed directly to State Governments). [redacted]

GIP's Previous Submissions to Treasury in relation to the Stapled Structures Package

GIP has made a number of submissions to Treasury over the last 18 months in relation to the issues identified in the stapled securities integrity package.

Broadly, GIP is supportive of targeted integrity measures where existing investments that have been made under pre-existing rules (which were at the time heavily endorsed by various levels of governments) have their valued preserved. To that end, GIP welcomes the partial grandfathering provisions that are included in the legislation – although we would have liked to have seen the transitional timeframes extended further given the long-dated nature of infrastructure investment.

GIP made a submission to Treasury in relation to the exposure draft of the legislation seeking, amongst other matters, to:

[redacted]

- Seek clarification of the impact of the proposed legislation on the tax rates of *clients (i.e. beneficial owners)* of *managers* in circumstances where managers had aggregated client interests in pooled vehicles or entities

None of our suggestions appear to have been taken up in the draft Bill which sits before the committee.

Our concern lies not with the fundamental policy that the legislation seeks to address (i.e. reforming the taxation of stapled securities, related party debt deductions, foreign superannuation funds and sovereign wealth funds), but with a seemingly unintended consequence of the *drafting* of the legislation which has material adverse consequences for fund managers (as set out below).

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Detrimental Impact on Fund Managers of Certain Elements of the Proposed Changes to Taxation of Foreign Pension and Sovereign Wealth Funds

There are two fundamental problems with the proposed bill that impact on the efficiency and viability of the funds management sector. These are:

- The adverse consequences arising from the testing of the portfolio interest at the first level of investment in Australia
- The adverse consequences arising to fund managers from the aggregation of common managed stakes for the purposes of the influence test

Adverse Consequences Arising from Test Entity Being "First Level" of Investment

The explanatory memorandum seems to require that all portfolio interest and influence testing (in respect of the foreign superannuation fund and sovereign wealth exemptions) is undertaken at "the first level of...investment in Australia" (or in the case of a foreign superannuation fund who invests in a pooled trust, at the level of that pooled trust – see Explanatory Memorandum at para 3.13). This unfortunately conflates the interest that an investor may have in an onshore holding or pooling vehicle as distinct from its look-through ownership interest in an underlying asset (which could be materially lower). For example, if a sovereign entity owned 50% of the units in an Australia unit trust (which we will assume is a MIT managed by a third party fund manager) and that MIT, in turn, owned 5% of an underlying infrastructure investment, the sovereign entity would fail the portfolio interest test, even though its look-through interest in the underlying investment is only 2.5%. In other words, the legislation seems to implicitly force sovereign and foreign superannuation fund entities to invest directly in underlying assets in order to ensure being able to meet the portfolio interest test.

Otherwise, the circumstances of the investment holding structure (including the uncontrollable relativities of other investors in a pooled vehicle) determines your tax status. This is unacceptable.

Effectively requiring all foreign investors to invest directly conflicts with a number of key commercial objectives of foreign superannuation and sovereign entity clients of fund managers including:

- **Many "funds" would cause their clients to fail the portfolio test** – The reality is that many traditional "funds" in Australia adhere to a version of the 80/20 rule – a minority of investors by number (typically large global institutional investors) supply the majority of the capital by value. This results in a situation where it is unlikely that a managed pooled vehicle would have not a single investor with a >10% equity interest in the fund (as distinct from a look through interest in the underlying asset). In other words, Example 3.3 in the explanatory memorandum is not a reflection of the practical reality of investors' pooled interest distribution. In that example, an investor with 2/3 of the capital of Aus Trust would have a look through interest of 10% in the underlying Portfolio Investment Co –fair enough that, in that case, they fail to qualify. But if they had anything greater than 10% and less than 2/3 – say 15% - of Aus Trust they would fail the test, even though their look through interest is well below the threshold.

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- **Efficiency and simplicity of structure** – should all otherwise pooled investors be forced to invest directly to retain their tax status, ownership at the level of the underlying investment would be highly fragmented and complex to administer. This is generally not acceptable to consortium equity partners given the impact of administrative complexity and cost. Most asset management teams and administrative systems are not equipped to deal with this level of administration – in fact, a smaller ownership group is one of the traditional benefits of private unlisted ownership. The fund administration industry exists to undertake this task on behalf of fund managers.
- **Confidentiality** – a direct investment will require disclosure of the investor's identity to other investors in the underlying vehicle (and potentially become ascertainable through public register searches to the extent the underlying vehicle is a company).
- **Expense allocation and remuneration** – a pooled fund provides a common charging point for fund expenses and fund manager compensation. Should all investors hold direct interests, billings and expenses must be issued individually to clients (rather than to the fund as a whole). This is grossly inefficient.
- **Financing** – pooled fund structures provide superior access to third party debt financing at the fund and holding entity level (i.e. above the underlying asset) for investors. Should investors be required to invest directly, it would diminish their ability to access efficient financing as the complexity of ownership structures and lack of a pooled vehicle would dissuade third party lenders.

In essence, a pooled fund structure minimises the costs of asset ownership for underlying investors who cannot cost-efficiently or easily manage direct interests – this is particularly the case for smaller investors. Destroying the utility of pooled funds would act as a disincentive to investment for smaller foreign institutional investors to invest in Australia and erode foreign investor confidence.

Adverse Consequences Arising From "Pooled Governance" Denying Tax Advantages to Clients

Proposed new subsections ITAA1936 128B(3CD)(a)(ii) and ITAA1997 880-105(6)(a)(ii) extend the Influence Test to circumstances where the relevant foreign pension fund or sovereign wealth fund "acting in concert with others, is directly or indirectly able to determine... the identity of at least one of the persons who, individually or with others, make... the decisions that comprise the control and direction of the...entity's operations".

Example 4.7 in the Explanatory Memorandum provides that where a fund manager has aggregated (under common *management*, not *ownership*) ownership stakes of clients that individually would not contravene the Influence Test (and so would otherwise be eligible for the exemptions), the exemptions would be lost solely on account of the common management.

This is a highly deleterious and, we hope, unintended consequence of the overall package. The implication of interpreting the "acting in concert" provision in the manner suggested by Example 4.7 would be to provide an insurmountable disincentive for clients to appoint managers to manage their interests in circumstances where that manager has (or is likely to have) an aggregate *managed interest* in an asset at a level which permits some participation in genuine governance.

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This element of the proposed legislation would create a number of disadvantages and potential costs that are damaging to fund managers and clients:

- **Disincentive to Appoint Managers:** The fundamental concern arising from the draft legislation is that foreign superannuation and sovereign wealth fund clients are now dis-incentivised to appoint managers in circumstances where that appointment may cause a change in their tax position. This is extremely damaging to the active and control-oriented local funds management industry which has traditionally pooled underlying clients to achieve thresholds of governance that permit active management of assets (e.g. material business vetoes and board appointments). Fund managers play an important role in providing access to infrastructure on behalf of smaller and more passive global investors who cannot access the Australian market directly.

  This is distinct from situations where foreign institutional investors *in their own right* have consciously taken such governance positions (e.g. certain global institutional infrastructure investors such as ADIA, GIC, BCIMC, CPPIB, OMERS and CdPQ which have taken substantial direct ownership stakes in Australian infrastructure assets in recent years).

  The smaller global clients managed by fund managers will simply cease to invest in Australia as they do not have the resources or scale to establish a direct presence – they must use a manager. This is extremely damaging to the Australian funds management industry as foreign capital is the key source of funding given the "closed" nature of the majority of the Australian funds management industry (the available capital for unlisted infrastructure within Australia is primarily either internally managed (e.g. AustralianSuper) or managed by captive vertically integrated entities (e.g. IFM which is owned by several dozen of Australia's largest industry superannuation funds)).

- **Existing Fund Structures May Not Be Compliant:** Existing fund structures may provide certain customary and limited rights to investors – e.g. rights to be appointed to an advisory board of a fund that may need to be consulted for certain major fund actions (e.g. related party transactions or bridge financings). It is not clear whether these rights contravene the Influence Test. It would be highly problematic if the consequence of the Influence Test was to require Australian fund managers to employ off-market / globally incompatible terms in respect of clients in order to preserve their existing tax arrangements.

- **"Acting in Concert" is Too Broad a Test**: The "acting in concert" test is too broad and vague as drafted. The provision should be directed to circumstances where related parties are genuinely acting together or are genuine associates in relation to an underlying entity. There are two obvious material problems with the wording as drafted:
  - First, it should not apply to *managers* of stakes. This is recognised, for example, in the Corporations Act which has (in section 16(1)(a)) a specific exclusion from associateship in circumstances where "one gives advice to the other, or acts on the other's behalf, in the proper performance of the functions attaching to a professional capacity or a business relationship". The legislation should make it clear that merely because a party *manages* an interest on behalf of another, neither the manager is associated with the underlying client, nor are commonly managed clients associated with each other for the purposes of the acting in concert test.

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- Second, there are clear practical limitations of how this operates in the context of traditional consortia and post-acquisition governance arrangements. In future, there will be significant herding of investor equity interest at just below the 10% threshold. There are many technical and practical issues that arise in analysing customary shareholders agreements against the new law. This increases cost and uncertainty. Does the mere entry into a shareholders agreement that provides for the possibility of governance rights (e.g. on a springing basis) contravene the Influence Test? Who can constitute the board or governing organ of a body in a circumstance where 11 investors each hold less than 10% and none of them have any director appointment rights?

Our Recommendation

We would propose that the legislation be amended to clarify several essential matters:

1. The application of the portfolio interest test should be measured at the look-through level of an underlying asset, not the "first level of investment" into Australia. This will ensure that investors' actual interests in assets are tested and they are not victims of the collateral circumstances of their particular holding structure (which are likely outside of their control). This will also permit investors to continue to invest via pooled vehicles and will not drive an incentive to fragment otherwise pooled investors into inefficient and costly direct holdings.

   We believe this can be legislated by providing that any tax transparent structures are to be ignored for the purposes of the portfolio interest test until one reaches the "source" of the relevant income that is subject to the potential exemption. This "source" should be the "test entity" for the purposes of the exemption.

2. The application of the Influence Test should also be measured at the look-through level of an underlying asset. This prevents otherwise benign and customary pooled fund terms causing an investor to lose their tax status.

   To address the above points there should be clear legislative guidance that the "test entity" should be the first level of investment that is not an externally managed pooled fund (or subsidiary thereof). One suggestion might be as follows (as applicable to foreign superannuation funds, similar amendments would be required for proposed subdivision 880-C in relation to sovereign wealth funds and relevant examples in the explanatory memorandum):

   Amend subsection 128B(3CB)

   (a) unless paragraphs (b) ***or (c)*** *apply~~ies~~ – the entity that paid the interest, dividends or non-share dividends as mentioned in subparagraph 3(jb)(ii);~~or~~*

   (b) ***subject to paragraph (c),*** *if subsection 128A(3) applies in relation to a resident trust estate (within the meaning of Division 6) – the trust estate; or*

   (c) if the entity which paid the interest, dividends or non-share dividends satisfies the following (a disregarded managed trust):

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(i) *the entity is a trust estate;*

(ii) *the entity is a managed investment scheme (within the meaning of section 9 of the Corporations Act 2001);*

(iii) *the person that operates or manages the entity is not an associate of the superannuation fund; and*

(iv) *the entity satisfies the licensing requirements in any of subparagraphs 275-35(1)-(3) of the Income Tax Assessment Act 1997; or*

(v) *the entity is a trust estate and is a wholly owned subsidiary of an entity which satisfies all of subparagraphs (i)-(iv) above; or*

(vi) *the entity is a trust estate and all of its beneficiaries are entities which satisfy either subparagraphs (i)-(iv) or (v) above, but only to the extent that for each entity relying on this subparagraph (vi), the person that satisfies subparagraphs (iii) and (iv) in respect of each other entity directly or indirectly satisfying subparagraphs (i)-(iv) or (v), is the same,*

then the test entity will be the first entity in a chain of ownership or beneficial interests which is itself not a disregarded managed trust and is either

(vii) *a resident trust estate (within the meaning of Division 6); or*

(viii) *the entity that paid the interest, dividends or non-share dividends as mentioned in subparagraph 3(jb)(ii)*

3. Finally, the legislation should positively exclude the role of *managers* from generating any application of the Influence Test. This can be achieved by utilising conceptual language analogous to that in Section 16 of the Corporations Act. A possibility is presented below:

Insert after subsection 128B(3CE):

(3CF) A superannuation fund does not have influence of a kind described in subsection (3CD) where it has appointed a third party fund manager (who is not an associate of or controlled by the superannuation fund) to give it advice, or to act on its and other investors' behalf, in the proper performance of the functions attaching to a professional funds management capacity and that third party fund manager has influence of a kind described in subsection (3CD).

Consequential amendments would be required to the proposed subsection 880-105 in relation to sovereign wealth funds and to Example 4.7 in the Explanatory Memorandum to make it clear that in those circumstances the investors SWF and SFFR would retain their eligibility for their respective tax exemptions.

We welcome the opportunity to have provided these comments.

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Should you have any further questions in relation to any element of the attached, feel free to contact [redacted]

Yours Sincerely

[redacted]

Global Infrastructure Partners Australia