Greenwoods & Freehills

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Matter 103353

Dear Mr Silver-Thomas

QR User Funding Agreements

The purpose of this letter is to set out at a high level certain Australian income tax-related concerns relevant to the current drafting of the QR User Funding Agreements. In particular, this letter summarises the following for the Queensland Resources Council (**QRC**):

- concerns with the tax indemnity included in the 'QR Contractor' model proposed in the current draft of the QR User Funding Agreements;
- advantages of the 'Direct Construction Contract' model; and
- the appropriate manner for dealing with QR Network Pty Ltd (**QR Network**) when adopting alternative terms to the standard terms of the Construction Agreement.

All references in this letter to 'QR Network' should be read to include the head company of any tax consolidated group of which QR Network is a subsidiary member.

1 QR Contractor model

1.1 Summary

In summary, the QR contractor model creates an unreasonable tax-related risk for Funding Users in that the Funding Users may have to compensate QR Network as a result of QR Network not being able to obtain a specific income tax treatment of its construction costs.

This is discussed in further detail below.

Importantly, even if this risk does not materialise at the time of entry into the Construction and Participation Agreements, it is possible that the risk could materialise at a later point in time due to changes to the tax laws or the Australian Taxation Office's (**ATO**) interpretation of it.

1.2 Application of IT 2450

At present the draft Construction and Participation Agreements reflect the 'QR Contractor' model. Under this model it is intended, by QR Network, that QR Network will be entitled to treat the profit that arises under the Construction Agreement in accordance with ATO ruling IT 2450. IT 2450 addresses the income tax treatment of long-term construction contracts. We understand that QR Network intends to have this income tax outcome confirmed by applying for a private ruling from the ATO (although it is not entirely clear based on discussions to date at what point in time QR Network intends to apply for that private ruling).

Whilst the ATO's acceptance of this income tax treatment is technically a risk for QR Network rather than the Funding Users, QR Network's view that it should not be exposed to any tax risk whatsoever has meant that QR Network's tax risk becomes the Funding Users tax risk. Based on discussions with QR Network and its representatives we understand that QR Network considers there to be relatively low risk that it would not be entitled to adopt the treatment set out in IT 2450. However, QR Network's stated intention to obtain a ruling from the ATO on the matter indicates that the position is certainly not free from doubt.

In our experience, QR Network's position on tax risk is very unusual. Specifically, whilst we agree it is normal market practice to seek:

- to minimise tax risk associated with transactions; and
- tax indemnities from other parties to the transaction to protect against exposure to tax liabilities of (i) those other parties or (ii) to periods prior to the transaction,

it is quite rare for a party to not accept any tax risk whatsoever in a transaction where it stands to profit from that transaction.

Under the QR Constructor model, the User Funders will effectively bear the tax risk twice in respect of a single payment – first, the User Funders will bear the tax risk regarding the treatment of their own payments made to QR Network[1]; second, the User Funders will bear the tax risk regarding the treatment of subsequent payments made by QR Network to the constructors.

For this reason, a Direct Construction Contract model (discussed below) is preferred. The Direct Construction Contract ensures that

- the User Funders do not bear the tax risk in relation to QR Network's expenditure, and
- QR Network does not bear any tax risk in respect of the construction costs, without the need of a tax indemnity.

This should result in an efficient alignment of the tax risks with the commercial substance of the transaction.

Nevertheless, as QR Network is insistent on that position it becomes critical for the Funding Users to minimise the tax risks to which QR Network is technically exposed. Furthermore, as QR Network's position is that it should not be exposed to tax risk at any time, it is important to recognise that the optimal structure may change over time as the tax law (and the ATO's interpretation of it) changes.

1.3 Applying for a ruling from the ATO

As noted above, QR Network will apply for a private ruling from the ATO on the expectation that the ATO will confirm the appropriateness of treating income and expenses under the Construction Agreement in accordance with IT 2450. However, the manner in which QR Network will approach the ATO, the timing of that approach and the contents of any submission are not clear.

Given that the Funding Users are expected to provide an indemnity in the event the ATO ruling does not support QR Network's position, it is reasonable for the Funding Users to have input into this process and that QR Network commits (in the undertaking) to a course of action acceptable to the Funding Users. In our view, it would be unreasonable to expect the Funding Users to effectively assume the tax risk without any input into the manner in which the risk is addressed.

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[1] Generally speaking, the User Funders will seek to be entitled to deductions over time under Division 40 of the *Income Tax Assessment Act 1997* (Cth).

Furthermore, in the event an unfavourable ruling is issued from the ATO or a favourable ruling is obtained but it subsequently ceases to apply for any reason, QR Network should be compelled to consider alternative structures that may achieve effective outcomes for Funding Users. This is a reasonable approach where a tax indemnity is in place and the Funding Users are asked to bear the tax risk.

2 Direct Construction Contract model

2.1 Summary

Under the Direct Construction Contract model, the Funding Users would engage the relevant third party builders, engineers etc directly rather than through QR Network. Under this model, QR Network could incur those third party costs as agent for the Funding Users. Rather than receiving a construction profit, QR Network would be paid a fee for managing and supervising the overall construction. QR Network would also grant a non-exclusive licence to the Users to access the track.

By adopting this model, the tax-related risks for Funding Users are significantly decreased because:

- there is no risk borne by either the Funding Users or QR Network in respect of construction costs incurred by QR Network, since QR Network will only incur those costs as agent (if at all); and
- Funding Users will be able to manage their own tax risks with respect to the extension costs paid to QR Network.

These outcomes are discussed in further detail below.

2.2 Management and supervising fee received by QR Network

The income tax treatment sought by QR Network under the QR Contractor model is aimed at ensuring QR Network is assessed on the net receipts under the Construction Agreement. However, as highlighted by the need for a ruling from the ATO regarding the treatment in accordance with IT 2450, there is a risk (borne by the Funding Users) that this net outcome will not be achieved.

Under the Direct Construction Contract there is no such risk. It is clear that the management and supervising fee received by QR Network (akin to the net receipts under the Construction Agreement) will be assessable in the hands of QR Network.[2]

Therefore, the income tax treatment for QR Network under the Direct Construction Contract model reflects the intended income tax treatment for QR Network under the QR Contractor model, but without creating the tax risks.

Further, we would not expect QR Network to require a ruling from the ATO confirming this treatment. Removing the ruling process should allow a more timely investment by Funding Users than the QR Contractor model, since the existence and scope of the proposed indemnity in the QR Contractor model may act to delay execution of the Construction Agreement by a Funding User until such time as QR Network obtains the ATO ruling for the project.

2.3 Extension costs incurred by Funding Users

The income tax treatment of the construction costs incurred by the Funding Users will remain the concern of the Funding Users, even where QR Network incurs the construction costs as agent for the Funding Users.[3] As a consequence the tax risk in respect of the construction costs lies with the Funding Users, negating the need for a tax indemnity in the Construction Agreement.

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[2] Section 6-5 of the *Income Tax Assessment Act 1997* (Cth).

[3] Generally speaking, the User Funders will seek to be entitled to deductions over time under Division 40 of the *Income Tax Assessment Act 1997* (Cth).

Ultimately, this result means that the User Funders are not being asked to bear additional tax risk in respect of the treatment of costs incurred by QR Network (i.e. there is no ‘doubling-up’ of the risk for User Funders).

3 Alternative terms to be negotiated with QR Network

As noted above, it is possible that tax laws and the ATO’s interpretation of them may change over time. This necessarily means that the most tax efficient structure could change over time. This is the case whether the model initially used is the QR Contractor model, the Direct Construction Contract model or some other model. We therefore recommend that QR Network be compelled to negotiate in good faith with the Funding Users in relation to the optimal funding structure to be used in respect of future rail infrastructure funding. Those good faith negotiations should have regard to the commercial effectiveness and tax efficiency of both QR Network and the Funding Users.

In other words, the model that is ultimately determined to be the preferred model during the current negotiations should not be taken to be the one and only funding model going forward.

Yours sincerely

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