

The impact of additional borrowings

We think the submission's analysis of the operation of the thin capitalisation rules is broadly correct except for two material matters:

- There is an assumption (on page 9) that 85% of total tax paid was Australian tax. If there was foreign tax paid, then in our view it must be highly likely that there will be a corresponding level of foreign assets and for consistency it should likewise be assumed that only 85% of all assets are Australian assets. This alters the thin capitalisation safe harbour calculation so that the maximum allowable debt level is \$58 billion (75% of \$77 billion).

Additional tax deductible debt is therefore \$43 billion (the existing debt was \$15 billion) which, at 8% creates additional deductible interest of \$3.4 billion per annum. We suggest this figure is more likely to be a correct estimate than the \$5.4 billion on page 15 of the submission, which fails to account for foreign assets and appears to overlook the existing debt of \$15 billion.

- While the major source of private equity financing is likely to be foreign, we do not accept that all of it would be. To the extent that additional borrowings are Australian sourced there would be an offsetting revenue gain in respect of interest received by those lenders, with a corresponding reduction in the net revenue impact. The CTA is not aware of any data in this area, but using what we consider to be a conservative estimate of 10% Australian sourced debt would reduce the additional interest impact by \$340 million p.a.

We estimate the net additional interest claims as totaling \$3.06 billion p.a. At 30% that represents tax of \$918 million p.a. or \$4.6 billion over a five year period.

Improved profitability

Broadly, the objective of private equity investment is to manage the target company without the distractions and short-term pressures of the listed environment which, together with a better alignment of the incentives for managers and owners, enables long-term changes to be made to the business that are likely improve its profitability over time. There will be some failures as well as successes over the broad spectrum of transactions, both in Australia and overseas, but improving profitability is what underpins the business model.

Accordingly, it is in our view not unreasonable to factor in a modest improvement in taxable earnings. Using the \$5.8 billion EBIT figures outlined on page 12 of the submission, and assuming 85% of that amount is attributable to Australia (\$4.95 billion), a 15% improvement in Australian taxable profits would come to \$740 million p.a., or \$220 million p.a. in additional Australian tax.

Over a five year period, the positive revenue impact arising from improved profitability at the entity level is estimated as \$1.1 billion.

Gains accruing to shareholders in the target company

In the CTA's view, the up-front revenue gain arising from profits realised by shareholders in the target company, while difficult to quantify precisely, is material and should be reflected in the analysis in some fashion.

We think the submission is incorrect in regarding only the amount of the take-over premium as representing the additional gain. We believe what is relevant in the analysis is the entire gain on the sale of shares into the private equity bid, worked out as the difference between the estimated average purchase price and the selling price. The basis for this view is that the transaction unlocks all at once both pre and post bid unrealised gains on shares which might otherwise have been held for many more years – particularly in the case of long-term investors.

The submission also asserts the premium gains are only a timing issue, as “a premium may only pre-empt the movement in the share value of that company” (at page 18). In our view, this suggestion is sharply at odds with recent corporate history. The Qantas board and senior management have consistently expressed their frustration about the failure of capital markets to properly value their company. We would suggest that it was only the private equity bid that ignited the Qantas share price, and while that bid is now off the table, market analysts consider it continues to set a floor under the share price going forward because of expectations about further bids. Given ongoing perceptions about poor business performance, it must be highly unlikely the Coles share price would be much above \$10 today absent the earlier private equity bid. These are necessarily suppositions – however, we submit they are more likely to be correct than those upon which the submission is based.

We believe the submission correctly raises the potential loss of future capital gains during the period of private equity ownership. However, we consider that those gains would be rather less than the up-front gains actually realised (ignoring the time value of money). This is firstly because such gains would crystallise much more slowly and they would be smaller. Many long-term shareholders would not be realising any gains in the normal course of events (or at least not within a timeframe that is relevant to this analysis). Secondly, the share price is unlikely, for the reasons outlined in the previous paragraph, to approach the levels brought about by the private equity bid. It would be appropriate to reduce the amount of the up-front gain by a factor which reflects foregone future gains, which is what we have done in the calculation below:

Average buy-in price (say, 60% of current price of \$65 billion)		\$39 billion
Sale price		<u>91 billion</u>
Gains by shareholders		\$52 billion
Foreign s/holders (assume 40%)	\$20.8 billion	exempt
Super funds (assume 30%)	\$15.6 billion	15% on 2/3 rd gain ¹
Individuals (assume 30%)	\$15.6 billion	25% on 1/2 gain

¹ The submission suggests that super funds have a much lower actual rate of tax than the statutory rate of 15% because of franking credits. In our view, that notion is incorrect because the tax impact of the discounted capital gains will be no different whether they create a net tax liability in their own right or reduce what would otherwise have been a refund of franking credits.

Tax paid by super funds	\$10.4 billion @ 15%	\$1.56 billion
Tax paid by individuals	\$7.8 billion @ 25%	<u>1.95 billion²</u>
Total up-front tax on disposal by Australian shareholders		\$3.51 billion
Less: future CGT gains foregone (say 1/3 rd)		<u>1.17 billion</u>
Net tax from disposal		<u>\$2.34 billion</u>

No doubt the CTA's analysis can be criticised on the basis of the assumptions used. We consider they are conservative, but some may argue the average buy-in price should be higher, or the adjustment for future gains foregone should be greater. On the other hand, others may consider we have been unduly conservative.

Whatever the precise answer, we consider it is highly likely that the up-front gain to the revenue from gains arising on the disposal of the shares in the target company is at least in the order of \$2 billion, and probably somewhat higher.

² In the case of both super funds and individuals, the CTA analysis assumes that all of these taxpayers are entitled to the capital gains tax discount. That is unlikely to be the case, as the discount is only available where the shares have been held for at least 12 months. This means our estimate of the revenue gain is conservative.

The reinvestment effect

As pointed out in a number of other submissions³, the proceeds from any private equity transaction generally need to be invested elsewhere. Of the \$91 billion sale price, some \$55 billion ends up in the hands of Australian super funds and individuals (60% of \$91 billion). We suggest that most of this money is likely to remain as part of the Australian tax base – that is to say, it will be reinvested elsewhere so that in one way or another it will generate additional tax revenue, through interest returns, by investing in new businesses or by bidding up the price of existing businesses.

It is very difficult to model the tax impact of these thousands of individual investment decisions. As in the case of the gains on disposal, however, we consider the impact on the tax base from the reinvestment of such a large capital sum to be material and as such should not be ignored.

- Assume that of the \$55 billion coming back to Australian investors, 90% is reinvested in Australia – i.e. \$49.5 billion⁴, split equally between super funds and individuals (i.e. 24.8 billion each).
- Assume the average return on these investments is 6%.
- This rate of return would therefore produce taxable income of \$1.5 billion p.a. for both super funds and individuals.
- Applying a 15% rate for funds and an average rate of 25% for individuals results in a revenue gain of \$600 million p.a., or \$3.0 billion over five years.

Once again, the assumptions used may be open to challenge, but the reinvestment effect will clearly have a significant positive revenue impact and should be considered in the analysis.

³ Ernst & Young, para 4.2 on page5

⁴ In fact, much of the \$36 billion returned to foreign investors may find its way back into Australian capital markets, given the country risk weightings that many overseas fund managers employ. This will bid up the price of Australian equity to some extent, although no attempt has been made to measure that.

Other factors

There are a number of other factors which we have not attempted to measure explicitly, but which we consider would have an additional positive revenue impact. These are the following:

- A number of significant private equity bids which have not in the end gone ahead will create significant up-front revenue gains, but without the negative impact of higher gearing. Qantas and Coles are two that come to mind, and there could be others in the future.
- Not every private equity investor is a non-resident, and any Australian based private equity investors would be subject to Australian tax on exit.
- Not all foreign debt used to finance will be exempt from interest withholding tax of 10%.
- If the private equity investment has been successful in improving long-term profitability, the target company will continue to generate higher income tax payments after exit and re-listing.

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