CORPORATE TAX
ASSOCIATION
of Australia Incorporated

27th April 2007

Mr Peter Hallahan
Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Mr Hallahan,

Inquiry into Private Equity Investment

The Corporate Tax Association (CTA), which represents the taxation interests of some 120 of the largest corporate groups in Australia, welcomes the opportunity to make this brief submission to the Senate Economics Legislation Committee in respect of its enquiry into private equity investment.

While the inquiry's terms of reference cover a number of relevant aspects of private equity investment, the CTA's submission only addresses item (c):

"an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects"

The only broad observation we would make in relation to the remaining four terms of reference is that we see no obvious policy grounds for government policy favouring or discouraging one form of ownership over any other in the absence of clear evidence of market failure.

Capital gains tax impact of acquisition

The acquisition of the shares in the target company through the private equity bid triggers off a capital gain in the hands of the shareholders. Because all of the shares are acquired in a successful bid, and the price is generally at a significant premium over the pre- bid price, the amount of the capital gain is generally very large.

While capital gains in the hands of individuals are taxed at a 50 per cent discount, and shares owned by non-residents are not generally subject to Australian tax, there is clearly a significant revenue windfall as a result of a successful bid – a windfall that would not arise but for the private equity investment.

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Interest deductions

It is understood that there are concerns about the high level of gearing that is often a feature of private equity investment, both in Australia and elsewhere. Putting to one side the source of the debt used to acquire the shares (if the lenders are Australian residents there may not be any net impact on revenue), it is possible that during the period of private equity ownership the target company will have a higher level of debt than would otherwise have been the case.

Under general principles, interest on borrowings used to acquire income producing assets is tax deductible. However, Australia's thin capitalisation rules place a limit on the extent to which a company can be geared. Exceeding the permitted gearing levels (there is a safe harbour ratio of 3:1) results in the disallowance of interest deductions. There are also debt/equity rules which ensure that instruments that provide an equity like return cannot create interest deductions. These two regimes have been in place since 2001, and taken together represent an effective and appropriate policy framework to prevent revenue losses through excessive gearing.

While the increased interest deductions that could arise under some private equity investments may have a net negative impact on revenue when looked at in isolation, it is thought that in most cases the total revenue loss over the period of private equity ownership (generally from three to five years) would more or less balance out against the initial capital gains tax windfall that arises on acquisition.

Improved long-term profitability

Where the business objectives of the private equity investors are met, and the underlying profit structure of the company is improved over the period of private equity ownership, the re-listed company (with more "normal" debt levels) will produce a higher level of company income over the long-term, so that the overall revenue impact is likely to be positive.

Capital gains tax position of non-resident private equity investors

The passage of Tax Laws Amendment (2206 Measures No 4) Bill 2006 late last year effectively places investments by non-residents in Australian companies outside the scope of Australia's capital gains tax regime. The main exception to this carve-out are investments in Australian companies that own underlying significant real property, which is expected to impact mainly on the mining, petroleum and property industries. At the same time, integrity measures were introduced to catch arrangements involving interposed entities. As a package, these measures have placed Australia in a similar position as other developed countries and should be a positive factor in attracting investment into Australia. That was the conclusion reached by this Senate Committee when it enquired into the Bill last year, and we respectfully submit that was the right conclusion.

It has sometimes been said that these changes have at least contributed to a number of recent large private equity bids for major Australian companies, and that the new rules confer an unfair advantage on foreign based private equity investors.

What such comments overlook is the fact that even without last year's non-resident capital gains tax changes, most foreign based private equity investors would have been outside the Australian tax system by virtue of the business profits article of the relevant tax treaty. That is to say, foreign investors that are engaged in an active business of acquiring and on-selling businesses are taxed in their own jurisdiction under Australia's major tax treaties.

It is considered highly unlikely that the private equity bid for Coles Myer, for example, would have been influenced in one way or another by the passage of last year's Bill, and we note that press reports about that bid were surfacing well before the measure was announced. Naturally, any resident private equity investors would be subject to Australian tax on any profit arising from the eventual disposal of the company.

Conclusion

While it would no doubt be prudent for the government to keep the taxation and other aspects of private equity investment under review, it seems unlikely that there will be an overall adverse revenue impact arising from these activities.

The existing tax rules governing interest deductibility in our view represent an appropriate cap on the potential impact of excessive gearing, and such impact should in any event be outweighed by the combined effect of the initial capital gains tax windfall as well as the longer term improved profitability of the re-listed company.

The fact that some non-resident investors may not pay tax on their ultimate gain is, in our submission, not relevant to the private equity discussion.

Please feel free to contact the writer on (03) 9600 4411 if the Committee would like any further clarification on any of the matters raised.

Yours sincerely,

Frank Drenth

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Corporate Tax Association