4 May 2007

The Secretary
Senate Standing Committee on Economics
P O Box 6100
Parliament House
Canberra ACT 2600

Members of the Senate Standing Committee on Economics:

Inquiry into private equity investment

This is my submission made in response to your letter to me dated 16 April 2007, in which you invited my submission for consideration by you in your inquiry into private equity investment.

This submission addresses aspects of only a single term of your terms of reference for your inquiry into private equity investment. That term is:

> (c) an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects.

This submission does not address the other terms of those terms of reference, as I do not possess the competence to address those other terms.

This submission is set out on the pages which follow, which include, at the beginning, a table of contents, and then a summary.

I am happy to provide, in the future, any further information you may require in relation to this submission.

The responsibility for this submission is exclusively mine.

Yours truly

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Summary

This submission addresses aspects of only a single term of the terms of reference of the Senate Standing Committee on Economics for that committee's inquiry into private equity investment. That term is:

> (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 Australian tax addressed in this submission is income tax. What is colloquially referred to in Australia as "capital gains tax" is, strictly, part of Australian income tax.

A loss of Australian income tax revenue may result, in relation to private equity investment, due to interest income derived by a lender that is not an Australian tax-resident (which has provided debt capital to an Australian tax-resident investee company) being liable to Australian income tax (payable by that lender) at a rate not more than 10%.

A loss of Australian income tax revenue may result, in relation to private equity investment, due to any capital gain made by an entity that is not an Australian tax-resident from the sale of shares owned by that entity in an Australian tax-resident investee company, not more than 50% of the value of whose assets is attributable to Australian real property, not being liable to any Australian income tax (payable by that entity that is not Australian tax-resident).

A loss of Australian income tax revenue may result, in relation to private equity investment, due to any capital gain made by an entity that is not an Australian tax-resident from the sale of shares owned by that entity in an Australian tax-resident investee company being liable to any Australian income tax (payable by that entity that is not Australian tax-resident) only to the extent of 50% of that capital gain. That is so where that entity (that is not an Australian tax-resident) is an individual or a trust, which owned those shares for at least 12 months (before the sale of those shares).

That loss of Australian income tax revenue (as outlined in the three paragraphs just above), however, arises from a position which is the status quo that already obtains. That loss of Australian income tax revenue, therefore, cannot be attributed to private equity investment, as that status quo is not unique to private equity investment.

All else being equal, private equity investment, as it represents an ordering of affairs resulting from the operation of free market forces, should not be caused any interference by Australian taxes, if the criterion of economic efficiency were to be satisfied. The incidence of Australian taxes that already obtains, as applicable to private equity investment, I have assumed (without detailed inquiry), are taxes whose design was carried out with due regard to the necessity for satisfying economic efficiency.

I have not been able to identify any authoritative literature which demonstrates that private equity investment, despite it being an ordering of affairs resulting from the operation of free market forces, nevertheless, is the outcome of a "market failure",

which, therefore, warrants some form of government intervention, through taxes or otherwise.

How is private equity investment typically undertaken?

The following is an outline of how, typically, private equity investment is undertaken:

- A private equity manager forms a limited liability partnership ("LLP") to raise capital from investors. The LLP will have a limited life, generally, of about 10 years.

- The private equity manager, with respect to the LLP, prepares a prospectus, which will define the LLP's investment objectives, outline the private equity manager's credentials, and canvass the upside potential as well as the downside risks of the LLP's investment objectives.

- The LLP solicits capital from investors, through efforts of the internal investor relations function of the private equity manager, through external placement agents, or both.

- Investors are admitted to the LLP. The private equity manager, which will itself be an investor of the LLP, will be designated a general partner ("GP"), and the other investors will be designated limited partners ("LPs"). LPs will usually largely comprise institutional investors.

- The fund of the LLP comes into existence as at the time of "first close". That is, as at the time, the LLP receives the minimum capital it requires, as specified in the prospectus. The LLP will have a few "closes" subsequently, until it receives all of the capital it requires for fulfilling its investment objectives.

- The LLP will, after the "first close", proceed to invest in investee companies, but usually the extent of its investment in any one investee company will not exceed 10% of the LLP's total fund, so that a balanced diversification in investments is maintained by the LLP.

- Usually, an investment by the LLP will represent a controlling equity interest in the investee company, with that company's management also being issued equity interests in that company.

- Where the investee company is a listed company, on the LLP gaining control of that company, the company is delisted.

- In order to finance its investment any one investee company, the LLP will usually borrow capital to the extent of three to four times its equity investment in that investee company. On gaining control of the investee company, the LLP may seek a distribution (of capital, retained profits, or both) from that company so as to enable the LLP to repay those borrowings. The investee

company will then itself be made to borrow sufficient capital to replenish the capital it lost due to making that distribution to the LLP.

- The private equity manager will, usually within three to five years of the LLP gaining control of an investee company, seek to improve that investee company's performance through a range of restructuring measures. At the end of that period, the LLP will sell its equity investment in the investee company to a corporate buyer, another LLP, or to the public (through re-listing the investee company).

- The LLP may then distribute to its investors the capital they subscribed, as well as any capital gain made on the sale of the LLP's equity investment in the investee company. A greater share of any such capital gain is distributed the GP, and a lesser share to LPs. During the currency of the investment, the GP (in its capacity as the private equity manager) also derives management fees from the LLP's fund.

What Australian tax issues are relevant?

The only Australian tax addressed in this submission is income tax. What is colloquially referred to in Australia as "capital gains tax" is, strictly, part of Australian income tax. Other taxes imposed by the Commonwealth government, such as goods and services tax, and taxes imposed by State and Territory governments, such as duty, are not addressed in this submission.

Two questions are considered relevant, in relation to private equity investment, in the context of Australian income tax:

- Can the level of debt capital (that is, borrowed capital, in contrast to equity capital) an Australian investee company is made to carry due to private equity investment result in a significant loss of Australian income tax revenue?

- Can the return from private equity investment derived by way of a capital gain (from the sale of shares in Australian investee companies) result in a significant loss of Australian income tax revenue?

Both of those questions were addressed in my article, titled "There's a different way to view takeover concerns", which appeared on page 75 of *The Australian Financial Review* of 13 April 2007. In this submission, on the pages which follow, the arguments outlined in that article of mine, with respect to those two questions, are essentially restated, and the bases for those arguments explained in more comprehensive terms.

What is the overall conceptual basis of this submission?

The prevailing ideological orthodoxy in Australia is that taxes should be so designed that the incidence of those taxes should cause the least interference to the operation of free market forces. That ideal is commonly referred to as "economic efficiency", and is widely advocated in Australia as a criterion that any tax measure should necessarily satisfy.

I do not express any opinion on the soundness (or otherwise) of economic efficiency as a criterion that any tax measure should necessarily satisfy. I do, however, adopt, for purposes of this submission, economic efficiency as a criterion that any tax measure should necessarily satisfy, given that it is a criterion that represents the prevailing ideological orthodoxy in Australia.

Accordingly, all else being equal, private equity investment, as it represents an ordering of affairs resulting from the operation of free market forces, should not be caused any interference by Australian taxes, if the criterion of economic efficiency were to be satisfied. The incidence of Australian taxes that already obtains, as applicable to private equity investment, I have assumed (without detailed inquiry), are taxes whose design was carried out with due regard to the necessity for satisfying economic efficiency.

I have not been able to identify any authoritative literature which demonstrates that private equity investment, despite it being an ordering of affairs resulting from the operation of free market forces, nevertheless, is the outcome of a "market failure", which, therefore, warrants some form of government intervention, through taxes or otherwise.

Can the level of debt (that is, borrowed capital, in contrast to equity capital) that an Australian investee company is made to carry due to private equity investment result in a significant loss of Australian income tax revenue?

Is there a reduction of Australian income tax payable by a lender that is not an Australian tax-resident?

The debt involved in private equity investment can be either capital borrowed by the LLP or capital borrowed by the Australian investee company. This submission does not address the scenario where the borrower is the LLP. That is so as the LLP, in almost all cases, will not be Australian tax-resident, and, therefore, in that scenario, no significant Australian income tax consequences will ensue.

Where the lender of that borrowed capital is an Australian tax-resident, a loss of Australian income tax revenue cannot arise. That is so for the following reason. Where the borrower is the Australian tax-resident investee company, the borrower will claim the interest expenditure as tax-deductible (for purposes of Australian income tax). The same amount of interest, however, symmetrically, will represent assessable income of the Australian tax-resident lender. Therefore, on that interest income, Australian income tax will be payable by that lender, at a rate of 30%, where that lender is a company, after deducting any expenses incurred by that lender in relation to that interest income.

Where, however, the lender of that borrowed capital is not an Australian tax-resident, a loss of Australian income tax revenue may arise. That is so for the following reason. Where the borrower is the Australian tax-resident investee company, the borrower will claim the interest expenditure as tax-deductible (for purposes of Australian income tax). There is an asymmetry, however, in that that interest received by the lender will be liable to Australian income tax at a rate not more than 10% (a rate which, in some cases, may amount to 0%) of the gross amount of that interest (that is, the amount of that interest without deducting any expenses incurred by that lender in relation to that interest income).

The extent of that loss of Australian income tax revenue, however, cannot be attributed to private equity investment, as the status quo described in the paragraph just above is not a position unique to private equity investment—that status quo is a position that already obtains.

Accordingly, the extent of that loss of Australian income tax revenue, if it were to be quantified, can be quantified only hypothetically. Perhaps, the most reasonable hypothesis that one can adopt in the circumstances is the lender (which is not an Australian tax-resident) being subject to Australian income tax on the net income which the interest income derived (from the Australian tax-resident investee company) yields. That is, that interest income derived will represent assessable income of that lender. Therefore, on that interest income, after deducting any expenses incurred by that lender in relation to that interest income, Australian income tax will be payable by that lender, at a rate of 30%, where that lender is a company.

Whether that hypothesis, when compared with the status quo, will result in a lower quantum of Australian income tax revenue will turn on the extent of expenses incurred by that lender in relation to that interest income (from which those expenses can be deducted in order to arrive at the net income on which Australian income tax is payable). It is, therefore, conceivable that, under that hypothesis, the quantum of Australian income tax revenue that will result will not be significantly lower than that which results under the status quo. That is so as, in all likelihood, that lender will have incurred expenses in relation to that interest income.

In any case, implementing that hypothesised position may not be feasible, given that the status quo is underpinned by provisions in double tax avoidance treaties that Australia has concluded with other countries. And Australia may not find it practicable to readily renegotiate amendments to the respective provisions in those treaties.

Is there a loss of Australian income tax due to the level of debt of an Australian tax-resident investee company being too high?

As noted earlier, where private equity investment is involved, the Australian tax-resident investee company may be required to borrow capital to the extent of three to four times that company's equity capital. One may, therefore, contend that that level of debt (borrowed) capital may result in a loss of Australian income tax revenue. In order to evaluate that contention, one has to establish the yield of Australian income tax revenue that will result if the Australian tax-resident investee company was capitalised, not with debt capital, but with equity capital.

The return (accruing to the provider of capital) from equity capital is dividends. Dividends paid by an Australian tax-resident company is not deductible by that company in ascertaining its net income on which that company is liable to pay Australian income tax. Dividends can be paid by an Australian tax-resident company only out of its profits after the payment of income tax (that is, out of its after-tax profits). The rate of Australian income tax applicable to companies is 30%.

Where an Australian tax-resident company pays a dividend from its after-tax profits which have suffered income tax at 30%, that company can fully-frank that dividend. A fully-franked dividend received by an entity that is not an Australian tax-resident is not liable to any further Australian income tax payable by that recipient. Therefore, where an Australian tax-resident investee company is provided capital by an entity that is not Australian tax-resident, the overall Australian income tax revenue resulting from equity capital, in contrast to debt capital, is 30%, which is a yield much higher than 10%, which (as noted earlier) is the highest rate of Australian income tax that debt capital yields.

Therefore, capitalising an Australian tax-resident investee company with debt capital, in contrast to equity capital, where that capital is provided by an entity that is not Australian tax-resident, results in lower Australian income tax payable by that entity. That position, however, cannot cause a significant loss of Australian income tax revenue which can be attributed to private equity investment. That is so as that

position, which is the status quo, is not a position unique to private equity investment—that status quo is a position that already obtains.

Further, such a significant loss of Australian income tax revenue is avoided due to a suite of provisions, contained in the Australian income tax legislation, colloquially referred to as the "thin-capitalisation rules".

With respect to an Australian tax-resident investee company (that is not a bank), generally, the thin-capitalisation rules have the effect of denying a tax-deduction to that company (for purposes of Australian income tax) for interest expenditure to the extent that expenditure relates to debt capital of that company that is in excess of thrice that company's equity capital. Therefore, if an Australian tax-resident investee company (that is not a bank) were to be able to claim the entirety of its interest expenditure as tax-deductible (for purposes of Australian income tax), that company's level of debt capital should not exceed thrice the level of equity capital of that company.

That ratio of debt capital to equity capital of 3:1 is not materially inconsistent with the level of debt capital an Australian tax-resident investee company may be made to carry as a consequence of private equity investment.

What ensures the integrity of the argument that the level of debt capital an Australian investee company is made to carry due to private equity investment may not result in a significant loss of Australian income tax revenue?

Under the two preceding headings, I have essentially argued that the level of debt capital an Australian tax-resident investee company is made to carry (due to private equity investment) may not result in a significant loss of Australian income tax revenue that can be attributed to private equity investment. For that argument to be sustainable, it is critical that there is uniformity in the distinction between debt capital and equity capital for purposes of determining, in relation to Australian income tax:

- whether a return on capital is deductible interest expenditure, or dividends paid (which are potentially frankable);

- whether a return on capital is interest income (from which Australian income tax may have to be withheld), or dividends derived (from which, if those dividends are fully-franked, no Australian income tax can be withheld); and

- whether capital is debt or equity for purposes of the thin capitalisation rules.

That requisite uniformity in the distinction between debt capital and equity capital is ensured by a suite of provisions, contained in the Australian income tax legislation, colloquially referred to as the "debt/equity rules" that comprehensively cater for that distinction.

Can the return from private equity investment derived by way of a capital gain (from the sale of shares in Australian investee companies) result in a significant loss of Australian income tax revenue?

A capital gain made by an entity that is not an Australian tax-resident from the sale of shares in an Australian tax-resident company is liable to Australian income tax (payable by that entity which is not an Australian tax-resident) if more than 50% of the value of the assets of that Australian tax-resident company is attributable to Australian real property.

Accordingly, it is possible that, in the event, a capital gain made by a LLP (as a result of private equity investment) from the sale of shares held by it in an Australian tax-resident investee company may not be liable to any Australian income tax.

That failure to raise Australian income tax revenue, however, cannot be attributed to private equity investment, as that status quo is not a position unique to private equity investment—that status quo is a position that already obtains.

Further, where such a capital gain is made from the sale of shares in an Australian tax-resident company, more than 50% of the value of whose assets is attributable to Australian real property, if the entity (that is not an Australian tax-resident) making that capital gain were either an individual or a trust (but not a company), only 50% of that capital gain is liable to Australian income tax (payable by that individual or trust). That is so where that individual or trust owned those shares for at least 12 months (before the sale of those shares).

The position noted in the paragraph just above may have limited application, if any, to private equity investment, where the investor in an Australian tax-resident investee company will be an LLP (whose partners may not be individuals or trusts, but companies). If that position does, however, have application, the resulting loss of Australian income tax revenue cannot be attributed to private equity investment, as that status quo is not a position unique to private equity investment—that status quo is a position that already obtains.

Conclusion

A loss of Australian income tax revenue may result, in relation to private equity investment, due to interest income derived by a lender that is not an Australian tax-resident (which has provided debt capital to an Australian tax-resident investee company) being liable to Australian income tax (payable by that lender) at a rate not more than 10%.

A loss of Australian income tax revenue may result, in relation to private equity investment, due to any capital gain made by an entity that is not an Australian tax-resident from the sale of shares owned by that entity in an Australian tax-resident investee company, not more than 50% of the value of whose assets is attributable to Australian real property, not being liable to any Australian income tax (payable by that entity that is not Australian tax-resident).

A loss of Australian income tax revenue may result, in relation to private equity investment, due to any capital gain made by an entity that is not an Australian tax-resident from the sale of shares owned by that entity in an Australian tax-resident investee company being liable to any Australian income tax (payable by that entity that is not Australian tax-resident) only to the extent of 50% of that capital gain. That is so where that entity (that is not an Australian tax-resident) is an individual or a trust, which owned those shares for at least 12 months (before the sale of those shares).

That loss of Australian income tax revenue (as outlined in the three paragraphs just above), however, arises from a position which is the status quo that already obtains. That loss of Australian income tax revenue, therefore, cannot be attributed to private equity investment, as that status quo is not unique to private equity investment.

All else being equal, private equity investment, as it represents an ordering of affairs resulting from the operation of free market forces, should not be caused any interference by Australian taxes, if the criterion of economic efficiency were to be satisfied. The incidence of Australian taxes that already obtains, as applicable to private equity investment, I have assumed (without detailed inquiry), are taxes whose design was carried out with due regard to the necessity for satisfying economic efficiency.

I have not been able to identify any authoritative literature which demonstrates that private equity investment, despite it being an ordering of affairs resulting from the operation of free market forces, nevertheless, is the outcome of a “market failure”, which, therefore, warrants some form of government intervention, through taxes or otherwise.

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