
**THE TAKEOVER OF AUSTRALIAN COMPANIES
BY FOREIGN PRIVATE EQUITY FUNDS -
TAX ISSUES**

S U B M I S S I O N

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CONTENTS

1. Introduction
2. Overseas response to foreign private equity fund takeovers
3. Should interest on borrowings to fund a takeover be a tax deduction against earnings of the company taken-over?
4. Loss of \$1.2 billion each year in company tax after the takeover of a sample 5 Australian companies
5. Importance of tax collected from companies
6. Capital gains on sales by shareholders

Appendix "A" Thin Capitalisation Rules

1. Introduction

Throughout the world the takeover of local companies by foreign private equity funds is causing alarm.

A number of countries are urgently examining whether interest on borrowings to fund these takeovers should be a tax deduction against the earnings of the companies taken-over.

In this submission, we have sought to gauge the effect of the takeovers in Australia on tax collections by assuming that 5 ASX companies were taken-over by US private equity funds.

The 5 companies were:

- Coles Myer
- Tabcorp
- Woolworths
- Qantas
- Wesfarmers

In 2005-06 the Australian company tax collected from the 5 selected companies was \$1.2 billion. We estimated that if those companies were taken-over by foreign private equity funds no company tax would be payable - a reduction in company tax collected of \$1.2 billion per annum.

The greater the number of Australian companies taken-over, the greater the loss of tax.

The loss of tax collected occurs because market equity is replaced by a mixture of highly leveraged foreign debt and equity. Interest on the debt is a tax deduction against the earnings of the companies taken-over.

We consider that no Australian government can risk losing this tax.

In our submission there is an urgent need for the existing Australian thin capitalisation rules to be amended so that when market equity in a company is replaced in a takeover by debt/equity, the interest on the debt is not a tax deduction against the earnings of the company taken-over. Instead, the interest should form part of the cost base of the shares acquired in the takeover and thereby reduce any gain on the ultimate disposal of the shares by the foreign private equity fund.

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2. Overseas response to foreign private equity fund takeovers

A number of overseas countries are urgently examining the likely tax impact of the takeovers of local companies by foreign private equity funds. The tax issues have primarily focussed on whether interest on the borrowings to effect the takeovers should be a tax deduction against the earnings of the company taken-over.

United Kingdom

There have been bitter disputes in the UK arising from private takeovers of UK companies, particularly as the result of loss of jobs.

The latest takeover of a UK company is the proposed takeover of Alliance Boots for in excess of \$25 billion. It is the largest takeover of this kind to date in Europe and is the first for a UK blue chip company.

Critics have lobbied the Government to change the UK tax laws so that interest on the debt to acquire companies is not a tax deduction.

In March 2007 the Economic Secretary to the UK Treasury referred to concerns that "shareholder debt" is replacing the equity element in highly leveraged private equity takeovers. He said that this shareholder debt is a form of risk-bearing equity that is treated as debt for tax purposes. The Economic Secretary announced that the UK Government would review the rules that apply to the use of shareholder debt where it replaced the equity element in highly leveraged takeovers in the light of market developments to ensure that the existing rules are working as intended.

France

In January 2007 the new French thin capitalisation rules came into effect, these are one of the strictest in Europe.

Under these rules, the debt to equity limit is 1.5:1 and, as well, there is an interest cap of 25% of an amount which approximates EBITDA of the company. Interest in excess of that amount is disallowed.

Germany

Earlier this year, Germany released a detailed technical draft reform package in which it proposed to modify its approach to the deductibility of interest payments.

In March 2007 the German Federal Government released the draft Bill for the *Business Tax Reform Act 2008* which now waits approval of the Bundesrat in July 2007.

Under the Act an "interest barrier" is to be introduced. This will restrict the scope of interest deductions based on taxable income so as to ensure that German domestic taxable income is not eroded. Interest will only be allowed to be tax deducted up to a maximum of 30% of taxable earnings before interest ("EBIT"). Excess interest can be carried forward to the following year and then deducted once again, within the limits of the interest barrier.

The above provision will replace those in the existing German thin capitalisation rules.

Denmark

Denmark has recently published a draft tax Bill concerning the deductibility of interest.

Under the Danish thin capitalisation rules a debt/equity ratio of 4:1 applies. In addition, the Bill proposes that "net financial expenses" would not be deductible at all if the amount exceeds an amount calculated as 6.5% of "operating assets". Even if the net financial expenses are within the ratio, only 55% is proposed to be deductible.

Netherlands

The Netherlands Parliament is reported as holding hearings into private equity funds.

South Korea

There is a growing public backlash against the high tax-free profits made by foreign private equity funds from investing in South Korea.

The South Korean tax authorities have sought to tax the gains. At present a large US private equity fund is facing efforts to impose tax in respect of the sale of its investment in the Korea Exchange Bank. The US private equity fund is arguing that it is protected from South Korean tax under the double tax treaty between South Korea and Belgium because the fund made its investment through a Belgium holding company.

In addition, the tax authorities are seeking back taxes from other US private equity funds on dividends they received from Mando, the largest auto parts maker in South Korea. The private equity funds sought to be taxed at 10% in accordance with South Korea double tax treaty with Netherlands. But the South Korean tax authorities are seeking tax at 25%. They claim that the beneficial owner of the dividends is not located in Netherlands and does not have the benefit of the treaty.

United States of America

The US is usually the tax beneficiary of private equity fund takeovers, because the takeover manager and fund participants are frequently US entities. Hence tax presently collected from the local country, eg Australia, ends up being paid to the US government.

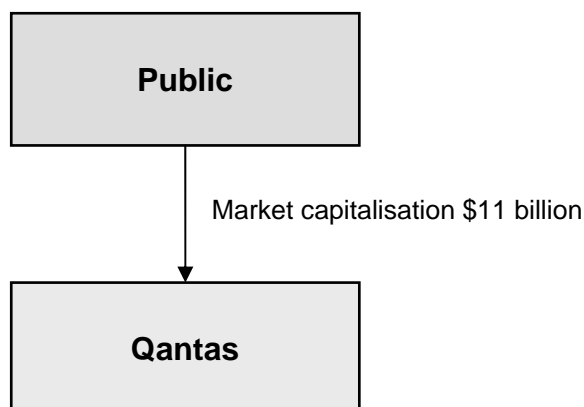
There are, however, growing tax concerns in the US about the tax treatment of the success fees charged by managers to private equity funds. The fees are usually 20% of the gain made by the fund on sale and generally these have been taxed as capital gains, which are subject to a much lower tax rate in the US (15% rather than 35%). The US issue is whether these fees should be taxed as ordinary income.

3. Should interest on borrowings to fund a takeover be a tax deduction against earnings of the company taken-over?

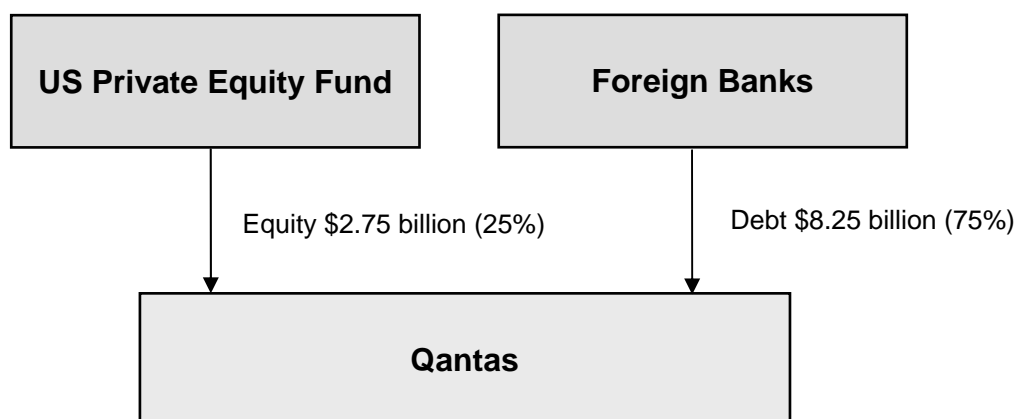
3.1 Foreign private equity fund takeovers convert equity to highly leverage debt and equity

The effect of many foreign private equity fund takeovers is to convert public market equity into a mixture of highly leveraged foreign debt and foreign private equity. For example, Qantas presently has a market equity capitalisation of about \$11 billion. After a 100% takeover this could be replaced by private equity of \$2.75 billion and foreign debt of \$8.25 billion.

Before takeover



After takeover



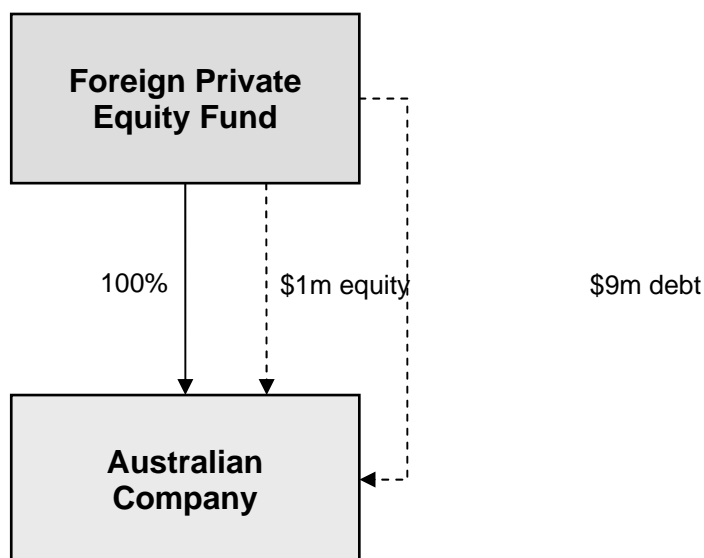
3.2 Existing Australian thin capitalisation rules

In calculating the tax payable by an Australian company any interest incurred in carrying on its income earning activities is generally a tax deduction.

There are limitations, however, in the Australian *Income Tax Assessments Acts 1936* and *1997* on when, and the extent to which, interest can be claimed as a tax deduction.

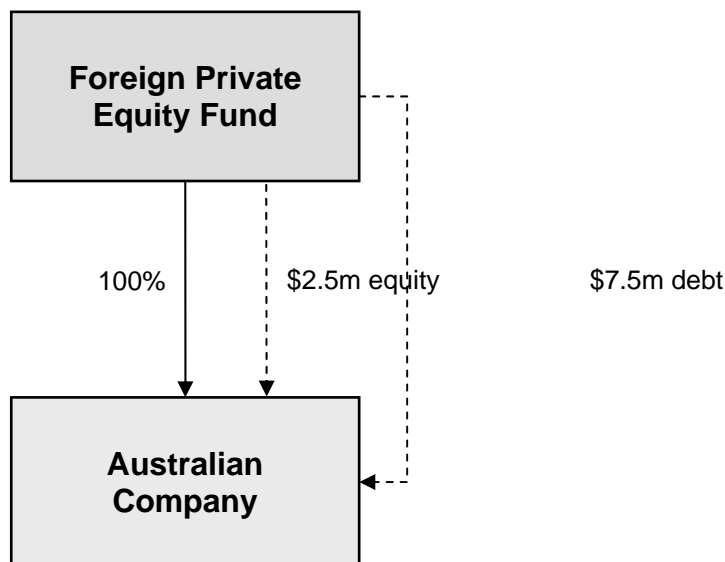
One such limitation is the thin capitalisation rules which are an anti-avoidance measure to ensure that foreign companies do not allocate an excessive amount of debt, and consequently an excessive amount of interest deductions to their Australian operations.

Example 1



Example 1 illustrates the high level of debt which the thin capitalisation rules are aimed at. A tax deduction would otherwise be claimed on the \$9 million debt against the earnings of the Australian company. In many cases the interest would be paid out free of withholding tax or other Australian tax.

Example 2



Example 2 illustrates the effect of operation of the thin capitalisation rules. Interest is only allowed as a tax deduction on that part of the debt which meets the debt to equity ratios in the rules, eg the permitted “safe harbour ratio” of debt to equity of 3:1.

The thin capitalisation rules, however, do not prohibit the borrowing of excess debt, eg the \$9 million in Example 1. Rather they limit the amount of interest which may be claimed as a tax deduction to an amount which at the time the rules were introduced in 2000 was considered reasonable, eg the ratio of debt to equity of 3:1.

The thin capitalisation rules have different debt/equity ratios depending on the type of company concerned. The relevant debt/equity ratio for non-banks is usually the safe harbour ratio of 3 debt:1 equity. The debt component could be increased if it was established that an unrelated third party would lend a greater amount.

More detail on the Australian thin capitalisation rules is set out in Appendix “A”.

4. Loss of \$1.2 billion each year in company tax after the takeover of a sample 5 Australian companies

4.1 Summary

We selected 5 ASX listed companies as examples to gauge the likely effect on Australian tax collected when Australian companies are taken-over by foreign private equity funds.

The company tax paid by the 5 companies in 2005-06 was:

■	Coles Myer	\$214m
■	Qantas	\$191m
■	Tabcorp	\$152m
■	Wesfarmers	\$419m
■	Woolworths	<u>\$446m</u>
	Total	<u>\$1,422m</u>

[Source: published annual financial reports for each company]

The published financial accounts of the 5 companies do not disclose what proportion of the company tax paid was Australian tax and what was foreign. We consider it reasonable to assume that at least 85% of the total tax paid by the companies was Australian tax. The total Australian tax paid in 2005-06 by the 5 ASX companies was, on that basis, at least \$1.2 billion.

We examined the operation of the Australian thin capitalisation rules on an assumed takeover of the 5 ASX companies. Whilst those rules are highly complex and all the relevant information is not publicly available, we considered a preliminary conclusion based on a number of assumptions could be made.

Our preliminary conclusion is that despite the thin capitalisation rules Australia would, after the takeover of the 5 companies, lose each year the \$1.2 billion in company tax previously collected from the companies.

4.2 Assumptions

In reaching our preliminary conclusion, we assumed that:

- The total borrowings of the 5 ASX companies was \$15 billion at their respective reporting dates in 2006.
- The total interest paid by the 5 ASX companies for 2005-06 was \$1.2 billion.
- The total takeover price of the 5 ASX companies paid by the foreign private equity funds was \$91 billion and this was the value of relevant net assets for the safe harbour ratio in the thin capitalisation rules.
- The takeover was funded 75% debt (\$68 billion) and 25% equity (\$23 billion).
- Interest at 8% p.a. was payable on the borrowings/debt.

It is not suggested that our conclusion is anything other than a guide. It depends on the assumptions made and other relevant information.

The drop in company tax collections would not be reduced by increased withholding tax collections as it is reasonable to assume that the interest would be paid out free of any Australian withholding tax.

We set out our examination in further detail in sections 4.3 - 4.7 following.

**LOSS OF \$1.2 BILLION EACH YEAR IN COMPANY TAX
AFTER THE TAKEOVER OF A SAMPLE 5 AUSTRALIAN COMPANIES**

4.3 Borrowings of the 5 companies in 2005-06

The on-balance sheet borrowings and assets of the 5 selected ASX companies at their annual reporting dates in 2005-06 is shown in the following chart:

Company	Total borrowings \$	Total assets \$	Ratio of borrowings to assets
Coles Myer	1,004m	9,135m	11%
Qantas	5,776m	19,183m	30%
Tabcorp	2,420m	6,755m	36%
Wesfarmers	1,543m	7,515m	21%
Woolworths	4,316m	13,346m	32%
TOTAL	15,059m	55,934m	27%

In accordance with the relevant accounting rules and thin capitalisation rules the reported assets of the 5 companies do not include internally generated goodwill.

**LOSS OF \$1.2 BILLION EACH YEAR IN COMPANY TAX
AFTER THE TAKEOVER OF A SAMPLE 5 AUSTRALIAN COMPANIES**

4.4 EBIT of 5 companies in 2005-06

The earnings before interest and tax ("EBIT") of the 5 selected ASX companies for the 2005-6 year is shown on the following chart:

Company	Reporting Period	Earnings before interest and tax \$
Coles Myer	30 July 2006	851m
Qantas	30 June 2006	726m
Tabcorp	30 June 2006	929m
Wesfarmers	30 June 2006	1,601m
Woolworths	30 June 2006	1,722m
TOTAL		5,829m

EBIT does not necessarily equal a company's Australian taxable income. At a tax rate of 30%, the assumed \$1.2 billion in total Australian company tax paid by the 5 companies (section 4.1) would result in an assumed total taxable income of \$4 billion for those companies.

**LOSS OF \$1.2 BILLION EACH YEAR IN COMPANY TAX
AFTER THE TAKEOVER OF A SAMPLE 5 AUSTRALIAN COMPANIES**

4.5 Assumed takeover price of 5 companies

The following chart shows the market capitalisation of the 5 selected ASX companies at their respective annual reporting date in 2006:

Company	Reporting Period	Issued ordinary shares at Reporting Date \$	Share price at Reporting Date	Market capitalisation at Reporting Date \$
Coles Myer	30 July 2006	1,246m	11.36	14,155m
Qantas	30 June 2006	1,955m	2.96	5,786m
Tabcorp	30 June 2006	525m	15.20	7,980m
Wesfarmers	30 June 2006	378m	35.33	13,355m
Woolworths	30 June 2006	1,172m	20.15	23,616m
TOTAL				64,892m

It is reasonable to assume that with the increased market movement since 2006 the takeover price for the 5 ASX companies would on average be at least 40% greater than the market capitalisation of the shares at the reporting date in 2006, eg our assumed takeover price for Qantas was \$4.14 against that actually offered by APA of \$5.45 per share.

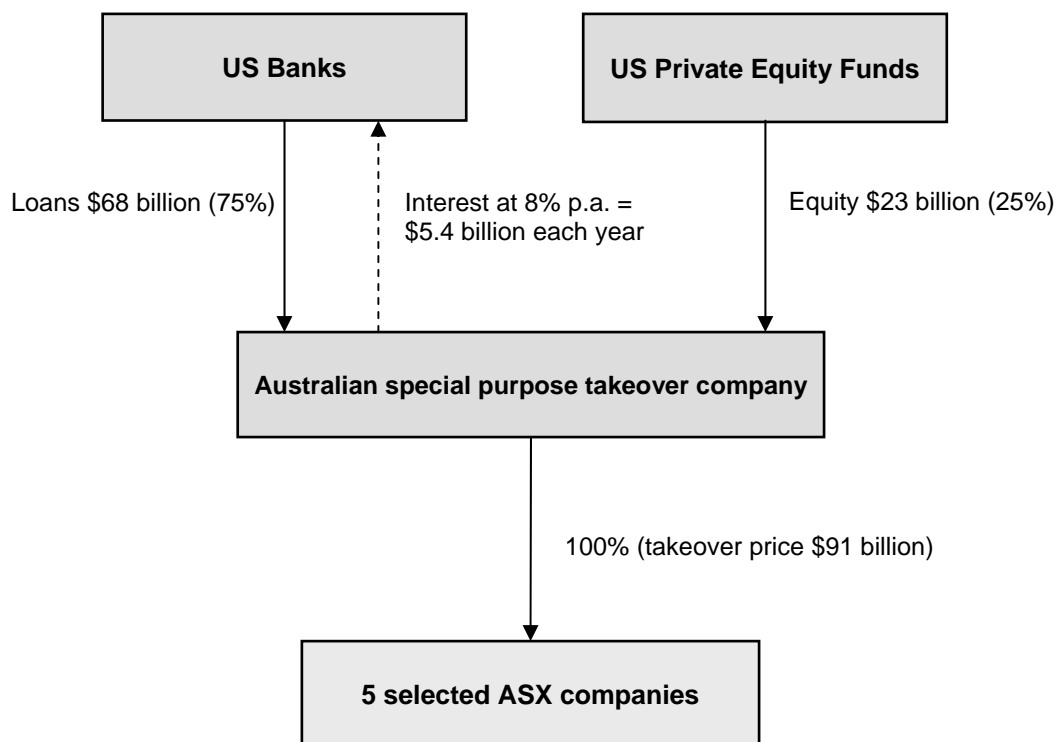
If US private equity funds took over the 5 ASX companies we assumed that the takeover price would be at least \$91 billion. The greater the price, the greater the amount of interest as an available tax deduction under the thin capitalisation rules.

As the takeover price exceeded the fair value of the assets of the 5 ASX companies, the excess is treated as purchased goodwill, which is an asset for the purposes of the thin capitalisation rules.

**LOSS OF \$1.2 BILLION EACH YEAR IN COMPANY TAX
AFTER THE TAKEOVER OF A SAMPLE 5 AUSTRALIAN COMPANIES**

4.6 Debt to fund takeovers

It was assumed that the borrowings of the foreign private equity funds to fund the takeovers of the 5 ASX companies would be as follows:



4.7 Operation of the thin capitalisation rules

The total borrowings of the special purpose Australian company and of the 5 selected ASX companies was assumed to be:

■ Borrowings to fund takeover	\$68 billion
■ Existing borrowings of 5 companies	<u>\$15 billion</u>
Total	<u>\$83 billion</u>

After the takeover of the 5 companies the permissible borrowing ratio under the thin capitalisation rules was assumed to be the safe harbour ratio of 75% x \$91 billion (takeover price of 5 companies) = \$68 billion. Accordingly the debt in excess of the "allowed debt" was \$15 billion (\$83 billion - \$68 billion).

As the total actual borrowings of \$83 billion exceeded the safe harbour amount of \$68 billion, the \$6.6 billion in interest (\$83 billion at 8%) would be reduced to the extent calculated as follows:

$$\begin{aligned} &\text{Interest on total borrowings of \$83 billion at 8\%} = \$6.6 \text{ billion} \quad \times \quad \frac{\$15 \text{ billion (excess debt)}}{\$83 \text{ billion (total debt)}} \\ &= \quad \$1.2 \text{ billion reduction} \end{aligned}$$

Accordingly \$5.4 billion in interest would be allowed as a tax deduction against the total taxable income of the 5 ASX companies (assumed to be \$4 billion).

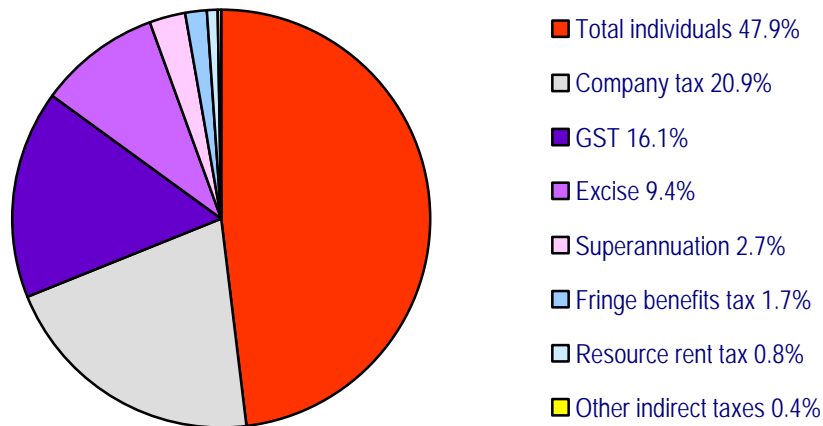
The result is that after the takeover of the 5 companies the total interest available to be claimed is a tax deduction would increase by \$4.2 billion per annum.

The effect of this additional interest deduction of \$4.2 billion per annum on borrowings to fund the takeover of the 5 selected companies is to reduce the Australian taxable income of those companies to nil. Accordingly, the company tax collected from the 5 selected companies would be reduced from \$1.2 billion each year to nil.

5. Importance of tax collected from companies

Tax collected from companies is a significant proportion of the total tax collected in Australia.

In 2005-06 the ATO collected net tax of about \$233 billion. Of this, about \$49 billion was collected from companies. In all, company tax represented 20.9% of the total tax collected.



[Source: Commissioner of Taxation: Annual Report 2005-06]

The tax collected in 2005-06 was 8.3% above that collected in the preceding year. The largest increase occurred in company tax collection, which grew by around \$8.5 billion (21.3%).

6. Capital gains on sales by shareholders

6.1 Introduction

There is no correlation between the loss of Australian company tax collected from the companies taken-over and the Australian tax collected from shareholders on the sale of their shares in those companies.

It is possible to predict the likely loss of company tax collected from companies taken-over if interest on borrowings to take them over is allowed as a tax deduction against the earnings of the companies taken-over. Using the example of the 5 selected companies the loss of tax collection over a period of 5 years would be \$6 billion, eg \$1.2 billion per annum.

It is, however, questionable the extent of any offsetting additional capital gains on the sale by shareholders of their shares in the companies taken-over. This is explored in the following sections.

6.2 No Australian tax collected when foreign private equity fund sells out

Private equity funds typically plan to sell out after 3-5 years. If a foreign private equity fund floats off the Australian special purpose takeover company or otherwise sells its shares in that company any gain would not be subject to Australian tax except in exception circumstances.

Private equity funds expect to make at least a 25% annual return on their investment in a takeover.

The equity investment in the 5 ASX companies was assumed to be \$23 billion. At the end of the 5 year period the expected gain on the investment would be about \$29 billion (25% x 5 x \$23 billion).

The foreign private equity fund is exempt from paying Australian tax of about \$9 billion on its gain of \$29 billion from the takeover of the 5 ASX companies.

Whilst there are considerable difficulties in calculating any net increase in tax collected from the sale of the shares in a takeover, it is clear that the foreign private equity fund when it sells out will not pay Australian tax.

Foreign residents are only subject to capital gains tax on "taxable Australian property": Division 855 of *Income Assessment Act 1997*.

“Taxable Australian property” is defined as real estate situated in Australia and assets used by the foreigner in carrying on a business through a permanent establishment in Australia; s855-15, 855-20. It also includes “indirect Australian real estate interests and Australian mining interests”.

6.3 Loss of capital gains tax during period the taken-over company remains privately owned by foreign private equity funds

In weighing up the net capital gains tax effect on the sale of shares in the company taken-over, it is necessary to take into account the loss of capital gains tax that would otherwise be collected from sales during the period the company taken-over is no longer listed on the ASX.

On the basis that the foreign private equity funds hold for 5 years the companies would have ceased to be listed on ASX during that period. Accordingly, there would not be the normal taxable capital gains made during that 5 year period if the companies had remained listed.

6.4 Difficulty of measuring Australian tax payable on takeover premium

When a company is taken-over a “premium” usually is paid for the shares purchased. There is a question, however, whether the premium in takeovers is only a timing issue; that is, in this context, the foreign private equity fund is anticipating a market increase. In our view, any Australian shareholder tax on any unique price premium in a takeover is not an alternative to the loss of company tax paid by the companies taken-over by reason of interest being allowed as a tax deduction. This is not an ‘either/or’ situation.

There is also a difficult question of quantification of the Australian tax that would be collected from shareholders on the premium in the year of the takeover for the following reasons:

- Foreign shareholders pay no tax on the premium.
- Australian superannuation fund shareholders pay tax at a maximum of 10% on the premium, and after franking credits the actual rate is much lower.
- The premium is subject to the 50% capital gain tax discount.

Accordingly, any notion of a unique premium giving rise to an additional amount of Australian tax is difficult to quantify, and to reconcile with the fact that a premium may only pre-empt the movement in the share value of that company – making it only a matter of timing of the tax on sale.

Appendix "A"

Australian thin capitalisation tax rules

The Australian thin capitalisation rules are tax rules to limit the extent interest can be claimed on borrowings by a foreigner investing in Australia or an Australian investing overseas.

The rules do not regulate how much an entity can borrow, but rather specify what proportion of interest can be claimed on the borrowings as a tax deduction.

In the Explanatory Memorandum to the Act containing the provisions it was noted:

"The objective of the thin capitalisation regime is to ensure that multinational entities do not allocate an excessive amount of debt to their Australian operations. This is to prevent multinational entities taking advantage of the differential tax treatment of debt and equity to minimise their Australian tax. More generally, as a measure introduced as part of the New *Business Tax System* it will also contribute to the fairness and equity of the tax system, by maintaining the integrity of the Australian tax base."

Interest is a tax expense and a dividend is not. This is particularly important for foreigners who wish to avoid paying Australian tax. They may seek to pay out the profits as interest, thereby avoiding Australian tax. The interest is a tax deduction in Australia and may be subject to Australian withholding tax of 10% or nil.

The rules are an anti-avoidance measure to prevent taxpayers treating amounts as debt when the amounts exceed what the rules consider would, in arms length transaction, be debt.

In the Explanatory Memorandum the following was noted:

"What is thin capitalisation?"

1.16 Thin capitalisation is an investment funding issue that arises in the context of international investment. The issue is principally about the extent to which an investment is financed by way of debt funding compared to equity funding. An entity's debt to equity funding can be expressed as a ratio. For example, a ratio of 3:1 means that for every dollar of equity the entity is funded by \$3 of debt. This is also known as gearing. If an investment is funded by excess debt, it is said to be 'thinly capitalised' (i.e. not enough equity is used to fund that investment).

APPENDIX "A"

1.17 The difference in the income tax treatment of debt compared to equity funding provides an incentive to finance investments using debt rather than equity. While this is not the only consideration, multinational investors have an incentive to allocate a higher proportion of their debt to particular investments and utilise their equity to fund investments outside Australia. It is where this results in a relatively high level of debt funding of the Australian operations that the thin capitalisation regime applies."

The current thin capitalisation rules are contained in Division 820 of the Income Tax Assessment Act 1997. This Division was introduced with effect from 1 July 2001.

When the amount of the borrowings used to fund foreigners Australian operations exceed the maximum amount of debt permitted by the rules:

- Interest on the excess cannot be claimed as a tax deduction.
- Interest on the excess cannot be added to the cost base of the foreigners' investment in Australia (s110-54).

The Explanatory Memorandum to Division 820 provides:

"8.37 An entity must comply with the accounting standards in calculating the value of its assets, liabilities and equity. As with foreign currency conversions:

- the relevant accounting standards are those made by the AASB; and
- an entity must comply with the accounting standards whether or not it is otherwise required to do so under a particular standard."

In the words of the Division where a foreigner has an Australian non-financial subsidiary, the "adjusted average debt" of the relevant tax group is calculated in respect of each income year. If that debt exceeds the maximum allowable debt provided in the Division, interest on the debt is proportionally reduced; s820-185(1).

The maximum allowable debt for a foreign controlled company is the greater of:

- 75% of the average net value of the relevant Australian assets (measured after adjustments are made for equity in and debt owed by associates). This is called the "safe harbour amount"; or

APPENDIX "A"

- The amount of debt which could have been borrowed by independent parties; s820-190.

The Division requires valuations to be made of the relevant Australian assets, liabilities and assets.

Purchased goodwill is a relevant asset for the thin capitalisation rules, but not internally generated goodwill.