

Chapter 4

Tax revenue implications

Introduction

4.1 Part (c) of the terms of reference asks the committee to make an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects, resulting from private equity (PE) takeover activity.

4.2 Theoretically, increased private equity investment activity may be expected to affect tax revenue in a number of different areas. These include:

- increased gearing in companies where private equity investment has taken place, which might be expected to have an effect on company tax paid;
- increased gearing on the part of companies that consider themselves to be potential targets for PE takeovers or who are seeking to emulate the PE model;
- capital gains tax receipts may be influenced by ownership shifts to foreign interests; and
- PE takeovers may give rise to general issues with taxation law compliance, for example in relation to GST liability, attribution of profits to capital accounts instead of income, and structuring of deals to derive taxation benefits.

4.3 Most observers, including the Treasury and the Reserve Bank of Australia (RBA), consider that there are few grounds for concern that increased levels of PE activity would affect government revenue levels significantly, at least at the present time. As noted elsewhere in this report, Treasury and the RBA make the point that PE activity only comprises a minor proportion of the overall capital markets, and indications are that levels of large scale PE takeover activity seen in the last year are unlikely to be sustained.

4.4 Treasury conceded however that it does not yet have a clear picture of what the longer term effects might be on taxation revenue:

The assessment of private equity is that it is not something that we are in a position at this stage to make a call on. ...In terms of what the revenue effect is. It is extremely unclear.¹

4.5 As noted by the RBA in the Financial Stability Review:

1 Mr Colin Brown, Manager, Costing and Qualitative Analysis Unit, Tax Analysis Division, Treasury, *Proof Committee Hansard*, 26 July 2007, p. 9.

The implications for Government revenue are hard to ascertain as there are currently insufficient data to fully model the effects of private equity investment on tax revenue.²

4.6 The evidence available to the committee indicates that assessment of the revenue implications resulting from increased PE activity is complex and does not lend itself to analysis of isolated examples. Offsetting factors also need to be taken into account before a reasonable assessment of revenue implications can be made. However, in the absence of hard information about trends in revenue collection, the analysis is somewhat hypothetical and needs to be treated with caution. Actual trends, as observed and reported by the Australian Taxation Office (ATO), can ultimately be the only reliable guide.

Taxation implications of private equity takeovers

Gearing and Capital Gains Tax

4.7 Leveraged buyouts of publicly listed and other companies invariably result in increased levels of gearing. The Reserve Bank of Australia confirms that companies that have been the subject of leveraged buyouts invariably carry higher levels of debt than listed companies:

In recent years, buyouts in Australia have typically resulted in debt-to-equity ratios (known as gearing ratios) of around 250 per cent, compared with pre-buyout ratios of around 50 per cent and a gearing ratio for the non-financial corporate sector as a whole of 65 per cent. This degree of leverage, while very high, is lower than during the late 1980s LBO boom in the United States, where it was not uncommon for debt-to-equity ratios to exceed 500 per cent.³

4.8 The interest payments resulting from these higher levels of debt are normally a deductible business expense, although the amount that may be deducted is limited by the thin capitalisation rules.

4.9 In Australia and in many other countries, governments impose restrictions on when, and the extent to which, interest can be claimed as a tax deduction. These rules are intended to ensure that foreign companies do not allocate an excessive amount of debt to their Australian operations, and thereby derive excessive interest deductions. Put simply, under these rules, interest payments arising from debt-to-equity ratios that exceed a ratio of 3:1 are not tax deductible. The rules do not impose a limit on gearing; rather, they impose a limit on the extent to which the interest on debt is tax deductible.

2 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 72.

3 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 60.

4.10 The 3:1 debt to equity ratio is not usually approached by publicly listed companies. As pointed out by the RBA above, pre-buyout ratios generally fall well below these levels. Accordingly, if an individual company's profit position remained constant, then the amount of company tax paid might be expected to fall following a leveraged buyout by a private equity company. However, the picture is actually more complex, as factors such as increased profitability, higher listing prices and capital gains tax events generated by a buyout all need to be taken into account.

4.11 A submission made by Mr Robin Speed of Speed and Stracey Lawyers sought to illustrate the possible implications for tax revenue of foreign private equity fund buyouts of Australian listed companies. This submission included estimates of the taxation implications of the acquisition of five listed Australian companies (Coles Myer, Tabcorp, Woolworths, Qantas and Westfarmers) by US private equity funds. The submission claimed that if these companies were taken over, the loss of company tax could be \$1.2 billion per annum as a result of interest resulting from increased debt being claimed as a tax deduction against the earnings of the companies taken over.

4.12 Mr Speed argued that the consequences flowing from such buyouts were significant, as company tax (about \$49 billion in 2005–06) represented 20.9% of the total tax collected.⁴

4.13 Mr Frank Drenth of the Corporate Tax Association of Australia (CTA) acknowledged that increased gearing associated with PE investment could have an effect on the amount of tax paid:

The major concern that arises is the leveraging of the transaction. Private equity tends to use more debt and it is possible through the consolidation regime for the debt deductions that arise from the borrowings that are made to offset the debt deductions against the cash flow in the taxable income of the target company. On the face of it, there is an issue.⁵

4.14 However, while broadly agreeing with Mr Speed's analysis, Mr Drenth disagreed with the magnitude of the losses projected by Mr Speed, saying that they were somewhat overstated. Using Mr Speed's example of the five ASX companies, Mr Drenth estimated that the additional deductible interest that would arise would be in the order of \$3.06 billion per annum rather than the \$5.4 billion projected in Mr Speed's submission, which, at the 30 per cent company tax rate, represents tax of \$918 million per annum.⁶

4.15 Mr Drenth argued that improved profitability resulting from PE investment also needed to be taken into account in this equation. He said that improving profitability is what underpins the business model:

4 Speed and Stracey Lawyers, *Submission 21*, p. 16.

5 Mr Frank Drenth, Executive Director, Corporate Tax Association of Australia, *Proof Committee Hansard*, 26 July 2007, p. 49.

6 Corporate Tax Association of Australia, *Additional Information*, p. 2.

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.⁷

4.16 The CTA's argument extended beyond the area of company tax losses and gearing, providing an overall assessment that PE investment would be positive for revenue when a number of other factors such as CGT gains by shareholders accepting PE offers and the re-investment effect are factored into the overall picture. This argument is examined in more detail in subsequent sections of this chapter.

Defensive gearing

4.17 The impact on revenue of defensive gearing by companies that consider themselves to be potential PE targets, and of increased gearing on the part of companies seeking to increase their own returns by emulating the PE model, is difficult to assess at the present time. The potential effects on the economy (although not specifically on taxation revenues) of such gearing is apparent to the RBA, which noted in the Financial Stability Review that:

Private equity transactions typically result in a significant increase in the leverage of the acquired company. In addition, the increase in LBO activity may encourage other companies to take on additional debt either as a defensive strategy, or in an effort to increase their own returns by replicating aspects of the private equity model. This increase in leverage, if it became widespread, could cause problems for the economy as a whole at some point in the future.⁸

4.18 Evidence from Mr Battellino, Deputy Governor of the RBA, indicated that behavioural changes in listed companies may be having a larger impact on corporate gearing than leveraged buy-out activity itself:

I think the bigger impact of LBO activity on corporate gearing is probably coming through from the impact it is having on the behaviour of listed companies. I suspect that quite a number of company boards are themselves looking to increase their gearing in order to protect themselves against takeover. In other words, in order to make sure that somebody else does not take over their equity by using debt, they are using some debt themselves to gear up their positions.⁹

7 Corporate Tax Association of Australia, Additional Information, p. 2.

8 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 66.

9 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia (RBA), *Proof Committee Hansard*, 25 July 2007, pp 7–8.

4.19 The committee questioned representatives of the ATO about whether there were any implications for company tax arising out of higher defensive or other gearing by companies. The Commissioner of Taxation, Mr D'Ascenzo, advised that while the ATO had seen anecdotal evidence of this trend, it has not been significant in the scheme of company tax collections at this stage.¹⁰

Capital gains tax

4.20 A further possible area of taxation revenue impacts is in respect of capital gains tax (CGT). As described elsewhere in this report, the usual pattern of PE investment is that the PE entities generally exit from their investments after a period of time, commonly three to five years. If the PE firm is wholly foreign owned, then it is likely that there will be no CGT paid on a profitable exit.

4.21 Much of the funding for large scale PE activity seen in Australian in the past year has come from overseas. In evidence to the committee, Mr Battellino told the committee that the foreign equity components of the large deals in 2006 greatly exceeded that from domestic investors so that 'this is really money coming from offshore'. Similarly, the biggest providers of the debt component are foreign banks.¹¹ This debt is generally securitised to other investors, a significant proportion of whom are overseas based.

4.22 Under Division 855 of the *Income Assessment Act 1997*, foreign residents are only subject to capital gains tax on 'taxable Australian property'—that is, real estate situated in Australia; assets used by the foreigner in carrying on a business through a permanent establishment in Australia; and 'indirect Australian real estate interests and Australian mining interests'.

4.23 In his submission, Mr Speed pointed out that PE funds typically plan to sell out after 3–5 years. He said that it is clear that the foreign PE fund will not pay Australian tax when it sells out. Based on a 25 per cent annual return on investment, he estimated that the exempt tax would amount to about \$9 billion on a potential capital gain of \$29 billion.¹²

4.24 The question is whether this should be a matter of concern and whether there is any need to modify Australia's tax arrangements as a result. A submission from Ernst & Young observed that in any event, foreign investors would be free of Australian tax under Australia's double tax treaties if the non-resident's investment is of an income nature, or if they characterise their PE investment as a short term trading

10 Mr Michael D'Ascenzo, Commissioner of Taxation, *Proof Committee Hansard*, 9 August 2007.

11 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia (RBA), *Proof Committee Hansard*, 25 July 2007, pp 5-6.

12 Mr Robin Speed, *Submission 21*, p. 16.

asset. Ernst & Young pointed out that Australian PE investors enjoy similar opportunities in overseas jurisdictions where there is a corresponding treaty.¹³

4.25 The ATO confirmed that the operation of these treaties was the major reason for non-residents such as foreign PE participants not being required to pay CGT:

For capital gains, obviously, shareholders' shares are purchased. If they sell that, it is a long-term holding, they are not a trader and there will be a capital gains tax effect. At the end of ... the leveraged buyout deal—it may well be that, if it is a foreign company or a foreign group, it is not taxable in Australia, not through the capital gains tax non-resident exemption, rather as a result of the business profits article in a double tax treaty.¹⁴

4.26 The tax amendments in 2006 to exempt non-residents from non-real property related CGT events were also introduced with a specific policy objective, namely to reduce disincentives to non-residents to establish and expand businesses in this country. Questioned by committee members as to whether this change had been a factor in driving PE activity, ATO representatives indicated that this had not been a significant feature in the leveraged buyout deals discussed with the committee at the hearing.¹⁵

Offsetting factors

4.27 While it is informative to examine each element of PE investment activity to determine its possible impact on taxation revenue, the picture that emerges from such an approach may be misleading. A range of offsetting factors must also be taken into account and this makes assessing the overall effect that PE investment may have on taxation revenue difficult. As emphasised by Treasury and others:

However, again, with individual transactions such as private equity, you have to be very careful...Not only can you point to potential impacts on the revenue from a particular transaction but also you have to look at what the flow-on effects of that transaction are elsewhere in the economy. Those impacts are often offset elsewhere.¹⁶

4.28 During the inquiry, some of the likely factors offsetting revenue loss brought to the committee's attention include:

- effects on lenders;
- increased profitability;

13 Ernst & Young, *Submission 22*, p. 7.

14 Ms Jan Farrell, Deputy Commissioner, Australian Taxation Office, *Proof Committee Hansard*, 9 August 2007, p. 8.

15 Ms Jan Farrell, Deputy Commissioner, Australian Taxation Office, *Proof Committee Hansard*, 9 August 2007, p. 13.

16 Mr Colin Brown, Manager, Costing and Qualitative Analysis Unit, Tax Analysis Division, Treasury, *Proof Committee Hansard*, 26 July 2007, p. 15.

- CGT events triggered by takeovers; and
- reinvestment.

Effects on lenders

4.29 The RBA has noted that one effect of higher PE investment activity is that to the extent that lenders for these deals are based in Australia, their taxable income is likely to increase and add to tax revenue. In the case of non-resident financiers, there may also be an increase in withholding tax collections, although this depends on the withholding tax arrangements in the bilateral tax treaties.¹⁷

Increased profitability

4.30 PE proponents argue that a major objective of the exercise is to increase the profitability of the companies taken over. Resulting increased tax receipts may at least partially offset reduced company tax associated with increased gearing. In his critique of the submission lodged by Mr Speed, Mr Drenth of the CTA argued that in the case of five companies used as a hypothetical example of the consequences of a PE takeover, it was not unreasonable to factor in a modest improvement in taxable earnings as an offset to the tax losses resulting from higher gearing.¹⁸

4.31 Increased profitability may be expected to be apparent as a long term effect, rather than in the short term.¹⁹ An acknowledged characteristic of PE investment is a J-curve effect—initial returns on investment may be low or negative, with profitability expected to rise late in the investment cycle.²⁰

4.32 Increased profitability after an LBO is far from guaranteed, particularly where gearing levels increase substantially, and thus cannot necessarily be relied upon to increase tax revenues. As pointed out by Standard and Poors:

Although very high debt levels can provide management a strong incentive to maximise earnings and capital efficiency, the risks of leverage are substantial. ...Debt laden companies have a significantly constrained capacity to accommodate cyclical earnings weaknesses or to respond to changing competitive and market conditions. ...the credit ratings of acquired companies typically fall to the "B" or "BB" speculative-grade ratings. At these ratings, the probability of default increases substantially,

17 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 72.

18 Corporate Tax Association of Australia, Additional Information, p. 3; *Submission 6*, p. 2.

19 Corporate Tax Association, *Submission 6*, p. 2.

20 See for example UniSuper Limited, *Submission 1*, p. 2.

with a "B" rated issuer historically having a one in three probability of default over a ten year period.²¹

CGT events triggered by takeovers

4.33 Where shareholders in a publicly listed company accept an offer for their shares in a buyout, capital gains tax will be payable on any gains realised by these shareholders. The CTA was amongst those who argued that this tax windfall has to be factored into any consideration of the overall effects on tax revenue of PE activity. As pointed out by the CTA, the transaction 'unlocks all at once both pre and post bid unrealised gains on shares which might otherwise have been held for many years – particularly in the case of long term investors.'²²

4.34 Referring to the submission of Mr Speed, the CTA argued that the tax gains from liquidation of those shares would probably exceed the CGT losses during the period of PE ownership:

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...²³

Reinvestment

4.35 A proportion of gains realised by shareholders whose shares have been acquired in a PE takeover continue to generate tax revenue. A number of witnesses emphasised that while it is possible that some of the money may be spent for non-investment purposes, much of it remains in Australian investments and continues to generate both taxable income and potential capital gains.

4.36 Ernst & Young submitted that the typical behaviour of shareholders in this situation was to reinvest, and that the income and subsequent disposal of replacement

21 Standard and Poor's, Leveraged buyouts in Australia – who really bears the risks, (accessed 13 August 2007): http://www2.standardandpoors.com/portal/site/sp/en/au/page.hottopic/lbo_viewpoint_3_1_hotopic/3,1,1,0,0,0,0,0,0,0,0,0,2,0,0,0.html, .

22 Corporate Tax Association of Australia, Additional Information, p. 2.

23 Corporate Tax Association of Australia, Additional Information, p. 4.

investments continue to be taxed in Australia. The company stated that it 'did not see any reason for concern about the revenue effects here'.²⁴

4.37 Mr Battellino of the RBA also emphasised the cyclical nature of investing:

The question is: what has happened to the capital that has been liberated by the private equity? How much tax are they paying? If I am the owner of some listed shares at the moment, I am getting my returns on dividends and capital gains and I am paying my tax on that. A private equity firm might come along and buy those and may find a way of paying less tax—and we will see about that—but the other question is: what has happened to the money I have got back from that investment? I have gone out and made other investments and I am still paying my tax. You cannot extrapolate from one particular thing to a general macro picture. My conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base.²⁵

General taxation law compliance issues

4.38 Aside from the structural issues associated with PE activity which might have an effect on future government tax revenue, there are a number of tax compliance issues that also have potential revenue effects.

4.39 At the committee's final public hearing on 9 August 2007, the Commissioner of Taxation, Mr Michael D'Ascenzo, advised the committee that PE would be a major compliance focus for the ATO in the coming year. He told the committee that the ATO had been examining some of the arrangements associated with larger PE transactions as part of the large business program and that the compliance plan for 2007–08 outlined features of PE deals that are likely to attract ATO attention. The Commissioner said that the ATO's focus was on leveraged buyouts, where turnover exceeds \$100 million per year. He outlined a range of features of PE deals of particular interest to the ATO from a compliance perspective:

- profit participation arrangements, where payments are received by participants such as executives of the target group, equity participants or their associates, on the successful completion of a deal. The ATO may need to confirm whether a proper characterisation has been made to these returns as being on revenue account or capital account. Where these arrangements result in payments being made to tax haven entities, the ATO is likely to check to ensure that any Australian residents involved are complying with the foreign income attribution regime;

24 Ernst & Young, *Submission 22*, p. 5.

25 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia (RBA), *Proof Committee Hansard*, 25 July 2007, pp 16-17.

- treatment of distribution to investors of unit trusts or other private investment vehicles, and whether the characterisation of those payments as being on revenue or capital account accords with tax law principles;
- transactions fees paid to advisers or participants—the ATO may need to confirm that the value of fees paid to related entities is in line with the arms length principle and is therefore deductible for income tax purposes;
- black hole expenditure incurred, for example by target companies in the course of failed PE bids and whether such expenditure is appropriately characterised;
- where non-residents are substantially operating in ATO jurisdiction, the value of profits properly attributable to any enterprise that constitutes a permanent establishment in Australia;
- cost based uplifts of assets, when structuring into, or out of a newly consolidated group, the nature of tax cost setting process to ensure that appropriate allocations have been made;
- the structure and tax character of debt and equity investments and the nature of any impacts on the thin capitalisation safe harbour measures to ensure substantial integrity of the tax law; and
- whether the making of financial supplies results in GST liability not being charged for the acquisition of services from off-shore entities and where appropriate, review of claims for input tax credits.²⁶

4.40 The Commissioner told the committee that these areas are not necessarily peculiar to PE—they have features that are common to many mergers and acquisitions. Nonetheless, they will be a focus for the 2007–08 compliance program. Information derived would be passed on to Treasury so that assessments can be made of whether there is any need to change current policy parameters.²⁷

Overall assessment of the revenue impact

4.41 The general consensus among organisations with acknowledged expertise in the likely impact of PE activity on taxation revenue was that the impact on revenue appears to be low and concerns about it overstated. The assessment of the Deputy Governor of the RBA, Mr Battellino, was that:

26 Mr Michael D'Ascenzo, Commissioner of Taxation, *Proof Committee Hansard*, 9 August 2007, pp 2-3.

27 Mr Michael D'Ascenzo, Commissioner of Taxation, *Proof Committee Hansard*, 9 August 2007, p. 3.

My conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base.²⁸

4.42 While increased gearing and shifting capital gains tax liability to parties who are not liable to pay it may affect revenue, offsetting effects also have to be taken into account, and it appears credible that these may reduce the extent of revenue losses or even result in additional revenue.

4.43 However, Treasury and ATO evidence indicates that there is insufficient information available to be certain about how increased PE investment activity will affect revenue, if it continues or sparks a more pronounced shift in defensive gearing among companies currently carrying lower levels of debt. The latter is a trend that will require careful monitoring, and the evidence of the Treasury and the ATO is that they are actively doing this already.

4.44 The committee is satisfied that PE is receiving adequate attention from the ATO to ensure that any compliance risks are identified. The current law appears to be sufficient, and the committee is not persuaded that any of the evidence presented during this inquiry is sufficiently persuasive for it to recommend any changes to tax law at this time. However, this is an area that will require close monitoring.

28 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia (RBA), *Proof Committee Hansard*, 25 July 2007, p. 17.

