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STANDING COMMITTEE ON ECONOMICS

Reference: Private equity investment and its effects on capital markets and the Australian economy

THURSDAY, 9 AUGUST 2007

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SENATE STANDING COMMITTEE ON

ECONOMICS

Thursday, 9 August 2007

Members: Senator Ronaldson *(Chair)*, Senator Stephens *(Deputy Chair)*, Senators Bernardi, Chapman, Hurley, Joyce, Murray and Webber

Participating members: Senators Adams, Allison, Barnett, Bartlett, Birmingham, Boswell, Boyce, Bob Brown, George Campbell, Carr, Conroy, Cormann, Eggleston, Chris Evans, Faulkner, Ferguson, Fielding, Fifield, Fisher, Forshaw, Hogg, Kemp, Kirk, Lightfoot, Ludwig, Ian Macdonald, Sandy Macdonald, Marshall, McGauran, Milne, Nettle, O'Brien, Parry, Payne, Robert Ray, Sherry, Siewert, Watson and Wong

Senators in attendance: Senators Bernardi, Chapman, Joyce, Murray, Ronaldson and Stephens

Terms of reference for the inquiry:

To inquire into and report on:

(a) an assessment of domestic and international trends concerning private equity and its effects on capital markets;

(b) an assessment of whether private equity could become a matter of concern to the Australian economy if ownership, debt/equity and risk profiles of Australian business are significantly altered;

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

(d) an assessment of whether appropriate regulation or laws already apply to private equity acquisitions when the national economic or strategic interest is at stake and, if not, what those should be; and

(e) an assessment of the appropriate regulatory or legislative response required to this market phenomenon, if any.

WITNESSES

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Committee commenced at 4.34 pm

CHAIR (Senator Ronaldson)—Welcome. I declare open this meeting of the Standing Committee on Economics. This hearing has been convened to receive evidence from the Australian Taxation Office in relation to the committee’s inquiry into private equity investment and its effects on capital markets and the Australian economy.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or it may determine that certain evidence should be heard in camera. I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee.

If a witness objects to answering a question, the witness should state the ground upon which the objection is taken, and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Of course, such a request may also be made at any other time.

The Senate has resolved that an officer of a department of the Commonwealth or of a state shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions asked of the officer to superior officers or to a minister. This resolution prohibits only questions asking for opinions on matters of policy and does not preclude questions asking for explanations of policies or factual questions about when and how appropriate policies were adopted. Any claim that it would be contrary to the public interest to answer a question must be made by a minister and should be accompanied by a statement setting out the basis for the claim.

[4.35 pm]

D'ASCENZO, Mr Michael, Commissioner of Taxation, Australian Taxation Office

FARRELL, Ms Jan, Deputy Commissioner, Australian Taxation Office

REED, Mr Andrew, Assistant Commissioner, Australian Taxation Office

CHAIR—Mr D'Ascenzo, I invite you to make an opening statement.

Mr D'Ascenzo—The terms of reference of this committee include an assessment of the long-term government revenue effects of private equity. As the committee knows, Treasury is the government agency that has ultimate responsibility for revenue forecasting. The tax office assists Treasury by providing advice on the current state of revenue collections and information on events that may affect revenue collections. In addition, along with Treasury, the tax office is also a member of the Council of Financial Regulators. While we have nothing further to add specifically to what Treasury said on revenue impacts, we are however happy to assist the committee by explaining our current focus on some of the features and potential compliance issues surrounding private equity.

As part of our large business program we have been examining some of the arrangements in the larger transactions where we see more potential for non-transparency. Our compliance plan 2007-08, which is due for release next week, will outline features of private equity deals that are likely to attract our attention. For the benefit of the committee I will quote extracts from the upcoming compliance program, under the heading 'Private equity: implications for compliance'. 'Our primary focus is on what are termed leveraged buyouts where substantial amounts of debt are employed to acquire equity with a turnover greater than $100 million.' Features of our private equity deal which attract our interest are as follows: 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 the deal. Also, the tax office may need to confirm whether a proper characterisation has been made to these returns as well as being on revenue or capital account. Where these arrangements result in payments being made to tax haven entities, we are likely to check to ensure that any Australian residents involved are complying with the foreign income attribution regime. Treatment of distributions to investors of unit trusts or other private equity investment vehicles also attracts our interest and whether the characterisation of those payments as being on revenue or capital account accords with tax law principles. In relation to transactions fees paid to advisers or participants we may need to confirm that the value of fees paid to related entities is in line with the arm's length principle and is therefore deductible for income tax purposes.

We may need to confirm expenditure incurred, for example, by target companies in the course of failed private equity bids and whether such expenditure is appropriately characterised. Also, where non-residents are substantially operating in our jurisdiction the value of profits properly attributable to any enterprise that constitutes a permanent establishment in Australia and cost base uplifts of assets when structuring into or out of a newly consolidated group. We may need to confirm the nature of the tax cost-setting process to ensure that appropriate allocations have

been made. These matters may be reviewed. We may also need to look at 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 offshore entities and, where appropriate, review of claims for input tax credits.

Members of the committee, those are the sorts of areas that we are likely to look at as part of our ongoing compliance program. They are not necessarily peculiar to private equity—they have features that are common to many mergers and acquisitions—but they certainly are a focus for our 2007-08 program. The broad intelligence that we get from that sort of activity will be used to inform Treasury as to whether any policy parameters need to be changed.

CHAIR—Thank you, Commissioner. Was this an outcome of the broad decisions made at the May council meeting where I think you indicated you were going to look at some of these matters in that report or was it completely an ATO decision?

Mr D'Ascenzo—We have been looking at the current boom in mergers and acquisitions, both globally and in the Australian context. If you look at our 2005-06 annual report you will see that we spoke about the possibility of further review of private equity at that time. I think that the ongoing debate and some large private equity arrangements over the last 12 months have certainly intensified the need for us to focus on this area, along with other mergers and acquisitions. The focus is very much at the large end of arrangements that involve companies with turnovers of greater than $100 million, particularly where offshore structures are involved, and particularly where the flows of funds are less clear than through listed companies.

CHAIR—Do I take it that the discussions we looked at in the executive summary of the May meeting were not the start of your interest in this?

Mr D'Ascenzo—That is right. We have already looked at the increasing mergers and acquisitions. In our last annual report we signalled that private equity could be an area we needed to look at in the coming year or years. Our approach has been to try to understand the dynamics of private equity, particularly large private equity deals. I think you need to differentiate between large deals, which use more complicated overseas structures. and the smaller domestic versions of private equity arrangements. We have a team, of which Jan Farrell has been the leader for some time, which is trying to understand the dynamics and which is trying to work out whether there are potential areas on which we need to focus as part of an ongoing compliance strategy. The areas that I mentioned in my presentation are areas that we will have to look at to ensure compliance with our laws.

CHAIR—Have you drawn upon any relevant international experience when looking at this or are those peculiarly Australian circumstances?

Mr D'Ascenzo—I think private equity is very much a global activity. Indeed, the size of private equity in the global market is huge, particularly in the United States. Jan, I do not know whether we did international studies along those lines, but it did come up in the meeting I attended in Seoul last year which was under the auspices of the OECD. Concerns over private equity were raised in that context.

Ms Farrell—Yes, it is a global issue and it was raised in September at the OECD meeting. From that, a number of jurisdictions have decided that if information can be exchanged we will do so within our treaty obligations.

CHAIR—Were those Seoul discussions based around the revenue implications for jurisdictions or was it a wider brief than that?

Mr D'Ascenzo—It was very much more a general topic in a wider range of discussions between about 35 commissioners from different tax jurisdictions around the world. It was a particular area of interest for the then United States IRS commissioner, Commissioner Iverson, who wanted further investigation into the promoters of private equity deals and how they dealt with private equity deals. That is a matter we should be looking at globally and that is part of the work that we have been doing.

Senator MURRAY—I apologise for missing the last two days of hearings on the grounds of a chest infection. Mr D'Ascenzo, my first question relates to your resources now that you have announced a program. Does your program fall within your normal organisational matrix—your large high-wealth individuals or your large organisational lines?

Mr D'Ascenzo—It fits in our large business program. Jan works within that wider organisational structure. Basically, we are not looking at private equity or singling out private equity as a feature in itself but in the context of leveraged buyouts, mergers and acquisitions. So it all falls within that wider scope of activity where we risk assess those companies that require us to ensure that high levels of compliance are being maintained.

Senator MURRAY—Would you describe it as heightened activity in an area that you would examine anyway?

Mr D'Ascenzo—I think that is right.

Senator MURRAY—Does it require special training or expertise to get up to speed with some of the modern mechanisms of structuring these deals and the way in which finance is moved around and designed?

Mr D'Ascenzo—Yes, it does. Indeed, that is the reason for having Jan lead a team to acquire an understanding of what the structuring arrangements might be.

Senator MURRAY—How is that expertise acquired? Is it acquired through interaction with other regulators overseas, or is it acquired through further academic study? What is the mechanism by which you get up to speed?

Mr D'Ascenzo—I will allow Ms Farrell to answer that question. My understanding would be that we have spoken to private equity groups and sought their assistance to try to piece together the various structures that occur.

Ms Farrell—I am a deputy commissioner case leader in large business and international. Our approach has been to try to look at it on a project basis, first of all by understanding the business and the economic drivers. We started from a perspective of looking at our large business clients,

talking to them about the impact of private equity deals, and then having a look at the deals themselves. So we are trying to develop a picture of what I would call the private equity lifecycle, as the commissioner mentioned, in the large business segment for LBOs.

Senator MURRAY—So no special study or exchange program with overseas regulators or anything of that sort is underway?

Ms Farrell—We are tracking the reports that are coming out of overseas jurisdictions from committees such as yours and from other information that comes to hand. We are keeping track of those developments. As I indicated previously, under our double tax treaties any information that comes to hand that would be relevant and within the treaty legalities we would be providing to other jurisdictions, as they would be providing to us.

Senator MURRAY—It is no criticism of the ATO but it is commonly a feature of your lives that because of the huge resources and the flexibility of the market you are often in a catch-up situation. New financial structures, new systems and people make it difficult for you to catch up. Do you feel that you are very far behind in understanding the new market?

Mr D'Ascenzo—I do not have that feeling, Senator.

Senator MURRAY—It is akin to asking how long a piece of string is.

Mr D'Ascenzo—We have a draft private equity arrangement which I can share with the committee. It is only a draft, it is not necessarily generic and it is not based on any particular case, but it gives an understanding of what is involved in the steps and how it fits into the scheme of things. As you can see, we do have an understanding of the essence of major private equity deals. I can submit this to the committee.

CHAIR—Commissioner, you obviously have discussed this with your colleagues. Are you happy to table that or would you prefer to circulate it?

Mr D'Ascenzo—I am happy to table it. It is really generic and it does not relate to any particular taxpayer. It is just an understanding of what a large-scale private equity arrangement might look like.

Senator MURRAY—Thank you.

CHAIR—Would you like to formally table that?

Mr D'Ascenzo—I am happy to formally table it.

Senator BERNARDI—Mr D'Ascenzo, you referred on a couple of occasions to a large leveraged buyout, or a large LBO. How do you define this? Is it in accordance with your large business clients? Is it an incentive turnover or is it a quantum of deals?

Mr D'Ascenzo—The focus is mainly the target company, or the acquirer might have a turnover of over $100 million.

Senator BERNARDI—And that is a threshold turnover of over $100 million?

Mr D'Ascenzo—That is the way we have internally divided our resources. In that segment, which we call large business, that is the population. Then we do a range of risk analyses to see which cases might be of higher risk. Even if they are of higher risk, that does not necessarily mean there is anything untoward; it just directs our resources to confirm their compliance with the law.

Senator BERNARDI—Thank you. I just wanted to clarify that.

CHAIR—Commissioner, in fairness to you and so that it is on the public record, I take it that this is a draft document which may be subject to change?

Mr D'Ascenzo—That is right. The word 'draft' is on it and it is an outline of how a large private equity deal might look in broad steps but no more than that. Am I correct?

Ms Farrell—Yes, that is right, Commissioner. It is a very simplistic overview of a leveraged buyout attempting to outline the generic lifecycle based on what we have constructed as a private equity model. We talked to companies in the course of their private equity deals and asked what is occurring broadly, how it will play out, and whether there might be any tax risks or any advice that they would like to give us about the implications. It sets out those broad structures and features which we thought you might find informative in tracking through the different parties and the different stages of private equity.

Mr D'Ascenzo—It is only a draft and it is only simplistic. The reason I decided to table it was to try to give some confidence in response to Senator Murray's question about whether or not the underlying drivers of private equity have been considered and taken into account by the tax office. It is very generic, it is very simplistic, and it is only a draft. What it does not do is go into the detail of the particular documentation. That is the process you go into when ultimately you want to review the risk features that we have talked about.

Senator MURRAY—It is conceptional and generic, not specific.

Mr D'Ascenzo—That is right, yes.

Senator MURRAY—I want to stay with the issue of scale and concentration. My view expressed elsewhere—which I think is a common view amongst all those interested or concerned in this area—is that private equity or leveraged buyouts are only of policy interest if their scale is such as to affect a market or markets in a significant manner, which may be positive, neutral or negative, or where there is market concentration, or where the industries affected are of particular economic or strategic significance with respect to Australia. An oil and gas company would be an obvious one in that circumstance. Before I ask my question I want to give you a quote which will put this into perspective for Australia. The quote, which comes from the *Business Review Weekly* of 12-18 July 2007, is headed 'Economy Watch' and is written by Jason Baker, general manager of IBISWorld. He writes as follows:

IBISWorld data show that of 500 industries in Australia, 108—

that is, one-fifth—

> have a ‘high’ level of concentration, meaning that the top four companies in that industry earn more than 70 per cent of total industry revenue—a figure that provides incumbents with oligopoly powers. High-profile oligopolies include petroleum wholesaling, retailing and refining, supermarket retailing, commercial banking, telecommunications, gambling, beer, wine and soft drink manufacturing, pay TV and air transportation. In 2006-07 the 108 highly concentrated industries earned revenue of $559.2 billion.

That indicates that there is already a quite refined analysis of the Australian economy. You would be familiar with those on the macro models that are available through Melbourne, Econtech, and indeed our own government. My question is: do your ears prick up, from an ATO perspective, when private equity is moving within those highly concentrated sectors where the market impacts and the revenue impacts could be much higher than might be the case in a more dispersed market situation?

Mr D’Ascenzo—Not in that sense. Again, our role mainly is to ensure that people are complying with the law. So our risk profiles are not there to second guess the policy parameters that may facilitate that, or the broad revenue impact, other than when we see it at an administrative level. When we see it operating then we would provide that information to Treasury. But in areas where there is slightly less transparency than listed arrangements where there are significant flows of funds, high leveraging arrangements and possible use of overseas structures, that coincides with that sort of activity and that does prick our attention in the sense that it requires us to ensure that the law is applying as intended.

Senator MURRAY—As you know with respect to the sectors, some are far higher revenue generators than others. For instance, in the supermarket sector, which is a very concentrated sector, the revenue importance to the ATO is quite low because supermarket chains do not develop the same sorts of profits as, say, banks or mining companies might develop; whereas if you went to a particular mineral sector the profit generated and, therefore, the revenue generated to the ATO might be much higher. Do you identify concentrated sectors in your large business organisation in terms of revenue, and so that is where you focus more, or is there another way of examining those?

Mr D’Ascenzo—Not really, because while securing revenue that is rightfully owed under the law is part of our role, the bigger role is to administer the laws. The laws have a range of results. It is not just for the collection of revenue; they may well have an economic or a policy objective. We pay out a lot of refunds and we pay out input tax credits. The aim of the tax office is not to collect revenue but to administer those laws and to try to apply them in a way that produces the right sort of outcome in accordance with those laws. Under the laws, if someone were rightfully to be entitled to huge deductions or to huge refunds, then, so far as we are concerned, part of our role is to try to provide that deduction and refund to them efficiently.

We would tell Treasury if there were differences or significant impacts from what might well be budget estimates. On a monthly basis we gauge whether or not the budget estimates are tracking to what was expected. If there is a dip or an increase we see whether or not there is a compliance impact one way or the other. It could be that people are paying too much, for instance, because they do not understand the law, or it could be that they are paying too little

because of some compliance loophole. So we look at it from that perspective, but I certainly do not focus on the revenue other than in our work with Treasury.

Senator MURRAY—As you know, that is one of the items in our terms of reference. I asked you the question specifically for that purpose.

CHAIR—Commissioner, I have looked at this document and I have discussed it with the secretary. It appears to be an in-confidence document. Are you tabling that document for in-camera viewing, or are you happy for it to become a public document? I just wanted to clarify that issue.

Mr D'Ascenzo—It was our internal in-confidence documentation on it, but there is nothing in there that is anything more than generic. I am comfortable for it to be tabled.

CHAIR—Okay, I just wanted to clarify that. That document is now a public document.

Senator MURRAY—I want to turn now to some specifics and I want to stay on the revenue side if you do not mind, Commissioner.

Mr D'Ascenzo—Sure.

Senator MURRAY—It seems to me that if leveraged buyouts are of a very large scale, the revenue effects are likely to be principally in three areas. The first would be as a result of gearing, reducing the profit available from which you would take your share; the second would be disregarding gearing if costs were raised within the business and, therefore, a charge against profits and your revenue would fall, which is pretty well what you meant when you were talking about the fees area and that sort of thing; and the third area would be capital gains. Before I go to a specific question, could you indicate to the committee whether you have any broad concerns about those three areas. In your opening statement I picked up your concerns about fees, which might be ramped up, shall we say—my words, not yours. I did not pick up anything on capital gains, nor did I pick up anything on reducing profitability as a result of gearing. Perhaps you could enlarge on those areas.

Mr D'Ascenzo—The gearing comes into the second-last point I made about the thin capitalisation impacts. Provided it comes within the right thin capitalisation parameters, that is what we would be looking at. In other words, if, for instance, it goes over the three-to-one ratio, non-deductible interest would be payable. Some of the other aspects go into that in an indirect way—questions about whether or not interest is properly deductible for other reasons; and questions about whether something is capital or income are also relevant to that description. Jan, in the capital gains tax area, you might be closer to those provisions.

Ms Farrell—Yes. 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 exit, on the example that you have there—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. That does not necessarily always occur when the private equity group exits the group that it has taken over.

Senator MURRAY—I want to ask you a specific question on the capital gains side. You do not need to refer to it because I will quote it but, for the purposes of *Hansard*, I will quote from page 5 of submission 21 from Speed and Stracey, which is in our little booklet. I am using this because it is quite a precise kind of statement. The statement, which is headed 'United States of America', reads:

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.

We covered that earlier. It continues:

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.

I want you to expand on that issue. Two issues are outlined there. The first issue is that of higher tax on ordinary income, which in our case is 30 per cent versus the capital gains tax; and the second issue, of course, is that somebody else gets the tax benefit, not us.

Ms Farrell—Yes. As the commissioner outlined in the compliance plan, one of the first indicia or features that we said we were looking at was to distinguish between what might be revenue gains and what might be capital gains. That is very much a question of fact. But in the circumstance that you read out, if I properly interpreted it, there are two effects. You would be saying in relation to the profit on the sale of a capital asset that that would be a capital gain and there would be a lower tax rate. I just point you again to that diagram and to what the general partner gets as a 20 per cent carried interest or profit share on exit—as it is widely termed, the carried interest.

That issue is very much in play in the United Kingdom and the United States due to the fact that, as we understand it, the law states that it may well be returned on a capital account which attracts a lower tax rate in both the United States and the United Kingdom. In Australia, for a venture capital limited partnership, which as you know has a smaller frame and it has a cap on it, a provision in our capital gains tax law states that where a general partner of a venture capital limited partnership receives that carried interest it will be a capital gains tax event. But if it is not a venture capital partnership as prescribed by the venture capital legislation it will depend on the terms of the agreement that the general partner has, whether it is in the nature of remuneration for services performed or they might have some equity or stock that they have disposed of, in which case it would be likely to be on a capital account or a capital gains tax event as opposed to being in the nature of remuneration for services performed.

Senator MURRAY—I will conclude my session of questioning with this question because others will want the call. It might be impossible for you to answer my question at this stage. Has the tax office been able to forecast an expected revenue loss as a result of heightened leveraged buyout opportunities from known deals that have already occurred? By significant, I do not

mean hundreds of millions, because that happens in the nature of global and international interaction, but something really significant, perhaps in the billions.

Mr D'Ascenzo—I do not think we have. Andrew, you work with Treasury on revenue forecasts.

Mr Reed—We work closely with Treasury whenever we see some changes in patterns of behaviour which might be a case where something different is happening to what has happened in the past. We have been talking to Treasury about what we are seeing, and we are still trying to tease that out, but it would be a question for Treasury as to whether there is a revenue implication in terms of a full revenue forecast.

Senator MURRAY—I'm sure there is a revenue implication. Frankly, it does not concern me because the nature of global trade and the mergers and acquisitions market is that it does have revenue effects; that is what a market does. All I am concerned about is large-scale revenue loss because that is material to a government's forecasts. My instinct is that you would not yet be in a position to know that, and if you want to take the question on notice, you may. The question is simply whether there is a very large-scale revenue change understood to be likely from the heightened activity that has occurred in the LBO market.

Mr Reed—We can take that on notice.

Mr D'Ascenzo—The short answer is that while there has been a lot of activity, not all of it has been successful. We have not seen any impact of a significant amount. But, in working with Treasury, we have people trying to track that issue to see whether at any point in time there are greater costs. They are the sorts of matters that Treasury would take into account in terms of the policy parameters that might be appropriate in this area. But at this stage we are not seeing any change in trend in corporate tax collections that indicate any significant downward pressure.

Senator MURRAY—Frankly, I would not have expected it at this stage, but thank you for your answer.

Senator JOYCE—You might have already answered this. If I got to the exit and we have got a position of $14 billion and we kick out $25 billion so that we have a $9 billion profit, and if the entity that did the private equity deal was based in New Zealand—which we know does not impose capital gains tax—not only would there be no capital gains tax paid in Australia but there would be no capital gains tax paid anywhere in the world on that transaction.

Ms Farrell—Yes. The analysis is that, if the profit is actually the business profits that go to an entity in a country to which we have a double tax agreement and they are the profits of that enterprise in that contracting state, then it will not be taxable in Australia—unless that enterprise carries on a permanent establishment in Australia.

Senator JOYCE—This question comes up over and over again, but it is drilling down to the cost ramifications. We can discuss that here, you guys would be fully aware of it, and you would be thinking, 'That seems like an easy out for someone.' If someone has billions of dollars to save and they have got good tax advice, how are we going to deal with that? Are we envisaging dealing with it?

Mr D'Ascenzo—Again, Senator, what we try to do is to provide that sort of understanding of these transactions. Then it becomes a matter for setting the policy parameters, and that is outside our bailiwick.

Senator JOYCE—Let's go back to another issue. With capital gains tax exemption, which obviously has an extremely close connection to private equity deals—in fact I would say they have a symbiotic relationship—rather than pointing the finger, should we reinvestigate what the potential costing of that is? We have the $60 million or $50 million—the generic number—on the possible revenue lost. Should we go back and have another look at it?

Mr D'Ascenzo—We have provided what information we can in contributing to those forecasts. I am not sure that there is much more that we can add to that.

Senator JOYCE—Right. You talked about capital account and revenue account. All these organisations are in the business of buying and selling companies. They are not in the business of holding them for the long term. They are buying and selling companies. If that is the primary role, rather than the long-term holding of it, is the question ever raised—and I suspect that it would never be—that you might decide to move towards revenue account?

Mr D'Ascenzo—You asked me this at a Senate estimates hearing, Senator, and I said that we would look at that issue as part of our review.

Senator JOYCE—I will rephrase it. Have you looked at that issue as part of your review?

Mr D'Ascenzo—We are talking about a program that starts in 2007-08. One of the aspects of the question about whether something is on capital account or revenue account is the question that you raised.

Senator JOYCE—Yes.

Mr D'Ascenzo—If you look at that sort of arrangement, you find a situation where you have a foreign limited partnership, and that may have a whole range of different entities involved in that partnership. In a different private equity deal, there might be a different set of partnership members.

Senator JOYCE—Yes.

Mr D'Ascenzo—It makes it more difficult to argue that there is a controlling mind such that you might be able to look behind the corporate veil.

Senator JOYCE—Yes, sure.

Mr D'Ascenzo—But it is an area that will depend on facts. It is one of the areas that we will be taking into account as part of analysing the risks to the revenue and the proper compliance with our law. It is not an easy argument because of the use of specific purpose arrangements with varying underlying controllers.

Senator JOYCE—Have any of these private equity firms ever approached the ATO in regard to a tax ruling on any debt instruments to clarify whether they are debt or equity instruments?

Ms Farrell—We have had a number of private rulings that cover those things—not specifically private equity, but we have looked at hybrid instruments as part of a project review. When companies come to the tax office and ask for a private or class ruling, we would have looked at it in those situations.

Senator JOYCE—Have any private equity companies ever approached the tax office?

Ms Farrell—Not specifically. Private equity companies may not be the ones who would want to come to talk to the tax office. It may well be the actual takeover company itself when getting some assurance around the tax implications of what they are entering into.

Senator BERNARDI—When you said no private equity company initiated any transaction, at the other end of the scale, when they are seeking to exit, do they come to the tax office for an indication of their tax responsibilities, or do they rely on private advice?

Ms Farrell—They may want to, but generally in the large business sector they are usually very well advised firms who are familiar with the tax law, and we do not find that as much.

Senator JOYCE—Are the private equity firms that require generic commercial advice generally in the confines of the major accountancy firms that have a presence in Australia, like KPMG and Deloittes? Without nominating them, are they using Australian-based accountancy firms, or are any tax issues lodged with you lodged by other means?

Ms Farrell—We are not aware to what extent they are employing Australian local expertise or whether they have their own international experts.

Mr D'Ascenzo—I suspect you will find a mixture of international experts and Australian experts in some of the large deals.

Senator JOYCE—Aside from the New Zealand example, which I know is a hoary chestnut, do you have other examples of other countries where people could operate from? Could you now devise for us a structure which is perfectly legal and which would allow you to buy and sell companies in Australia and not pay any tax?

Mr D'Ascenzo—Anywhere in the world?

Senator JOYCE—Anywhere in the world.

Mr D'Ascenzo—It depends at what level, but if we are just talking at the capital gains tax level, a structure that operates such that a capital gain is derived as a business profit here in respect of a country where we have a double tax agreement, and that other country does not have a capital gains tax regime or a concessional capital gains tax regime, you would pay no tax on that, or less tax on that than if you were taxable in Australia.

Senator JOYCE—Yes. Maybe this is more of a Treasury question for Mr Andrew Reed. During our last discussions on private equity we talked about possible market fluctuations and what happens 'if'. Unfortunately, since that point in time we have had major market fluctuations. We hope that is not a preamble to something on a grander scale, but maybe it is. If that were the case, do you feel that private equity places an accelerant on those market fluctuations by reason of their leverage, by reason of the terms and conditions attached to the loan agreements and by reason of knock-out clauses that make people realise their investment?

Mr Reed—I do not think I have the expertise to comment on that, Senator.

Senator JOYCE—That is fine. Thank you very much, gentlemen.

CHAIR—What is the data collection time frame that will flow from this announcement next week likely to be? Are we talking about post 2007-08 tax lodgement? I am just interested in when you will start to get sufficient information back to start making value judgements.

Ms Farrell—As the commissioner indicated, some of the arrangements that we have looked at have not become private equity arrangements. They have become mergers and acquisitions, or the private equity players have not gone through with the deal. Ones that we have looked at have not come through. We would need to wait until the ones that are currently playing out lodge their tax returns to find the full accounting and tax ramifications. Again, getting back to the diagram, if you are looking at the period in which they come and take over a private equity group and then they hold the group, pay down some of the debt and then make a profit, the life cycle is a little bit longer than one tax year. To get a proper cross-sectional analysis, you need to look at a trend over time.

Senator STEPHENS—Thank you very much for making yourselves available this afternoon. I have one technical question and then I want to go to some of the evidence that we received in Melbourne, if I may. The Tax Laws Amendment (2006 Measures No. 4) Bill provided a capital gains tax exemption for non-residents other than gains on real property. Are the estimates of revenue losses in that bill still accurate, given the increase in leveraged buyouts involving private equity investment? Was an allowance made for an increase in private equity activity in the costings?

Mr D'Ascenzo—Ms Farrell can correct me, but I think the issue of capital gains tax application is really more dependent on whether it is business profits under our treaties. It may not really be a total fit with that exemption.

Ms Farrell—The costings that we gave Treasury at that time obviously would have been all the information that we had at that time. With respect to the capital gains tax exemption that you are talking about, the exemption is not always a feature of the deals. That would apply to a non-resident investing in, say, an Australian private equity, or a non-resident investing who has shares in one of the groups that is a target group. We are not aware to what extent that is greater than what was indicated by Treasury, but we do not see it as a significant feature in these leveraged buyout deals that we have pointed you to this afternoon.

Senator STEPHENS—If you could look at some of the issues raised in Melbourne, that would be helpful. One of the first issues is that Mr Battellino told the committee that he thought

the concerns about taxation and private equity were overstated. He pointed out that capital is liberated in a private equity deal, and said that this money is still generating tax. This seems to have been one of the issues that has been coming through public commentary and in some of the concerns raised in other submissions we received. Does the ATO have a view about the implications for future capital gains tax receipts from private equity activity? If activity escalated greatly off its current low base, is this something that the ATO would be concerned about?

Mr D'Ascenzo—Again, I do not think we have any information that can shed light one way or the other on that. In terms of the proposition about the generation of wealth in Australia, that can occur if businesses are structured more efficiently and create productive capacity. That is an economic question that, again, is outside our understanding. In terms of the likely impact on current and future capital gains tax provisions, at the moment we are not seeing a significant dip, but we would be feeding any intelligence that we get from our activities into the Treasury models. That would then see whether or not the right set of policy parameters were in place. But at this stage I really have nothing more to add than what Treasury might have said.

Senator STEPHENS—Thank you. We also received evidence in Sydney from the RBA that the threat of acquisitions through leveraged buyouts resulted in an observable rise in defensive behaviour by other companies who sought to increase their gearing to make themselves less attractive as a takeover target. What are the implications for company tax if there is a trend towards higher gearing by companies?

Mr D'Ascenzo—We have seen some anecdotal suggestion that that is correct. But again, it has not been significant in the scheme of our company tax collections at this stage. If it balloons, that sort of intelligence would be fed back to Treasury for their consideration. At this stage we have seen some anecdotal information of that occurring, but it is not at a significant level.

Senator STEPHENS—There is the financial stability review. The RBA informs us that the ATO has been working with some businesses, as you have described today, where private equity takeovers either have been completed or announced in 2006. Can you tell us whether there is a bias towards structuring deals for tax benefits?

Ms Farrell—As I have indicated, most of our work was looking at the market and economic drivers. Obviously, tax is a cost, like any other, and we are looking at the extent to which there is any aggressiveness about the structuring. To date, it is a bit too early to say that we have any compliance risks that are presenting themselves in the way that you are suggesting, but certainly part of our review, as we have indicated, will be to clarify further the extent of those compliance risks, if they arise.

Senator STEPHENS—I was reading a document over the weekend which was about the future of the agricultural sector and the takeover of family farms by corporations. I wondered whether you were seeing any evidence of private equity activity in taking over unlisted family companies for the purposes of being able in that way to distribute assets to family members.

Ms Farrell—Probably the way that we are looking at private equity is a public company that is listed on the stock exchange where a private equity interest comes in and buys that out, in part or in whole, and makes that taken-over entity private, and holds it for a period of time with a view to making profits and selling. So there is some scope in the small business market where,

with generational change, we will see a sole proprietor who may want to expand the business or carry it on and who will be into some sort of venture capital financing; but that is not really in the scope of what we are discussing today.

Mr D'Ascenzo—We have actually spoken to the smaller private equity players in Australia that operate at that level. One of the reasons that some businesses sell to private equity concerns is that they want to retire, they want to move out, and they have someone to whom they can provide the ongoing continuation of the business they have grown. That does occur. We need to ensure that, when they get paid out, it is paid out and, if it is a capital gain, that is taxable; and if it is a business profit in Australia, that is taxable. That is part of our small business activity, but it has not been one of our major risks.

Senator STEPHENS—Earlier I had to dash out for just a little while, so I am sorry if we have already dealt with this issue. I know you addressed in your opening remarks the question of thin capitalisation rules. Did we cover that?

Mr D'Ascenzo—Only briefly, to the point of how gearing might play out in terms of tax revenue.

Senator STEPHENS—Yes.

Mr D'Ascenzo—Our concern would be to ensure that the gearing ratio of the relevant companies would be within that three-to-one ratio.

Senator STEPHENS—Okay. That was really the basis of my question.

Senator MURRAY—But the point is that that still does not prevent a reduction in profit. You can shift your gearing from 40 per cent to 60 per cent and not fall foul of the thin capitalisation rules.

Mr D'Ascenzo—That is right.

Senator MURRAY—But you have reduced the profitability.

Mr D'Ascenzo—There may be situations where the company can absorb, within that ratio, significant debt.

Senator STEPHENS—Is that one of the issues that you are considering as part of your review?

Mr D'Ascenzo—Not from our perspective. It might be of interest to Treasury, but it is not of interest to us, provided they fit within the requirements of the law.

Senator STEPHENS—Thank you.

Senator CHAPMAN—I have no questions.

CHAIR—May I go back to the council again—APRA, ASIC, Treasury and the RBA. Is that the appropriate forum for a watching brief and exchange of information in this area? We have had some varied views about whether the council should be looking at this as a whole, or whether there is the reporting back by individual agencies within the council. My view probably is that there is no harm in this being looked at in a whole-of-agency manner, particularly over the next couple of years while we are seeing the growth or decline of private equity. What is your view on that?

Mr D'Ascenzo—I have not thought through that perspective, other than trying to provide whatever support we can to that council. We have done it primarily as an adjunct to Treasury's involvement and to provide information to Treasury in relation to what we are seeing in aggregate terms.

CHAIR—Would it be an inappropriate forum for a watching brief to be kept?

Mr D'Ascenzo—I am generally supportive of whole-of-government approaches.

CHAIR—You mentioned the thin capitalisation rules, which have, if you like, and for want of a better word, an in-built revenue protection mechanism. Obviously there are general taxation mechanisms. Are there any other current in-built revenue protection mechanisms that are worth talking about?

Mr D'Ascenzo—I think the thin cap puts a cap to how much gearing one can absorb. That is dependent on the capital structure of the company. They can still push through quite a lot of debt, as Senator Murray mentioned. The transfer pricing rules and the arm's-length principle in theory become a moderator in terms of the amount of payments people can make to non-arm's-length parties in international transactions. That is a feature of the law. They are two areas.

Ms Farrell—The commissioner is quite right. He has pointed out that, if there are related party dealings, we will use our transfer pricing mechanisms to make sure that there is an arm's-length price in a related party situation. Where there is not, and there is more internationalisation of the companies to make sure that there is not excessive debt loaded into Australia, there are rules around thin capitalisation safe harbours. However, there is also the general law test for debt—that, to be deductible, it has to be in relation to the business operations. But, broadly speaking, the company will be given a rating by a ratings agency, and third party debtors will decide how much debt they will lend in a market situation. So there are market factors also at play as to how much debt can be borrowed.

Mr D'Ascenzo—And the reality is that court decisions have indicated that a strict tracing approach is not necessary for debt in relation to the company perspectives. By and large, bona fide borrowings are likely to be on revenue account.

Senator STEPHENS—Commissioner, can you advise the committee of who has the discretion to determine whether it is income or capital?

Mr D'Ascenzo—The law says whether it is income or capital. It is a question of making a determination or an analysis of whether the facts put it on one side of the equation or the other

side of the equation. Part of the responsibility of the tax office under Australian tax law is to make that determination, if and when it comes to our attention.

Senator MURRAY—But the key question there is this issue of carried interest. The international concern, both in Britain and in the United States, has been about whether that should be regarded as normal income. That is the way in which these operators make their money and therefore it must not be classified as capital. Of course, if it is classified as income, you immediately get a higher revenue take. Is that in your discretion?

Mr D'Ascenzo—No, because ultimately, at the end of the day, those foreign jurisdictions have to make a decision under their law as to what the characterisation is for their law.

Senator MURRAY—What happens under our law with respect to carried interest?

Ms Farrell—If the general partner is a non-resident, as in this example here, as we understand it, the profits go back to the private equity owners. They would pay out of that profit a percentage or a proportion to the general partner. If the general partner is not located in this jurisdiction, as the commissioner said, that will happen offshore. The jurisdiction or contracting country in which that general partner is located will have the taxing rights. In the situation of the general partner being located in the Australian jurisdiction, again, as the commissioner said, it is a question of what the general partner is being rewarded for. There is no automatic assumption that it is capital or revenue. It would depend on the facts, except in that instance that I outlined to you about a venture capital limited partnership.

Senator MURRAY—If I can interpret that answer, and tell me if I am right or wrong, if a taxpayer is regarded as Australian for your purposes, the issue of carried interest will be determined by the tax office, whether it is income or capital, with respect to the individual circumstances of the taxpayer. That is correct?

Ms Farrell—Yes.

Senator MURRAY—So it is at your discretion; it is not a policy matter that needs to be adjusted.

Ms Farrell—It might be a bit misleading to say—

Mr D'Ascenzo—There is no discretion. It is how the law applies.

Ms Farrell—It is an interpretation of the tax laws. Discretion implies that we may be able to take into account a number of factors and give some determination, as opposed to properly applying the law.

Senator MURRAY—But that was your answer. Your answer to the committee was that you evaluate the taxpayer that you are assessing to see how they have earned their income.

Ms Farrell—Not the taxpayer.

Senator MURRAY—And how they have earned their income, therefore, has a consequence as to whether it is regarded as income or capital.

Ms Farrell—Not the actual taxpayer itself, but the nature of the document that evidences the transaction. What actually occurred is what I was trying to get to; that is, was the amount of carried interest paid as a part of the remuneration or services that that general partner performed, in which case it would indicate it is probably on revenue account, whereas if the general partner had any equity interest in the shares that were sold, it may indicate that it is on capital account. It would be a matter of interpreting the facts of the situation, the actual transaction, or the nature of the agreements that the general partner had.

Senator MURRAY—You may well understand why Senator Stephens and I have put these questions this way, but for the record let me make sure that you do understand. The question for the committee is whether a policy change would require a law change to make these issues clearer and more decisive. As I understand your answer, there is no need for the committee to come to that view because the way in which the law is already structured enables you to make a proper determination on the facts and on the documents before you. You do not need further clarity on the issue of income and capital relative to the circumstances or the documents. Is that an accurate understanding?

CHAIR—We are getting into a policy area.

Mr D'Ascenzo—That is okay, and I will endeavour to make my answer a proper answer to you. There is no more difficult area of determination in tax law than the capital-income dichotomy.

Senator MURRAY—Yes. It was always thus.

Mr D'Ascenzo—It was always thus, and it applies not just to private equity but across the whole gamut of that distinction. To say whether the law is clear in that distinction is difficult. It has been thus: we have pronouncements by high courts and others that we use as criteria to analyse the facts. At the end of the day, you do that as properly as you can and you come to a conclusion which you believe to be the correct conclusion, having regard to a proper weighing of those facts against the legal principles that have been established.

Sometimes you can't always be sure one way or the other that that is going to be right, and sometimes the courts themselves, when matters have been taken to the courts, have acknowledged that dichotomy and that that choice is a difficult one to make. I am not sure, as a matter of policy, unless you have a specific area of concern, where you can be more prescriptive, or that it is easy to have a simple distinction that will cover the variety of capital income issues with which one is faced in modern life.

Senator MURRAY—That makes it clear to me. Without getting into the policy discussions you have with the government and so on, it would seem to me, based on your responses, that there is no obvious policy problem with the law; that you are able, through jurisprudence and with the law available to you, to make the determination that is necessary, even when it is difficult.

Mr D'Ascenzo—That is right.

CHAIR—I suspect, without looking for an answer that, if you tried to make it more prescriptive, you would probably make it even more difficult. Ms Farrell, you were talking about the variety of rules that are in place at the moment. What is the extent of the compliance and enforcement activity in relation to those rules?

Ms Farrell—Broadly, the large business compliance program covers all the risk areas that the commissioner has pointed out for 2007-08. In that area we would be expending effort on ensuring that the features we have indicated in the compliance plan represent themselves in our review of large corporates.

Mr D'Ascenzo—Given the very large arrangements and the previous question about the level of local and international advisory support that people involved in these arrangements have, the issue is unlikely to be one of fraud, but rather one of characterisation, close analysis of the documents, and the arrangements that have been put in place. You really do not know that until you look at the documentation.

CHAIR—We will now conclude the hearing. I thank the commissioner and his colleagues for making themselves so readily available. It has been very constructive. I thank my Senate colleagues, Hansard and the committee staff. I now officially close the hearing.

Committee adjourned at 5.45 pm