11 December 2019

Brian McKay
Corporate and International Tax Division
Treasury
Langton Cres
Parkes ACT 2600

Via email: [*corporate.tax@treasury.gov.au*](mailto:corporate.tax@treasury.gov.au)

Dear Brian,

Extending the definition of a Significant Global Entity (SGE) – November 2019

The Australian Investment Council welcomes the opportunity to comment on the Treasury's consultation, *Extending the definition of a Significant Global Entity (SGE) – November 2019*.

The Australian Investment Council is the voice of private capital in Australia. Private capital investment has played a central role in the growth and expansion of thousands of businesses and represents a multi-billion-dollar contribution to the Australian economy. Our members are the standard-bearers of professional investment and include: private equity (PE), venture capital (VC) and private credit (PC) funds, alongside institutional investors such as superannuation and sovereign wealth funds, as well as leading financial, legal and operational advisers. Our members are comprised of both Australian domestic and offshore-based firms.

Private capital fund managers invest billions of dollars into Australian companies every year. For the first time in history, Australian-based private equity and venture capital funds under management topped $30 billion in 2018, testament to the growth in available capital to support investment into businesses across every industry sector of the economy. Fund managers secured an impressive $6.6 billion in new investment commitments over the past year, which means the industry has a combined total of around $11 billion in equity capital available to be invested in the short-term.

The Australian Investment Council (including under its previous name, the Australian Private Equity and Venture Capital Association) has for many years been supportive of reforms to our taxation system that help to ensure our economy is competitive and which encourage the growth and expansion of businesses. In particular, we are supportive of reforms that encourage or tackle barriers to greater levels of PE, VC and PC investment into Australian businesses.

In line with our submission on 17 August 2018, we believe that expanding the SGE definition would have detrimental outcomes for businesses that are backed by PE investments. It would discourage investment in Australian companies by PE funds and other investment entities due to the increased reporting and regulatory compliance burden that such entities and underlying portfolio companies would have to bear. Additionally, the proposed change to the SGE definition is likely to result in small-to-medium sized Australian businesses, which operate solely within Australia, becoming SGEs and, therefore, subject to a penalty regime designed for large multi-national groups – an outcome that can be avoided if our recommended amendments to the definition of SGE are adopted.

Supporting our Australian businesses is particularly important given the current position of the Australian economy. Initiatives that could reduce investment into Australian businesses and hamper growth and employment should be considered carefully. Our recommendations below aim to maintain the intended policy outcomes while reducing the potential unintended and negative consequences on both Australian businesses and the broader Australian economy.

Level 12, Aurora Place
88 Phillip Street
Sydney NSW 2000
+61 2 8243 7000
mail@aic.co
aic.co

We look forward to participating in any future discussion about the themes set out in this submission as part of the Treasury's consultation process. If you have any questions about specific points made in our submission, please do not hesitate to contact me or Brendon Harper, the Australian Investment Council's Head of Policy and Research, on 02 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive

The potential impact on private capital investment in Australia

a) Intention of the legislation

Our understanding is that the intent of expanding the SGE definition is to close an unintended consequence of the current criteria used to determine if an entity is an SGE. The broadened SGE definition seeks to remedy situations where an entity, or a related group of entities undertaking the same business, is currently not considered an SGE solely on the basis that it is owned by an entity which is not required to consolidate its financial statements according to accounting standards.

We also understand the objective and rationale to have consistent treatment of large corporate groups with revenue exceeding the SGE turnover threshold, notwithstanding differences in their ownership between corporate groups and those owned by investment entities such as PE, VC and PC funds or the managers of those funds.

a) Unintended consequences of the legislation

We recognise that the focus of the expanded SGE definition is to ensure that cross-border related party transactions fall within the scope of the package of integrity measures under Country-by-Country (CbC) reporting, Multinational Anti-Avoidance Law (MAAL), and Diverted Profits Tax (DPT) rules.

In a PE context, such cross-border related party transactions occur within a subgroup of related entities rather than between separate portfolio companies controlled by the same investment entity (i.e. controlled by the same PE fund). As such, we believe that the focus of the expanded SGE definition should solely be targeted at subgroups of related entities which satisfy the SGE definition in their own right (by, for example, reaching the $1 billion of global income threshold) notwithstanding being controlled by an investment entity.

In our view, the broadened SGE definition would require the aggregation of all investments of a PE, VC or PC fund, or a number of funds managed by the same firm, together. The consequence would be that the proposed legislation would capture individual companies or subgroups of entities conducting separate businesses – which have not entered into transactions with one another, cross-border or otherwise. On a standalone basis these individual companies would not exceed the SGE turnover threshold, but when aggregated with the other entities the PE fund invests in (which are conducting entirely unrelated businesses), could have a combined income higher than the SGE threshold and be deemed to be an SGE. This would, in our view, be an inappropriate outcome which, as described below, would likely negatively affect investment into the Australian economy.

The nature of PE funds mandates that standalone businesses are operated separately and independently of any other investments the PE fund makes. This is on the basis that the entities owned by the PE fund vary in size, level of management teams, the existence and number of co-investors, geographical location, industry sector, business activity, and investment holding period. Similarly, different minority shareholders or debt lenders will be providing capital separately to each portfolio company and would potentially have an influence on the financing or operational decisions of the business.

Whilst these businesses are not commercially related, and not a 'group' for the objectives and purposes of the SGE definition and the measures which apply as a result, a PE fund and the independent and separate portfolio companies it owns could be captured by the broadened SGE definition on an aggregated basis merely by the virtue that they are owned by the same transparent fund vehicle. For instance, we note that the intention of the DPT targets entities within multinational groups that enter into arrangements to divert their Australian profits to offshore related parties in order to avoid paying Australian tax. The broadened SGE definition will bring in-scope entities which have the characteristics of passive investment vehicles, which do not enter into the types of arrangements the DPT seeks to address.

The result, and presumably unintended consequence, of this would be reduced investment into a small-to-medium sized enterprise, whose turnover on a standalone basis is considerably lower than $1 billion, by PE investors. That is to say, there would likely be reduced investment into Australian business both from domestic and international investors.

b) Impact on the PE sector

Portfolio companies within a standard PE fund operate as standalone businesses as they are separately managed and normally have no transactions between themselves. The standalone portfolio companies within a PE fund often operate in different and unrelated industries as well as different geographies.

The purpose of acquiring stakes in each of the portfolio companies by the PE fund is to generate investment returns for fund investors. Other co-investors may also take stakes in those companies alongside the PE fund at the time of investment.

Each portfolio company is run by a different and separate management team, may have a separately arranged and managed debt package as part of its capital structure, and does not typically transact with other portfolio companies owned by the PE fund. Importantly, the fund entity is not required to consolidate the financial statements of individual portfolio companies for reporting purposes. We therefore believe that it is not appropriate to aggregate separate portfolio companies owned (fully or partly) by a PE fund or other collective investment vehicle into a single consolidated group.

The OECD's own Public Discussion Draft report on *BEPS Action 4: Interest Deductions and Other Financial Payments*[1] highlights two potential issues that arise when grouping PE portfolio companies for group-wide tax rules:

> *Firstly, in applying a group-wide rule an entity would need to obtain financial information on the position of its connected parties which would not be included in the group's consolidated financial statements. This could impose a significant burden on entities and tax administrations. Secondly, under this approach, the total third party interest expense of two connected groups (for example, those held by the same private equity fund) would be combined and allocated between entities in both groups. This could lead to undesirable results, particularly where the two groups operate in different sectors and have different funding needs.*

As the passage above highlights, the proposed changes to the SGE definition could potentially create a significant compliance burden. Investment entities such as PE funds generally have no centralised treasury or financial reporting function. In order to abide by the rules that apply to SGEs, PE funds would need to address this issue either through internal resourcing or the use of external accountants and advisers, thereby increasing their tax compliance costs. Conversely, an individual company would be limited in its ability to self-assess whether or not it itself is an SGE, and would need to place reliance on the above mentioned sources as arranged by the PE fund, including information relating to other companies owned by the PE fund. This again would be a difficult position to reconcile in circumstances where individual portfolio companies have no commercial relationship.

Ultimately, bringing in investment entities such as PE funds (including the fund manager entity and all underlying portfolio companies) under the same anti-avoidance rules that have been put in place for multinationals would see no material benefit to government revenue or the Australian tax base. Instead, there would be an increase in costs and a reporting burden for PE funds which provide much needed capital to many Australian businesses. The proposed amendments may deter them from making further investments in the future. An inflation in compliance costs for PE or VC fund managers would result in higher compliance costs which would ultimately lead to reduced returns for investors such as domestic superannuation funds.

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[1] *BEPS Action 4: Interest Deductions and Other Financial Payments*, OECD, December 2014

c) Impact on individual portfolio companies

In addition to the potential impact of the proposed legislation at the PE fund level, the broadened SGE definition may have unintended and undesirable outcomes on each portfolio company. For example, the undertaking of commercial opportunities or the use of debt in the company capital structure by each portfolio company could be affected due to these entities being deemed SGEs and being subject to certain group-wide rules.

It may also create costly reporting obligations for the underlying portfolio companies (which vary in size and level of management function) or affect the way that these businesses operate, to the detriment of the financial performance of those companies.

The Australian Investment Council's recommendations

a) Definition of SGE

A simplified solution would be to have a harmonised definition of SGEs across CbC reporting and general purpose financial statement obligations, with the definition being the existing CbC reporting entity definition. This definition should also apply in respect of MAAL and DPT for individual companies or subgroups of related companies. Under the exposure draft legislation, such entities would – in our view unfairly – meet the definition of an SGE solely by being part of a notional listed company group while not meeting the SGE annual global income threshold.

The proposed definition of a CbC reporting entity in the exposure draft would achieve the same outcome as would arise under the model legislation in Action 13 of the BEPS Action Plan, but without the unintended consequences and impact of the broadened SGE definition as it currently stands on our industry and investment entities more generally.

We therefore propose that this definition (as set out below for CbC reporting entities) also be used as the definition of an SGE.

b) Definition of Notional Listed Company Group

The proposed changes to the CbC reporting group definition included at Section 815-380 is how we believe the proposed Notional Listed Company Group should be defined. The purpose of this change would be to ensure portfolio company groups beneath a fund with an annual global income of over $1 billion or greater would be brought into the SGE legislation which we understand is the intention of the change. Defining the group this way would not, however, aggregate each of the portfolio investments for the purposes of testing the SGE revenue threshold. This approach would be consistent with OECD recommendations.

c) SGE administrative penalties

Broadly, the majority of PE investment in Australia is provided to small-to-medium sized entities. Given the nature and size of these businesses, it is most likely that they do not have a specialised in house tax recourse. If an entity is considered to be an SGE it will be subject to an increase in administrative penalties. In particular, with effect from 1 July 2017, SGEs are liable to substantially increased penalties for late tax filings. The minimum penalty unit is $105,000 (for documents up to 4 weeks late). The maximum penalty increases to $525,000 (where a document is more than 16 weeks late). It is important to note that this is not limited to late tax returns, but also other ATO tax filings (for example, CbC reporting obligations, activity statements and other notifications).

As discussed above, the proposed change to the SGE definition is likely to result in small-to-medium sized Australian businesses, which operate solely within Australia, becoming SGEs and, therefore, subject to a penalty regime designed for large multi-national groups. Modifying the proposed definition, as described above, would remove what we consider to be an unintended consequence.