

13 April 2023

International Tax Unit
Corporate and International Tax Division
Treasury
Langton Crescent
PARKES ACT 2600

MNETaxIntegrity@treasury.gov.au

Dear Sir

Submission by Sonic Healthcare Limited in relation to the removal of the deduction for section 768-5 NANE income

As you are aware, the Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation proposes amendments to sections 25-90 and 230-15 of the Income Tax Assessment Act 1997 to restrict the ability of multinational groups to deduct interest expenses for tax purposes.

Sonic Healthcare Limited (“Sonic” or “we”) welcomes the invitation extended by Treasury seeking stakeholders’ views on the exposure draft legislation and accompanying explanatory material implementing this measure. Specifically, we would like to use this opportunity to highlight the significant financial and commercial adverse consequences which will arise to Sonic if the proposals are enacted as set out in the Exposure Draft legislation, in ways which seem at odds to the original policy intent behind the proposals.

Sonic has been surprised by the proposed amendments to sections 25-90 and 230-15 given that they have not previously been announced and that similar changes were reviewed and rejected in 2014.

If you would like to discuss any aspect of this submission or require any further information, please do not hesitate to contact me on 02 9855 5404.

Yours sincerely



Chris Wilks
Chief Financial Officer and Finance Director
Sonic Healthcare Limited

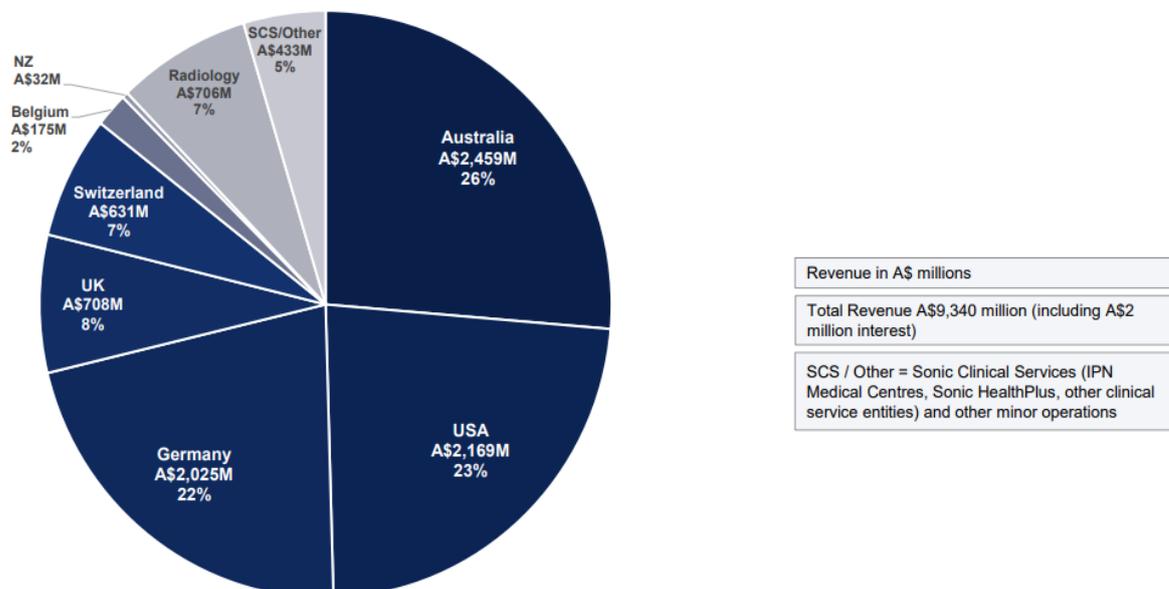
1. An Introduction to Sonic Healthcare

Sonic Healthcare is an Australian public company listed on the Australian Securities Exchange (ASX code: SHL), and is classified as an ASX Top-50 company. Sonic's annual revenues exceed \$8 billion and our current market capitalisation is over \$16 billion. Sonic and its subsidiaries employ over 19,000 people across Australia, and a further 21,000 overseas. Sonic's shares are widely held, predominantly by Australian investors. Sonic's share price has increased by a compound annual growth rate of 15.2% over the last 29 years (30 June 1993 to 30 June 2022), plus the company has generally maintained a dividend payout ratio of around 70% of net profit.

Sonic is recognised as one of the world's largest international medical diagnostics companies, delivering high quality laboratory services to patients and medical professionals in 7 countries located across 3 continents. Sonic also provides radiology and medical centre services in Australia.

Sonic holds pathology market leadership positions in Australia, Germany, Switzerland, the UK and Northern Belgium (Flanders), and is the third largest provider in the US. We are now the 3rd largest medical diagnostic company in the world and the largest international player, the two larger players essentially only operate in the USA. Our company is structured as a decentralised federation of medically-led diagnostic practices, with our global head office located in Sydney, Australia.

Sonic's geographic revenue breakdown for the 2022 financial year was as follows:



The Australian components of revenue include 'Australia' (which is Australian pathology revenue), 'Radiology' (which is Australian radiology revenue) and 'SCS/Other' (which is predominantly medical centre services revenue).

Sonic has been subject to various ATO reviews over the years and has received no material negative outcomes.

2. Sonic's Expansion Strategy

Sonic is considered by many to be a significant Australian success story. Starting with one laboratory (revenue ~\$13 million) in Sydney in 1987, Sonic expanded by acquisition and organic growth to become the market leader in Australia. Having reached a dominant market share in the early 2000's from which it would be difficult to grow further by acquisition in Australia due to antitrust restrictions, Sonic sought to take its strategy of consolidating pathology markets to fragmented offshore markets, using its unique medical leadership culture, federation model and other intellectual property to provide competitive advantage.

As proven by Sonic over decades in Australia and over the last 20 years offshore, the pathology industry is one in which economies of scale are very significant, and so consolidation of fragmented markets by the acquisition of businesses produces significant synergies over time, as specimen collection infrastructure, courier networks and laboratory infrastructure and workflows are rationalised and procurement benefits are obtained. Business acquisitions have therefore been a fundamental part of Sonic's model, and over 80 significant acquisitions have been completed over the last 29 years. The graphic attached as Appendix 1 sets out the years, names and countries of these acquisitions.

3. Funding

The acquisitions described above have been funded by a combination of equity and third party debt, so as to optimise the cost of capital over time, thereby increasing shareholder returns. Sonic is not an overly geared entity – group debt metrics (calculations as per Sonic's syndicated bank debt facility definitions) at 31 December 2022 were:

- Gearing ratio 10.5% (Net debt/[Net debt + equity]; external bank covenant limit <55%)
- Interest cover ratio of 36.9 (EBITA/Net interest expense; external bank covenant limit >3.25)
- Debt cover ratio of 0.5 (Net debt/EBITDA; external bank covenant limit <3.5)

To manage currency translation risk Sonic uses "natural" hedging, under which foreign currency assets (businesses) are matched to the extent possible with same currency debt. This means that:

- as the AUD value of offshore assets changes with currency movements, so does the AUD value of the debt; and
- as the AUD value of foreign currency EBIT (Earnings before Interest and Tax) changes with currency movements, so does the AUD value of the foreign currency interest expense.

This hedging is extremely important to Sonic's shareholders as it significantly reduces the volatility in earnings per share (and equity values) that would otherwise occur when the AUD strengthens or weakens against the USD and/or EUR.

As an Australian company, Sonic's equity funding is naturally sourced in the form of AUD. As a result of this (i.e. equity is used for AUD funding requirements, or has been used to repay historic AUD debt), and Sonic's hedging strategy noted above, 97% of Sonic's existing debt is currently denominated in USD, although borrowed in Australia. In prior years, Sonic has also borrowed funds in Australia that were denominated in EUR. Borrowing in USD and EUR has had the additional benefit in recent years of being significantly cheaper than borrowing AUD via lower base rates.

Under existing Australian tax law, Sonic achieves the same tax outcome as the accounting outcome, that is the interest on the foreign currency debt is an allowable deduction / accounting expense however currency gains or losses on the borrowings are not assessable or deductible for tax and not recorded as income or expense against profit (under accounting standards the currency gains/losses go to the Foreign Currency Translation Reserve in the balance sheet).

The most commercial approach has been for Sonic's Australian group to borrow the third party debt for offshore expansion as:

- Sonic's Australian operations have very strong cash flows and are very well understood and perceived as lower risk by Australian based banks;
- Earnings/cash flows of the offshore acquisitions have not been strong enough to support the desired level of debt, at least at economical pricing, especially in the early phases of entering a new geographic market. It is only once several acquisitions are made in a market and synergies have been achieved that local earnings substantially increase;
- Sonic's Australian based banks have been able to lend in the required currencies at competitive rates, reducing the number of banks with which Sonic has been required to deal; and

- Local laws in various jurisdictions make borrowing in those jurisdictions difficult or uneconomic. For example, Sonic's German and Belgian subsidiaries are prevented by local corporations laws from giving the level of guarantees expected by Sonic's banks, and are therefore not allowed to borrow under Sonic's existing debt facilities. In Belgium and Switzerland, subsidiaries cannot be "grouped" for tax purposes, making it uneconomic to introduce significant debt/interest expense into those countries for acquisitions.

Sonic's Australian group annually satisfies the thin capitalisation safe harbour test in respect of its debt funding. That is, the Australian business of Sonic can independently support its borrowings, including the foreign currency debt which was used to fund its global expansion. It is anticipated that Sonic will satisfy the proposed Australian thin capitalisation Fixed Ratio Test commencing on 1 July 2023.

4. Proposed repeal of sections 25-90 and 230-15

Sonic strongly opposes the proposed repeal of sections 25-90 and 230-15. We have structured Sonic's finances over the last 22 years (in which time almost all of Sonic's offshore expansion has occurred) based on the certainty of allowable deductions for interest under sections 25-90 and 230-15. Removal of sections 25-90 and 230-15 would alter the entire basis for deductibility of Sonic's funding of its foreign expansion, despite the legislative history.

Please note that debt with non-deductible interest is not a form of funding which would be acceptable to Sonic's shareholders or the financial markets generally, impacting Sonic's share price. In addition, we would assume that the majority of the interest we pay is returned as taxable income in Australia by the banks to whom we pay it, so to have a non-deductible portion would seem to be a form of double taxation.

Any non-deductibility would raise Sonic's cost of capital, making us less competitive against our foreign competitors.

Prior to the introduction of section 25-90 in 2001, Sonic was required to trace the use of its borrowed funds to distinguish between deductible interest on borrowed funds used for local operations and non-deductible interest on borrowed funds used for offshore acquisitions. This led to the situation where companies used debt to fund their foreign acquisitions and equity or cash reserves to fund foreign acquisitions. The introduction of section 25-90 was seen as a compliance saving for both the taxpayer and the ATO as the tracing exercise did not need to be undertaken. The proposed removal of sections 25-90 and 230-15 is counter to the compliance saving identified when the provisions were introduced. Further, as there has been no need to trace the use of borrowed funds post the introduction of section 25-90, it will be difficult, if not impossible, for taxpayers to trace through the use of borrowed funds over the last 20 years and determine the non-

deductible borrowing component that would arise on 1 July 2023 if sections 25-90 and 230-15 are removed.

4.1 Problems associated with restructuring our existing debt

Sonic's Australian group has debt in the form of notes on issue totalling USD550 million in the United States Private Placement market. The investors in these notes are major/global insurance companies. These fixed interest rate notes mature between 2030 and 2035 and attract "make good" costs which need to be paid to the investors if repaid early. \$2.45 million of upfront fees already paid may also need to be written off (which would otherwise be amortised over the remaining life of the facilities). Any amendment will involve additional costs, such as legal fees.

Sonic may also suffer reputational damage as a result of breaking long term financing arrangements with lenders, and any restructure could also result in the loss of the "natural" hedging of our offshore investments (described above), creating additional currency exposure and volatility in earnings. There is also the possibility of triggering millions of dollars of realised currency gains or losses on repaid debt, impacting profit (depending on accounting standards interpretations) and/or taxable income.

In addition, Sonic's Australian group has existing bank debt (totalling ~\$20 million) which is sourced under 3 separate debt facilities, involving combinations of the 4 major Australian banks and three other banks with offices in Australia and five banks with offices located offshore. These facilities have expiry dates spread out over the next 15 months. Sonic is committed to refinancing two of these debt facilities in April 2023 which will extend the facilities for four years and increase the borrowing limits of the debt facilities from ~\$800m to ~\$1.2 billion. To amend or terminate these bank debt facilities to facilitate a restructure of Sonic's finances will have a significant economic cost to Sonic, including potentially writing off approximately \$4m of upfront fees (which would otherwise be amortised over the remaining life of the facilities), and the incurrance of new fees. Base interest rates could also significantly different if Sonic is forced to borrow in AUD (versus USD or EUR).

If this policy is to proceed, we strongly request that implementation be delayed given the difficulty of restructuring Sonic's debt facilities in such a short time period ie prior to 1 July 2023. The shadow of the potential application of the Part IVA anti-avoidance provisions looms over any potential restructuring, on the basis the ATO may argue that the dominant purpose of the restructuring is for a "tax benefit". We submit that assurances from the ATO should be granted that Part IVA should not be applied to Sonic in such a scenario.

Further, with respect to currently existing debt, it is critical that the tax position of this debt be grandfathered so that there is no retrospectivity about the change adding to sovereign risk concerns of our investors, and changing substantively the economics upon which past offshore business acquisitions were conducted by Sonic.

4.2 Sonic could become uncompetitive when bidding for future acquisitions

The proposed removal of sections 25-90 and 230-15 could also make Sonic uncompetitive when bidding for future acquisitions due to a higher cost of capital, especially in new markets where Sonic will struggle to borrow and/or obtain a tax deduction for interest, against existing market participants with local earnings and borrowing bases. Had section 25-90 not existed when Sonic was bidding for our initial acquisitions in Switzerland (2007) and Belgium (2010), our cost of capital for these acquisitions would have been substantially higher, and we would have been far less competitive than other bidders.

All of above factors will adversely affect Sonic's share price and impact its (and every Australian multinational's) ability to compete on the global stage. We consider this outcome inappropriate and directly contradictory to the purported policy intent of stamping out abusive arrangements by foreign multinational groups in order to improve the fairness and equality of the Australian tax system. Under the earnings-based approach recommended by the OECD, non-taxable income such as foreign dividend income should not be included in the calculation of earnings. It is against the policy recommendation of the OECD and the rules implemented by other countries to introduce an additional limitation on interest expenses used to fund offshore operations.

5. Tracing and apportionment

If a repeal of sections 25-90 and 230-15 is pursued, Sonic may no longer be able to deduct financing expenses under existing arrangements unless a nexus between the expense and assessable income can be established. Even if such a nexus can be established, it is likely that issues of apportionment/allocation may also arise.

We submit that allocation of an Australian company's interest expense should not be based on any rule of thumb apportionment ratios (such as proportion of Australian assets to foreign assets, Australian operations income to foreign sourced income etc), but rather on tracing principles, with regard given to the funding capacity of the Australian operations (such as is currently required under the arm's length debt test for thin capitalisation purposes). An Australian corporate group should have the flexibility to decide, based on commercial factors, how it funds each division of its business, including its offshore operations, and should not need to fear that every dollar we borrow to fund genuine Australian operations may have some component of non-deductible interest.

APPENDIX 1



LEGEND

- Pathology / Laboratory medicine
- Radiology
- Clinical services
- Australia
- Belgium
- Germany
- New Zealand
- Switzerland
- United Kingdom
- United States

