Australian Government

Multiple entry consolidated groups — review

Report of the Working Group

APRIL 2014

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1. EXECUTIVE SUMMARY

1. This report has been prepared by a tripartite working group (the Working Group) that brought together the expertise and knowledge of private sector experts and Treasury and ATO officials. The Working Group was established to consider the complex policy and law design issues associated with addressing the inconsistencies in the tax outcomes between ordinary consolidated groups and multiple entry consolidated (MEC) groups (Chapter 2).

2. The Working Group was established after the 2013-14 Budget to examine options to improve the efficiency and equity of the tax system by addressing any systemic tax advantages available to foreign-owned MEC groups, and those groups capable of forming MEC groups, that are not available to Australian-owned ordinary consolidated groups (Chapter 2). The review's terms of reference anticipate that MEC groups will continue to exist as an alternative to consolidated groups.

3. The timetable for the review anticipated public consultation on a discussion paper. However, the review timetable was interrupted by the 2013 election and associated caretaker period and ultimately no public consultation process was feasible.

4. As part of this review, the Working Group identified six tax advantages MEC groups have over Australian-owned ordinary consolidated groups. In determining these advantages, the benchmark that (where possible) was generally applied by the Working Group was the tax outcomes that would result from an Australian-owned consolidated group undertaking a similar transaction. While the Working Group sought data to assess the revenue consequences of these inconsistencies, it was advised that no suitable data was available (Chapter 4).

5. Taking into account a range of factors, including foreign taxing rights, compliance costs and other commercial drivers, the Working Group has considered policy responses that target the specific tax advantages identified in Chapter 4 without introducing undue complexity or compliance costs. The Working Group concluded that in most cases there were no suitable solutions that did not introduce undue complexity or compliance costs, but has recommended the Government consult on the design and compliance costs of one option to address one of the tax advantages (Chapter 5).

6. In response to the Government's request, the Working Group also considered some technical amendments for MEC groups that are part of an announced but unenacted consolidation measure (Chapter 6).

2. INTRODUCTION

2.1 POLICY ANNOUNCEMENT

7. On 14 May 2013, the then Government announced that it would improve the efficiency and equity of the tax system by removing any systemic tax advantages available to foreign-owned MEC groups, and those groups capable of forming MEC groups, that are not available to Australian-owned ordinary consolidated groups.

8. This announcement formed part of the 2013-14 Budget measure *Protecting the corporate tax base from erosion and loopholes — closing loopholes in the consolidation regime*.

9. On 6 November 2013, following a process which considered all announced but unenacted measures, the Government announced that it would proceed with this measure as announced.

10. The policy arose partly in response to concerns raised by the Board of Taxation in its *Post implementation review into certain aspects of the consolidation regime* about inconsistencies in the tax treatment for MEC groups used by multinationals and ordinary consolidated groups. However, the Board also emphasised that this does not necessarily mean that groups that choose to structure themselves with multiple entry points into Australia do so for tax purposes, as there may be a range of commercial reasons why such a structure would be preferable over a single entry point into Australia. The review's terms of reference anticipate that MEC groups will continue to exist as an alternative to consolidated groups.

2.2 THE REVIEW PROCESS

11. The review process involved the establishment of the Working Group, chaired by the Treasury and consisting of members of the ATO and private sector tax specialists.

12. When the then Government announced the policy in May 2013, it released an Issues Paper outlining some of the key tax advantages available to MEC groups and the terms of reference for the Working Group (see Appendix 7.1).

13. The Issues Paper set out the proposed review process and indicative timeline. It was initially envisaged that the review process would involve the release of a discussion paper and public submissions, prior to the final report being provided to Government in 2014.

14. However, at the announcement of the dissolving of Parliament on 5 August 2013, ahead of the Federal election, the Working Group process was put on hold due to election protocols, so as not to pre-empt the policy direction of an incoming Government. This significantly limited the amount of time the Working Group had to develop options and effectively prevented the Working Group from undertaking public consultation.

15. Following the Government's November announcement to proceed with this process, it was decided that, given the limited available time, the Working Group would prepare a final report, based on the knowledge, research and conclusions that the Working Group had gathered to date.

16. Consistent with the original timeframe, it is anticipated that any changes to MEC Group arrangements will apply from 1 July 2014.

3. Consolidated groups and MEC groups

3.1 Purpose and key features of tax consolidation

17. The tax consolidation regime was introduced in 2002, following recommendations made by the 1999 Review of Business Taxation. The Review recommended a system of tax rules for wholly-owned corporate groups to overcome efficiency and integrity concerns that arose regarding the taxation of wholly-owned groups under the previous corporate tax system.

18. Prior to the introduction of the consolidation regime, Australian resident companies were taxed as separate entities. Although grouping rules were available, they were complex and unwieldy to administer and caused a number of distortions and integrity concerns. The consolidation regime was introduced as a structural solution to address these problems.

19. The consolidation regime is now a fundamental component of the business tax system in Australia. Approximately 83 per cent of wholly-owned groups in the medium to large business sector (groups with turnover of more than $50 million) and 93 per cent of wholly-owned groups in the large business sector (groups with turnover of more than $250 million) fall within the consolidation regime.

20. The objectives of the consolidation regime were to assist in the simplification of the tax system, reduce taxpayer compliance costs and ATO administration costs, improve the efficiency of business restructuring and strengthen the integrity of the tax system by preventing double taxation and the provision of double tax benefits.

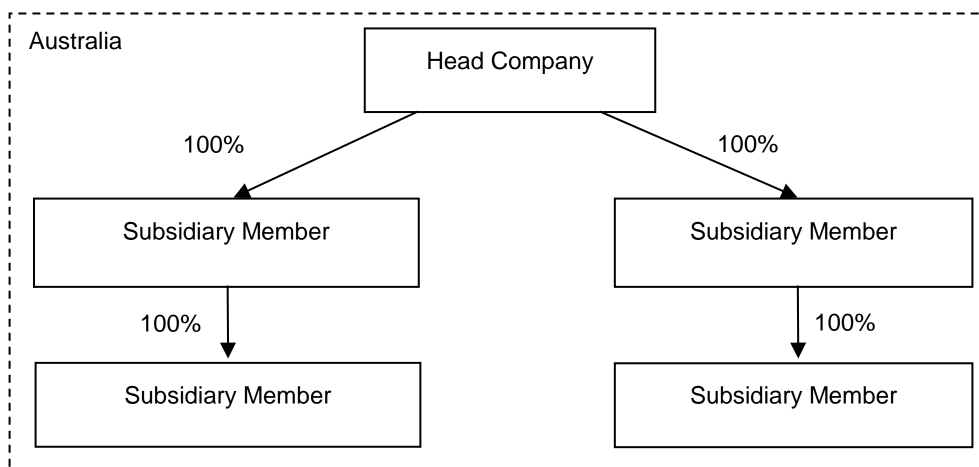
21. The Board of Taxation's report *Post Implementation Review into Certain Aspects of the Consolidation Regime* considers that the consolidation regime as a whole has delivered substantial efficiency and integrity improvements to the Australian tax system when compared with the previous tax grouping rules. However, the Board also acknowledged that there is substantial complexity in the current operation of the consolidation regime, particularly when entities enter a consolidated group.

3.2 The operation of ordinary consolidated groups

22. The consolidation regime applies to wholly-owned groups of Australian resident entities that choose to form a consolidated group for income tax purposes.

23. A consolidated group generally consists of an Australian resident 'head company' and all of its wholly-owned Australian resident subsidiaries; entities in a consolidated group must be 100 per cent owned by either the head company or one or more of its subsidiaries (see Diagram 1).

Diagram 1: Ordinary Consolidated Group



24. Once the head company of a wholly-owned group chooses to consolidate, the members of the group are considered to be a single entity for income tax purposes. The decision to consolidate is irrevocable. Members will leave the group if they are no longer wholly owned by the head company or one or more of its subsidiaries. In addition, all entities that are eligible to join the consolidated group must do so. This requirement is known as the 'all-in' principle.

25. When a subsidiary enters or exits an ordinary consolidated group it is subject to the tax cost setting rules. Upon entry, these rules establish the tax costs that are given to the assets of the subsidiary. Upon exit, these rules use the value of the subsidiary's assets to establish the tax cost of the membership interests in a subsidiary that is exiting a group.

26. When an ordinary consolidated group acquires an entity (which is necessarily at the subsidiary level), the cost bases of the entity's assets are reset using the consolidation entry tax cost setting rules. These rules generally reset the entity's asset cost bases with reference to how much was paid for the entity's shares plus the accounting value of the entity's liabilities (with other adjustments in particular circumstances). This amount, known as the entry allocable cost amount (ACA), is then 'pushed down' into the value of the underlying assets; that is, the assets' cost bases are reset based on their proportionate share of the entity's market value.[1] This process is known as the 'entry ACA method'.[2]

27. When an ordinary consolidated group disposes of an entity, the above process is essentially reversed. That is, the cost base of the shares in the exiting entity is determined with respect to the tax costs of the entity's net assets. This generally involves subtracting the accounting value of the entity's liabilities from the tax values of the entity's assets (with other adjustments in particular circumstances). This amount, known as the exit ACA, is then 'pushed up' into the entity's shares. This is known as the 'exit ACA method'. Any taxable gain/loss on the sale of the entity is calculated by reference to the difference between the cost base of the shares and the price the shares are sold for, and the resulting tax liability will be payable by the head company.

1 The value of some assets, such as cash, is not reset. These are known as retained cost base assets.
2 Tax cost setting treatment is also applied to taxation of financial arrangements liabilities.

28. In addition to the clearly defined, Australian-owned consolidated groups, there is also a class of ordinary consolidated groups that are foreign-owned. While these entities operate identically to ordinary consolidated groups, their structure is not fixed as is the case for Australian-owned ordinary consolidated groups. They can, on acquisition or incorporation of an eligible tier one company (ET-1), elect to convert to a MEC group structure.

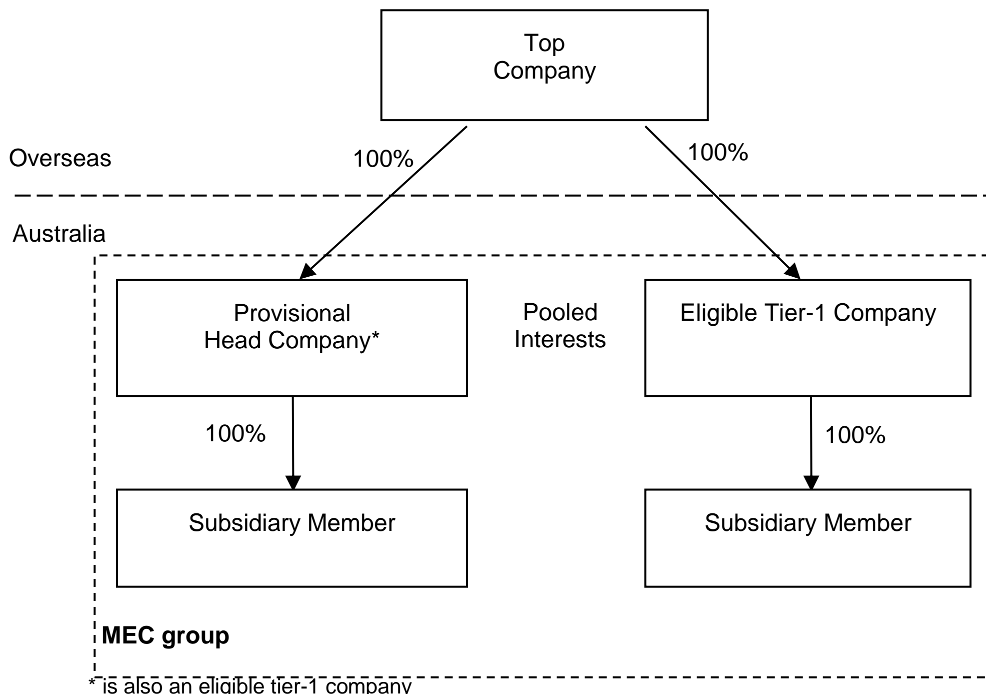
3.3 THE OPERATION OF MEC GROUPS

29. Originally only ordinary consolidated groups were intended to form part of the consolidation regime. However, during the design of the regime it became apparent that some groups that at the time were accessing the old grouping provisions (which had a number of integrity and efficiency issues and which the consolidation regime replaced) would not be able to readily restructure to form ordinary consolidated groups. These were groups with a non-resident parent company and two or more wholly owned Australian resident subsidiaries.

30. While it may have been possible for some of these groups to restructure under a single Australian parent company, or form several consolidated groups, a decision was taken to allow some level of flexibility for them to form a MEC group. Part of the reason for this was that the then Government sought to ensure that no groups under the old grouping provisions would be made worse off over the transition to the consolidation regime.

31. MEC groups are groups that consist of Australian-resident entities that share a common ultimate foreign owner (Top Company) (see Diagram 2). The entities that represent the first entry points of ownership by the Top Company into Australia are referred to as ET-1s. To be an ET-1, the Top Company must own 100 per cent of the shares in a company but only one of these shares needs to be owned directly, with the remaining shares able to be held indirectly.

Diagram 2: Multiple entry consolidated groups



32. At least two ET-1s are required to form a MEC group, one of which is elected to be the provisional head company (PHC). The PHC operates in a similar manner to the head company of an ordinary consolidated group. If the PHC of a MEC group becomes ineligible to head the group (for example, if it is sold), the MEC group may elect another ET-1 in the group to be the PHC for the MEC group to continue.

33. MEC groups are not subject to the 'all-in' principle with regard to ET-1s. That is, the non-resident Top Company can have wholly-owned entities within Australia that are not members of the MEC group, despite those entities being eligible to join the group as ET-1s.

34. Similar to ordinary consolidated groups, when a MEC group acquires or disposes of a subsidiary of an ET-1, the entry and exit ACA calculations are applied as they are for an ordinary consolidated group. However, in the case of the acquisition or disposal of an ET-1 by the foreign owner, alternative processes are used. This is because the shares in ET-1s are owned by entities outside of the group and retain their own tax cost bases. As such, ET-1s are treated similarly to the head company of a consolidated group, whose shares are also held by entities outside of the group.

35. This means that the cost bases of an ET-1's assets are not reset when they enter a MEC group, that is, they are retained. This is the same treatment that the assets of the head company of an ordinary consolidated group receive on formation.

36. On exit, the sale of an ET-1 is treated like the sale of a portion of the shares in a head company of an ordinary consolidated group. Consequently, when an ET-1 leaves the group, the cost base of its shares is calculated using a different set of rules than those that govern the sale of subsidiaries. These rules are known as the pooling rules.

37. Under the pooling rules, the shares in each ET-1 are referred to as pooled interests, with the total sum of the cost base of those interests (that is, the total value of the MEC group's ET-1s) being analogous to the cost base of the shares in the head company of an ordinary consolidated group. As a result, the reset cost base for the shares in an exiting ET-1 is calculated by allocating a proportion of the group's pooled cost amount[3] to the exiting ET-1's shares based on their relative contribution to the market value of the group (just before the ET-1 exits the group):

$$\text{Cost base of the shares in the exiting ET-1} = \frac{\text{Market value of the membership interests in the exiting ET-1 just before exit}}{\text{Market value of the group just before exit}} \times \text{Pooled cost amount}$$

38. Any tax payable on the sale of an ET-1 is calculated by reference to the difference between the reset cost base of the shares in the ET-1 (calculated under the pooling rules) and the price the shares are sold for.

39. The pooling rules were designed to ensure that, on average and over time, the correct amount of taxable gains are recognised when ET-1s are sold. However, for specific sales, a higher or lower taxable gain might be recognised on the ET-1s' shares as compared to the indirect gain in respect of underlying assets of the exiting ET-1.

3 A pooled cost amount (PCA) reflects the amount paid for the shares in the MEC group through the eyes of the top company of the worldwide group. The PCA is then used to determine the cost base of the shares in ET-1s that are later sold out of the group.

40. Although the additional flexibility granted to MEC groups over ordinary consolidated groups can result in inconsistent tax outcomes, as indicated above, MEC structures exist for a range of commercial reasons, not purely for tax purposes. These commercial reasons include that it may be more efficient for the different business lines of a multinational group to be owned and run separately through each ET-1 of a MEC group, and any associated subsidiaries, rather than through a single Australian resident holding company. This may particularly be the case where the different business lines in Australia are only brought together by a merger of two multinational groups. The provisional head company then provides tax administration services to the rest of the group.

41. This is particularly important for Australia because as a capital importer, foreign investment plays an important and beneficial role in the Australian economy. Foreign investment provides additional capital for economic growth, creates new employment opportunities, improves consumer choice and promotes competition. Foreign investment can also improve Australia's competitiveness and productivity by introducing new technology, infrastructure, access to global supply chains and markets while enhancing Australia's skill base.

4. IDENTIFIED TAX ADVANTAGES

42. The terms of reference asked the Working Group to consider how to best remove the tax advantages available to MEC groups, and groups capable of forming MEC groups (that is, foreign-owned ordinary consolidated groups), that are not available to Australian-owned ordinary consolidated groups. The terms of reference anticipate that MEC groups will continue to exist as an alternative to ordinary consolidated groups. When assessing the tax advantages, the benchmark that where possible was generally applied by the Working Group was the tax outcome that would result from an Australian-owned consolidated group undertaking a similar transaction.

43. In applying the benchmark, the Working Group considered an initial set of issues that arise in relation to specific tax policies, which exist outside the consolidation regime, where the transaction involved an allocation of taxation rights between Australia and foreign jurisdictions. For example, the Working Group considered interaction between the Australia's bilateral international tax treaties and the non-resident Capital Gains Tax (CGT) exemption for foreign owned companies, and consolidation concepts such as the single entity rule and the all-in principle.

44. These interactions were particularly relevant when examining the tax consequences of the sale of an ET-1. That is, whether (from an international perspective) the owner of the shares should be subject to principles such as the single entity rule and how that would interact with treaty rights for the non-resident.

45. After some consideration, the Working Group concluded that these interactions necessarily require consideration of broader policy issues associated with international tax policy and this would be outside the scope of this review.

46. In light of this, the review has focused on whether domestic transactions are providing the correct taxation outcome in Australia where the transaction involves MEC groups.

47. When applying the benchmark, a second set of issues arise when determining how the benchmark should apply to ET-1s to ensure that there is an approach to cost setting across MEC groups and ordinary consolidated groups that reduces the inconsistencies between them. This is because a fundamental difference between Australian-owned consolidated groups and MEC groups is the absence in MEC groups of a single Australian resident parent company, which is central to the overall flexibility that MEC group's currently enjoy.

48. In light of the issues highlighted above, the Working Group has identified six tax advantages that MEC groups have over ordinary consolidated groups. The Working Group acknowledges that these may not be the only items; however, it believes that these represent the material differences that the Working Group is aware of at the time of writing this report. The Working Group also notes that there may be a range of commercial considerations that limit the advantages in practice.

49. In addition, the Working Group sought data to assess the revenue impact of the inconsistencies between ordinary consolidated groups and MEC groups, and the revenue impact of the advantages below. The Working Group was advised the necessary data was not available.

50. The Working Group, as part of the review, also notes that there are some tax disadvantages faced by MEC groups as compared to ordinary consolidated groups, however, other than as discussed in paragraphs 93 to 96 below, these are outside the scope of the terms of reference.

4.1 Advantage 1: The ability to retain or reset asset cost bases on entry

51. On entry, MEC groups have the ability, subject to a range of commercial considerations, to retain the cost base of assets by bringing an entity holding the assets in at the ET-1 level or reset the cost base of assets by bringing the entity holding the assets in at the subsidiary level. This provides an incentive for MEC groups to bring in entities at the ET-1 level when the entity's assets have lower market values than their current cost bases. By retaining the higher cost bases of these assets, MEC groups can reduce future capital gains or enhance depreciation deductions, depending on the character of the assets.

4.2 Advantage 2: Deferring the recognition of tax preferred income on progressive acquisitions

52. When a subsidiary member joins an ordinary consolidated group its assets are treated as belonging to the head company and the tax costs of its assets are reset using the entry ACA method.

53. Step three of the entry ACA method implicitly prevents any tax preferred income[4] accrued over a progressive or creeping acquisition from being pushed down into the cost bases of the joining subsidiary's assets. However, this does not occur for joining ET-1s as the tax cost setting rules are not applied, providing potential opportunities for MEC group to reduce future capital gains or enhance depreciation deductions, depending on the character of the assets.

4.3 Advantage 3: The ability to apply the pooling rules or exit ACA method

54. Assets may be sold directly, by selling the assets themselves, or indirectly, by selling the entity that holds those assets. The consolidation regime enables assets to be transferred between the members of a group with no tax consequences. A MEC group can therefore sell assets by transferring them to either an ET-1 or a subsidiary member of the group and then selling that entity. In doing so, the group has the ability, subject to a range of commercial considerations, to determine whether a better tax outcome could be achieved by selling an entity at the ET-1 level or selling an entity at the subsidiary level.

55. While the CGT outcomes provided by the pooling rules, which apply to the sale of an ET-1, generally reflect the underlying economic transactions on average and over time, the CGT outcomes for individual ET-1 sales can be distorted. This provides an incentive for MEC groups to sell assets through the sale of an entity at the ET-1 level when the pooling rules underestimate the capital gains on the sale, and to sell assets through the sale of an entity at the subsidiary level when the pooling rules overestimate the capital gains.

4 Tax preferred income is income that is recognised by an entity for accounting purposes but not tax purposes and is therefore not assessable to the entity. It includes, for example, tax exempt income and income that arises as a result of the application of tax concessions such as accelerated depreciation.

56. The Working Group notes that the pooling rules were introduced as a mechanism for setting tax cost bases for the membership interests of ET-1s, because the shares in ET-1s are owned by entities outside of the group and retain their own tax cost bases. That is, the pooling rules allocate the historical cost base of membership interests in ET-1s so that the calculation of any gain or loss on the disposal of membership interests in an ET-1 is aligned to those consequences for the disposal of membership interests in the head company of an ordinary consolidated group.

57. In addition, the Working Group notes that the pooling rules perform an important revenue protection role in that they prevent value-shifting between ET-1s and prevent tax preferred income from escaping the tax system, which would be possible if the exit ACA method were applied to ET-1s. That is, while the operation of the pooling rules contribute to a tax advantage for MEC groups (as described above), they also address an integrity concern (that is, the scope for value-shifting) and another potential tax advantage (that is, no or minimal tax being paid on tax preferred income in Australia) that would otherwise arise for MEC groups when compared to ordinary consolidated groups.

4.4 Advantage 4: Leveraging ET-1s to reduce CGT liabilities

58. MEC groups may be able to seek to minimise tax on the sale of assets that have increased in value by transferring the assets to an ET-1 that purchases the assets with debt funding and then selling the ET-1 with minimal tax consequences. This occurs because the ET-1 that acquires the asset has a low market value, as the value of the asset is largely offset by the value of the financing liability. CGT event L5 prevents subsidiaries in ordinary consolidated groups from leveraging entities to avoid CGT. It ensures that a capital gain arises under the exit ACA method when an exiting entity's accounting liabilities exceed the tax costs of its assets. This process does not apply to ET-1s because they are not subject to the tax cost setting rules.

4.5 Advantage 5: The interaction between the non-resident CGT exemption and the single entity rule

59. MEC groups have the potential to seek to minimise tax on asset sales by first transferring the asset to a non-land rich ET-1, and then selling the shares in the ET-1 with the non-resident CGT exemption. In contrast, the owners of foreign owned ordinary consolidated groups can only access the non-resident CGT exemption if they sell the entire group.

4.6 Advantage 6: The non-application of the 'all-in' principle to ET-1s

60. The 'all-in' principle of the consolidation regime was designed to prevent intra-group transactions (related party arrangements) that enable:

- the deferral of tax through altering the timing of recognition of income or expenses;
- loss duplication and value shifting between group members; and
- the re-characterisation of income (revenue to capital), and expenditure (non-deductible to deductible).

61. As the 'all-in' principle does not apply to potential ET-1 members of a MEC group, the group can choose which potential ET-1s join the group and which potential ET-1s remain outside the group. MEC groups may therefore be able to undertake intra-group transactions to generate tax advantages. MEC groups may also be able to generate tax advantages in relation to tax losses and thin capitalisation rules by choosing which potential ET-1s remain outside the group.

5. TARGETED APPROACHES TO ADDRESSING IDENTIFIED ADVANTAGES

62. The Working Group considered the options that were available to the Government to reduce the inconsistencies between MEC groups and Australian-owned ordinary consolidated groups identified in Chapter 4, having due regard to Australia's international tax policies and treaty network and without introducing significant new compliance costs or distorting business practices.

63. The Working Group notes that the ATO still has recourse to the general anti-avoidance rule which can be used in determining whether the relevant transaction has been entered into for the dominant purpose of producing a tax benefit.

5.1 OPTIONS IN RESPONSE TO ADVANTAGE 1

64. The tax advantage of bringing the entity in at the ET-1 level by the MEC groups could be reduced by applying the entry ACA method that applies to subsidiary members of consolidated groups to ET-1s. While applying the entry ACA method to ET-1s would better ensure that CGT outcomes on the disposal of assets of the joining entity reflect the underlying economic transaction, other consequences would arise as a result of such a change.

65. To apply an entry ACA method in respect of membership interests held by entities outside of the MEC group (as would be the case for membership interests held in an ET-1) would represent a departure from the general approach adopted for the entry ACA method and result in the cost of external membership interests being pushed down into the cost of the MEC group's assets. This outcome is different to the usual consolidation approach where shares owned by entities outside of the group retain their own tax cost bases.

66. In addition to this conceptual issue, a number of practical difficulties would arise in applying an entry ACA method to membership interests held by entities outside of the MEC group. In particular, a difficulty in applying the entry ACA method to an ET-1 is that the acquisition of the membership interests may have occurred at a higher level (outside of Australia). Accordingly, the Working Group observed that the determination of the correct amounts that should be used in the entry ACA method for an ET-1 (and ensuring that this produced both equitable and appropriate outcomes) would involve high compliance costs.

67. Furthermore, applying the entry ACA method may create integrity concerns relating to the acquisition and sale of interposed non-resident members of worldwide groups, and would involve significant transitional costs. There would also be a considerable risk of unintended consequences that would require time to work through and address.

68. Given this, the Working Group decided that applying the entry ACA method to ET-1s should not be pursued.

69. The Working Group also considered an alternative option of extending the unrealised loss provisions (Subdivision 165-CC, as modified for consolidation by Subdivision 715-A, of the *Income Tax Assessment Act 1997*) to the assets of ET-1s that join MEC groups. Two approaches were considered.

70. The first approach would be to extend the application of section 715-60 (about creating a loss denial pool for the head company's own assets in an unrealised loss position) to an ET-1 that joins a MEC group.

71. Broadly, if, at or prior to the ET-1's joining time, there has been a majority change in ownership or control of the ET-1 and at that time it had a unrealised net loss, the head company of the MEC group would be required to create a loss denial pool for the joining ET-1's assets (provided a modified same business test is not satisfied for that joining ET-1). The loss denial pool would be equal to the unrealised net loss for that joining ET-1 and its assets would be tagged at the joining time. Should a tagged asset subsequently be disposed of at a loss, the loss would be denied to the extent of the balance of the loss denial pool.

72. The second approach is a modified version of the loss denial pool approach. Under this approach there would still be a requirement for there to have been a change in the majority ownership or control of the joining ET-1 at or prior to the joining time and for it to have an unrealised net loss in respect of its assets at that time. However, there would be:

- no requirement to apply the modified same business test to the joining ET-1; and
- the joining ET-1's unrealised net loss would be used to immediately reduce the tax cost of the joining ET-1's assets, which are themselves in an unrealised loss position, at the joining time.

73. The tax cost of an asset of a joining ET-1 that has an unrealised loss (loss asset) at the joining time would be reduced by a proportion of the total unrealised net loss of the joining ET-1. The loss asset's proportion of the unrealised net loss for this purpose is the amount that represents that loss asset's proportionate share of the total unrealised loss for all of the loss assets at the joining time.

74. The Working Group acknowledges that both approaches will go some way to remove one element (that is, the ability to retain unrealised losses on a joining entity's assets) of an advantage that a MEC group has because it can, subject to commercial considerations, bring a joining entity in as an ET-1 (and retain existing tax costs for assets) or an ordinary subsidiary member (and reset the tax cost of the assets).

75. The Working Group recommends that the second approach be considered because it better targets the element identified by way of immediate adjustments that can impact on capital allowance deductions as well as gains and losses on subsequent disposal of loss assets. It also has the following compliance cost advantages:

- there is no requirement for the modified same business test to be applied, and
- the immediate reduction in the tax cost of the joining ET-1's loss assets at the joining time will mean that there is no need to tag these assets on a going forward basis.

Recommendation 1

The Working Group recommends that the Government conduct further consultation on the proposal to extend a modified version of the unrealised loss provisions to the assets of ET-1s that join MEC groups, so that the residual unrealised net loss is applied to reduce the tax value of loss assets held by the joining ET-1.

5.2 Options in response to Advantages 4 and 5

76. Both of these issues relate to an intra-group transfer of assets followed by a divestment of an ET-1 (either immediately or at some point in the future). The transaction ultimately may result in the group not being subject to a CGT liability that may otherwise have been incurred.

77. The first option considered by the Working Group was to create a new CGT event that captures the unrealised gains that existed at the time of a relevant intra-group asset transfer within a MEC group, if there is a subsequent divestment of an ET-1 that holds such transferred assets (with the assets being tagged at the transfer time for future reference). This option would be modelled on CGT event J1, which applies to capture deferred gains on certain intra-group transfers.

78. Under this option, the quantum of the gain would be the amount by which the market value of the transferred tagged asset at the transfer time exceeds its cost base at that time. The gain would be triggered when an ET-1 silo holding the tagged asset leaves the MEC group. If an ET-1 silo holding tagged assets leaves the MEC group the cost base of the tagged assets would at the time be increased by an appropriate amount. To avoid double taxation, offsetting rules would prevent the gain being recognised twice (that is, under the new CGT event and under, for example, CGT event L5 or the non-resident CGT rules).

79. A second option considered by the Working Group is a specific anti-avoidance rule (SAAR), which could be inserted in Division 719 of the *Income Tax Assessment Act 1997* (the MEC group provisions) to capture internal transactions that are intentionally structured to avoid CGT.

80. Under this option, a SAAR would apply in circumstances where there is a scheme involving a transfer of assets (and/or liabilities) with an unrealised gain within a MEC Group to an ET-1, where the assets are disposed of outside the group by disposing of some or all of the shares in the ET-1. For the SAAR to be satisfied, it would need to be demonstrated that a person expected to receive a tax benefit from the scheme and that the scheme was entered into for the purpose of obtaining that tax benefit.

81. Unlike the 'dominant purpose' test currently used in the general anti-avoidance rule (GAAR) in Part IVA of the *Income Tax Assessment Act 1936*, the SAAR would instead apply a 'not less than incidental' purpose test. The SAAR that is part of the 'principal asset test' in the non-resident CGT provisions is an example of such a purpose test.

82. As with the option of a new CGT event, the application of a SAAR would bring to account for MEC groups an amount of assessable income relating to the unrealised gain incurred as a result of an internal (tagged) asset transfer.

83. The Working Group, in designing these options, recognises that both options have their own advantages and limitations.

84. The Working Group acknowledges that both options would, in limited and targeted circumstances, undermine the single entity rule which is one of the key advantages of consolidation.

85. Both options have a limited scope and may generate a behavioural response. That is, instead of moving the taxable asset into an ET-1 silo that is then disposed of, MEC groups could move assets they want to keep out of an ET-1 silo that holds a taxable asset that they want to sell. To limit this, consideration could be given to a complementary reform to the integrity provisions in Division 855 (in particular, consideration could be given to extending the integrity rule in section 855-30(5) to cover asset disposals as well as asset acquisitions).

86. While certain threshold tests could be considered to minimise compliance costs on business, the Working Group observes that, given the complexities of MEC group arrangements, both the SAAR and new CGT event options are likely to involve significant additional compliance costs for business. In particular, taxpayers may be required to track the market value of the assets that were transferred within the group unless modified approaches were utilised.

87. In addition, there are challenges involved in working out the gain under the new CGT event option or the tax benefit under the SAAR option. In either case it is necessary to establish the market value of the transferred assets; a common requirement under tax law. Experience with disputed valuation issues before the courts (for example, *Resource Capital Fund III LP v Commissioner of Taxation* [2013] FCA 363) shows that high costs can be incurred by both taxpayers and the ATO, and litigating parties face a high risk in achieving their desired outcome. The market valuation challenges may be particularly pronounced where, as in this case, an asset valuation is required for a past period.

88. It is recognised that a new CGT event would have the advantage of allowing greater certainty for taxpayers and the ATO as to the consequences of the transaction. However, it could involve significant legislative complexity and unintended consequences. Given the complexity of MEC group arrangements, it is also likely to be very difficult to ensure that the new CGT event captures all appropriate events.

89. The Working Group observes that the SAAR proposal would draw on relevant circumstances and facts when determining whether it should apply. Accordingly, the mechanism could allow more flexibility to take into account non-tax issues such as the value of the asset, or the timing of the transaction. However, a 'not less than incidental' purpose threshold for a SAAR may not necessarily be easier to apply than a 'sole or dominant purpose' test, noting that these issues were considered in *Mills v Commissioner of Taxation* [2012] HCA 51.

90. Given that there is currently no data to allow an assessment of the significance of the revenue risks associated with these tax advantages, and given that targeted solutions could involve significant compliance costs, the Working Group recommends that these options not proceed at the current time.

91. However, if evidence does emerge that these tax advantages are a serious risk to the Revenue, then the Working Group recommends further consultation on an appropriate response, including possible further consideration of either the new CGT event option or the SAAR option described above.

Recommendation 2

The Working Group recommends that there be no further development of any options at this time to address advantages four and five, given that: (a) the measures are unlikely to address all structural issues involving transfers between ET-1s of a MEC group; (b) there is currently no data to allow an assessment of the significance of the revenue risks associated with these tax advantages; and (c) each of the options considered could likely introduce significant new compliance costs and commercial uncertainties. Any new measure would need to deliver material compliance benefits over and above those delivered by existing integrity rules, such as the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936*.

If evidence does emerge that these tax advantages are a serious risk to the Revenue, then the Working Group recommends further consultation on an appropriate response.

5.3 Inability to apply a targeted approach to other advantages

92. The Working Group is unable to identify any suitable targeted solutions to address advantage two, three and six where the benefits outweigh the costs. The Working Group considers that these three tax advantages are relatively less significant than the other tax advantages that the Working Group identified in Chapter 4, and addressing these issues is likely to impose significant compliance costs on business.

Recommendation 3

The Working Group recommends no action from the Government regarding the following tax advantages, either because there is no clear solution to address them within the current legislative framework or because any solution would impose significant compliance costs on business. The tax advantages are:

- deferring the recognition of tax preferred income on progressive acquisitions;
- the option to apply the pooling rules or exit ACA method; and
- the non-application of the 'all-in' principle to ET-1s.

6. ANNOUNCED BUT UNENACTED MEASURE

93. On 14 December 2013, the Government announced the outcome of its consultations on the backlog of announced but not enacted tax measures. As part of the announcement, the Government indicated that it had referred some aspects of one measure, which seeks to improve the calculation and collection of income tax liabilities from consolidated groups, to the MEC Group Review for further consideration.

94. The relevant proposed amendments aim to ensure that the consolidation regime operates as intended by clarifying that:

    1) a provisional head company of a MEC group can enter into a tax sharing agreement with other members of the group;

    2) Pay As You Go (PAYG) instalments paid by a former provisional head company of a MEC group are attributed to that MEC group; and

    3) various parts of the income tax law apply to MEC groups in the same way that they apply to consolidated groups.

95. Given the approach the Working Group has adopted in this review, the Working Group considers that the first two issues should be legislated when time and resourcing allows, with the third issue to be considered in a broader 2015 review of consolidated groups.

96. The Working Group also notes that some inconsistencies between MEC groups and ordinary consolidated groups relating to the third issues can be relatively straightforward to legislate and therefore should be considered when time and resourcing allows. For example, there was a modification to CGT event J1 when the consolidation rules were introduced, but this modification did not apply to MEC groups resulting in adverse outcomes for MEC groups. This issue was raised by the Board of Taxation in its *Post implementation review of certain aspects of the consolidation tax cost setting process* (Recommendation 7.4). The Board recommends that the income tax law be amended to rectify the inappropriate outcome in the context of a subsidiary (non ET-1) member of a MEC group leaving the group.

APPENDIX A

TERMS OF REFERENCE

Objective

The Working Group will consider how to best implement the policy objective of removing the systemic tax advantages available to foreign-owned MEC groups, and those groups capable of forming MEC groups, that are not available to Australian-owned ordinary consolidated groups.

Scope

The Working Group will restrict its consideration to amendments that would remove the systemic tax advantages available to foreign-owned MEC groups, and those groups capable of forming MEC groups, that are not available to Australian-owned ordinary consolidated groups.

Criteria

The Working Group will take into account the following when assessing different implementation options:

1. the degree to which each option would achieve the policy objective;
2. the degree to which each option would minimise foreseeable unintended consequences;
3. how efficiently and effectively each option could be implemented and subsequently administered;
4. the degree to which each option would minimise business compliance costs; and
5. the timeframe necessary to implement any proposed legislative change.

Timing

The Working Group will deliver its report to the Treasurer in February 2014.

Consultation

The Working Group will release a discussion paper in mid-2013 seeking the business community's views on potential options for achieving the policy objective. The Working Group will meet with stakeholders if, and as, it becomes necessary throughout the course of the review.

Support

The Working Group will be supported by staff from the Treasury and the ATO.