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The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Post-implementation review into certain aspects of the consolidation regime

Dear Sir

The Institute of Chartered Accountants in Australia and the Taxation Institute of Australia (the Joint Bodies) welcome the post implementation review by the Board of Taxation into certain aspects of the consolidation regime.

Our submission which addresses each of the questions in the Board"s discussion paper is attached as follows:

Appendix A - Summary of key points
Appendix B - Responses to questions

References in the Appendices are to the Income Tax Assessment Act 1997 unless otherwise indicated.

If you would like to meet with representatives from the Joint Bodies or require any further information or assistance in respect of our submission, please contact Susan Cantamessa on 02 9290 5625 or Peter Murray on 03 9288 6677.

Yours sincerely

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The Institute of Chartered Accountants in Australia

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Appendix A

Post-implementation review into certain aspects of the consolidation regime

Summary of key points

The key points of our submission are set out below.

Chapter 2 – Policy benchmarks for considering the effectiveness of the operation of certain areas of the consolidation regime

- The consolidation regime has increased business efficiency and reduced compliance costs. However unnecessary compliance costs are still being incurred in respect of the simple restructures or acquisitions where:

  - The legislation mandates that a consolidated group deconsolidate and reconsolidate
  - A consolidated group acquires another consolidated group which has a transitional foreign held subsidiary.

  In our view the law could be amended to remove these inefficiencies without risk to the revenue.

  As a general rule, compliance costs will also be minimised by ensuring that changes to the law which are announced are enacted as soon as reasonably possible thereafter.

- There are various reasons why corporate groups have chosen not to consolidate. In no particular order these include:

  - Insufficient need/insufficient benefits from choosing tax consolidation
  - Costs of adopting tax consolidation outweigh perceived benefits
  - Uncertainty with the tax consolidation law which has caused some groups to defer entry or not to enter to date
  - Inability to apply transitional concessions for groups that delayed consolidation pending clarification of tax consolidation law
  - Inability to choose to consolidate on a retrospective basis for groups that delayed consolidation pending clarification of tax consolidation law
  - Complexities and inequities in applying tax cost setting rules
  - Complexities and inequities in applying loss rules
  - Potential traps for MEC groups/consolidated groups with group losses.

  These reasons reflect a mix of the design features of the legislation, its complexity, uncertainty surrounding its application and delays in resolving uncertainty. Where possible, we have suggested ways to minimise compliance costs and enhance the tax consolidation regime.

  We see merit in further investigating the possibility of a simplified consolidation regime for small to medium enterprises (SMEs). However, we suspect that the cost of such a simplified regime would still outweigh any benefits for small business corporate groups with satisfy the $2 million aggregated turnover test.

Chapter 3 – Operation of the single entity rule

- On the whole the single entity rule (SER) satisfies the policy objective of simplifying the tax system, reducing taxpayer compliance costs and increasing the economic efficiency and integrity of the tax system in respect of dealings between consolidated groups and third parties. This is more evident for groups which deal mainly with third parties and have limited transactions involving intra-group assets.

- We do not believe that additional rules are needed to support the basic operation of the SER. However, modifications to the existing provisions are likely to be required to ensure appropriate outcomes in particular cases

- In relation to the announced changes to section 711-40, we agree with the proposed amendment to subsections 711-40(2) and (3) in respect of third party incidental costs and capital expenditure in relation to intra-group assets. However, we do not agree that amendments should be made to limit the step 3 amount of the exit allocable cost amount (ACA) to those intra-group liabilities owed to a leaving entity that are “accounting liabilities”.

- In our view, in certain cases, it would be appropriate to recognise the SER from a third party perspective and achieve a proper balance between equity, efficiency and simplicity, e.g. to resolve the commercial debt forgiveness problem identified in the Board‟s Paper. However, we do not consider that this approach would be suitable in all cases.

Chapter 4 – Interaction between the consolidation regime and other parts of the income tax law

- This chapter raises issues in relation to the interaction of the consolidation rules with a number of other rules in the income tax law. In summary, in our view:

  Interaction with the trust provisions – we have identified a number of possible solutions to the interaction issues which arise in relation to the trust provisions. However, any solution will need to have regard to:

  - those aspects of the trust provisions being considered by the High Court in *Bamford’s* case and
  - the impact of the Government‟s response to the Board‟s recommendations arising from its review of the tax arrangements applying to managed investment trusts.

  Interaction with the foreign hybrid rules – we consider that the current law operates appropriately with the foreign hybrid rules.

  Interaction with the non-resident CGT rules – in our view there is no need for any specific amendments to the existing law to deal with perceived integrity risks. Those risks should be dealt with by the general anti-avoidance provisions of Part IVA.

  Interaction with the foreign currency rules and the TOFA rules – there is an issue in relation to the application of the functional currency rules to MEC groups which needs to be resolved.

  More work is required to ensure that the TOFA regime interacts appropriately with the consolidation regime. Further legislative refinements may be required.

  Other interaction issues - we have identified a number of areas where the consolidation provisions do not interact appropriately with the loss rules, the thin capitalisation rules and the CGT rules. There are a number of interaction issues with various small business provisions of the income tax law which we have not addressed. We anticipate that these will be identified in submissions of other parties operating in this space.

  We have no specific comments in relation to the questions posed in relation to CGT event J1.

Chapter 5 – Review of the inherited history rule

- At this stage, and based on current experiences, we do not advocate the replacement of the entry history rule with a clean slate rule. There are particular aspects of the consolidation law that interact with the inherited history rule in ways that result in anomalous outcomes, for example:

  - Accelerated depreciation
  - Privatised assets
  - Uniform capital allowance (UCA) and mining assets

  and these require consideration.

Chapter 6 – Operation of the consolidation regime for small business

- Certain barriers to entry into the consolidation regime identified in response to the question in Chapter 2 are more pertinent to the small to medium business sector.

  We support further investigation into the merits of a simplified consolidation regime for small to medium enterprises. However, as noted above, we are doubtful that the benefits of a simplified version of the consolidation regime would outweigh the costs for small business corporate groups.

  Consideration could also be given to reintroducing limited grouping, asset rollover and dividend rebate rules for certain SMEs.

Chapter 2 - Policy benchmarks for considering the effectiveness of the operation of certain areas of the consolidation regime

Question 2.1(a)

The Board seeks stakeholder comment on:

(a) In light of the policy drivers behind the introduction of the consolidation regime, do the single entity rule and the inherited history rules serve to increase business efficiency and integrity of the Australian tax system?

In our view the SER and inherited history rules, being the core foundations for the application of the consolidation regime, do enhance the business efficiency of those corporate groups which have chosen to consolidate and consequently the integrity of the Australian tax system. This is primarily because:

- it is easier to reorganise business assets and entities within a corporate group as the income tax implications of these transactions are typically eliminated due to the SER and
- the consolidation regime supports the integrity of the corporate tax system by reducing the double taxation of gains and multiplication of losses.

Question 2.1(b)

The Board seeks stakeholder comment on:

(b) For those corporate groups that have elected into the consolidation regime, has the introduction of the consolidation regime reduced the ongoing tax compliance costs associated with carrying on the group"s business? If not, what are seen as the key impediments to achieving reduced compliance costs?

For corporate groups which have elected to consolidate, the consolidation regime has generally reduced ongoing tax compliance costs. However, there are a number of:

- General impediments to achieving reduced compliance costs
- Specific areas of the law which create unnecessary compliance costs.

General impediments to achieving reduced compliance costs

Delays in having specific consolidation issues addressed by legislative amendment or through guidance from the Australian Taxation Office (ATO) has and continues to result in additional compliance costs, e.g. the introduction of *Tax Laws Amendment (2010 Measures No 1) Bill 2010* into Parliament on 10 February 2010 to implement measures some of which were first announced on 1 December 2005 and which have retrospective effect from 1 July 2002.

Legislative delays:

- result in additional compliance costs not only because of the need to deal with the uncertainty between the time of announcement and ultimate enactment of the law, but also in potentially having to revisit prior year tax positions and apply law retrospectively and

- create issues for financial reporting purposes, e.g. to the extent that the amendments currently before Parliament impact prior year tax positions, they will need to be reflected in current and

deferred tax balances in the next reporting period, assuming the measures are enacted prior to that time.

Similarly, there have been many technical issues where the ATO has taken time to reach a view and many issues which have not yet been finalised, e.g. the treatment of deferred tax balances when determining:

- the amount of a deferred tax liability to be used as part of allocable cost amount (ACA) calculations, relevant when an entity joins or leaves a tax consolidated group, and
- the tax consolidation implications of particular amounts which comprise the deferred tax asset balance.

We acknowledge that many of the unresolved issues are difficult. However, these delays are of concern to consolidated groups which are looking for guidance and in some instances, have had to resort to seeking independent advice and/or private binding rulings (which are often not able to be given) with resulting additional compliance costs.

In order to minimise compliance costs it is therefore important that proposed amendments, including any which arise from the Board of Taxation"s review, be legislated promptly following an appropriate period of consultation. It is also important that areas of uncertainty are addressed in ATO products without undue delay.

Specific areas of the law which create unnecessary compliance costs

Compliance cost issues associated with simple restructures or acquisitions

Additional compliance costs are incurred in relation to certain restructures and acquisitions because of the way the legislation is currently drafted. For example, consolidated groups are required to de-consolidate and re-consolidate where:

- a non-resident company, which owns 100% of a consolidated group, becomes eligible to be a head company of a consolidated group
- a consolidated group becomes 100% owned by a single company due to the cancellation of minority interests, or
- a consolidated group becomes 100% owned by another consolidated group due to the cancellation of minority interests[1].

The legislation also results in additional compliance costs for consolidated groups which acquire another consolidated group which has a transitional foreign held subsidiary[2]. The existence of such an entity means that the acquiring consolidated group cannot avail itself of Subdivision 705-C unless, prior to acquisition, the subsidiary is identified and appropriate restructuring (which may include deregistration of the company) is undertaken.

In our view Subdivision 705-C should be expanded to apply to a broader range of arrangements than is currently the case, including those outlined above. There may be other areas where, with the benefit of experience, the consolidation rules could be simplified to reduce compliance costs without risk to the revenue.

[1] It is understood that the potential application of Subdivision 705-C to these scenarios has been raised with the ATO through the NTLG Consolidation Subcommittee, and referred to Treasury for consideration

[2] Subdivision 701-C of the *Income Tax (Transitional Provisions) Act 1997*

Question 2.1(c)

The Board seeks stakeholder comment on:

(c) For those corporate groups that have not yet elected to consolidate, what are the key concerns that are keeping corporate groups out of the consolidation regime?

Issues and concerns that may be relevant to a broad range of corporate groups are set out below. There may be some overlap in our response to this question and the similar question in Chapter 6: Operation of the Consolidation Regime for Small Business.

A number of factors cause groups not to consolidate. These include, in no particular order of priority:

- Insufficient need/insufficient benefits from choosing tax consolidation
- Costs of adopting tax consolidation outweigh perceived benefits
- Uncertainty with the tax consolidation law has caused some groups to defer entry or not to enter to date
- Inability to apply transitional concessions for groups that delayed consolidation pending clarification of tax consolidation law
- Inability to choose to consolidate on a retrospective basis for groups that delayed consolidation pending clarification of tax consolidation law
- Complexities and inequities in applying tax cost setting rules
- Complexities and inequities in applying loss rules
- Potential traps for MEC groups/consolidated groups with group losses.

These issues are explored in more detail below.

Insufficient need/insufficient benefits from choosing tax consolidation

This is a factor rather than necessarily an issue of concern. For some groups, there is simply an insufficient need to choose to adopt tax consolidation. These groups are typically simple groups which did not utilise the previous grouping concessions, do not have a major need to adopt the SER and do not benefit from the tax cost setting rules or the consolidation loss rules.

For these entities we suspect that rectifying the various concerns we have with the tax consolidation regime may not be sufficient to influence their decision, that is, they would require some positive inducement to adopt consolidation.

Costs of adopting tax consolidation outweigh perceived benefits

There can be substantial compliance costs associated with the formation of a consolidated group including:

- internal costs, e.g. staff costs for a special project team
- external service provider fees for tax advice, valuation services and accounting advice and
- legal advice, particularly in relation to tax sharing agreements and tax funding agreements.

These costs can be an important factor in determining not to consolidate unless they are clearly outweighed by the potential benefits of adopting consolidation. Whilst this is definitely an issue for the small business sector, it also is a relevant consideration for medium size businesses where the tax consolidation benefits may be marginal.

The key areas that have heavy compliance costs are the tax cost setting rules and the consolidation loss rules. There are a number of ways that compliance costs could be reduced including:

- optional simpler rules for small to medium sized groups which:
    - reinstate, as a permanent measure, the transitional chosen transitional entity option which allows groups to adopt existing tax values for assets and
    - allow transferred losses (using existing tests) to be utilised over a 3 year period as an alternative to the burdensome available fraction rules.

- additional guidance materials from the ATO. In this regard we would encourage the ATO to continue to maintain its Consolidation Reference Manual

- better education of tax agents (especially smaller practitioners so that they may be able to provide appropriate services at a reduced cost).

Uncertainty with the tax consolidation law has caused some groups to defer entry or not to enter to date

The tax consolidation regime which commenced on 1 July 2002 represented a major income tax reform for corporate taxpayers and it understandable that there would be a period where the rules would be subject to a degree of refinement.

However, there was a considerable delay in enacting a long list of changes announced between 2005 and 2007. The Federal Government recently introduced 20 measures relating to the tax consolidation law in *Tax Laws Amendment (2010 Measures No 1) Bill 2010*, which has not been enacted to date.

The delay in resolving a number of important amendments contained in that Bill caused a number of groups to either defer entry into consolidation or to adopt less optimal positions due to the uncertainty with the law. For example, the promised amendments relating to pre-CGT proportions caused many privately owned groups with pre-CGT shares in subsidiary members to defer entry into consolidation. This was a precaution against the potentially adverse outcomes that could arise under the pre-CGT factor rules in the event that amendments of the kind proposed in the abovementioned Bill were not enacted as the existing law does not allow groups to revoke a choice to consolidate.

An associated consequence of uncertainty with the law are the added compliance costs associated with reviewing formation case calculations in response to a large number of amendments to the rules (specifically the tax cost setting rules). A number of groups would have chosen not to enter consolidation because of the prospect of ongoing compliance costs associated with amendments to the consolidation law (that is, they would consolidate once all the bugs were ironed out).

It should be noted that there are still quite a number of important unresolved issues that require either interpretative guidance from the ATO or legislative correction. It is important that key issues are resolved speedily and effectively, so as to not discourage corporate groups that are currently considering whether to adopt tax consolidation.

Inability to choose to consolidate on a retrospective basis for groups that delayed consolidation pending clarification of tax consolidation law

Some groups decided not to consolidate due to uncertainty associated with the outstanding proposed amendments to the tax consolidation law. Many of those groups are now unable to retrospectively choose to consolidate should the proposed changes be enacted. This is due to the limited time period for a group to choose whether to adopt tax consolidation.

There are some welcome changes contained in *Tax Laws Amendment (2010 Measures No 1) Bill 2010* which improve the administration of consolidation formation elections, but these changes do not fundamentally change the time limit for making a choice to consolidate. In effect, the choice must be made by the time the head company lodges its tax return for the income year during which the choice to consolidate would first apply. It is disappointing that the Bill does not either:

- provide groups with a limited transitional opportunity to choose to consolidate on a retrospective basis or
- provide the ATO with a discretion to extend the time limit for making a choice.

Lack of transitional concessions (especially relating to use of existing tax values) for groups that delayed consolidation pending clarification of tax consolidation law

This issue is related to the previous item, and will be relevant if an appropriate solution is not introduced to allow groups to retrospectively consolidate.

Those groups that were able to form a tax consolidated group before 1 July 2004, but did not due to uncertainty with the law, are now out of time to make a choice to consolidate with effect before 1 July 2004. Consequently, if they choose to consolidate on a date on or after 1 July 2004 they will not be able to avail themselves of various transitional concessions including the choice to adopt existing tax values for assets or the concessional available fraction rules for transferred losses.

In the absence of those transitional concessions being available, many new entrant groups into tax consolidation may be disadvantaged under tax consolidation by:

- reduced asset tax values (for all assets or certain types of assets-see below) and/or
- reduced ability to utilise tax losses due to reduced available fractions.

The simple solution to this issue would be to allow those consolidatable groups as at 1 July 2004 to have extended access to those transitional elections to allow them to consolidate now, but utilise the same transitional concessions that were available up to 1 July 2004.

Complexities and inequities in applying tax cost setting rules

The tax cost setting rules for consolidated groups, as well as the modifications for MEC groups, are very complex. As a consequence, a choice to consolidate involves significant compliance costs which are a greater burden for small and medium size businesses.

In addition, the tax cost setting rules can produce disadvantageous outcomes for groups in some circumstances, in the form of:

- reduced tax values for all assets due to insufficient ACA to cover the existing tax values of assets
- tax value being skewed away from revenue assets to long term capital assets such as goodwill and other intangibles (notwithstanding that the total ACA may equal or exceed the aggregate existing tax value of assets).

A worthwhile enhancement to the tax consolidation asset rules to ameliorate the complexity and disadvantageous outcomes would be to allow all groups the option of adopting existing tax values for each subsidiary member of a consolidated group irrespective of whether it is a formation case, single entity acquisition case or a linked group acquisition case.

Complexities and inequities in applying loss rules

The tax consolidation loss transfer and loss utilisation rules as they apply to consolidated groups (and as modified for MEC groups) are very complex, and there are significant compliance costs (tax advice and valuation costs) for small and medium size businesses in properly applying these rules.

In addition, the loss utilisation (available fraction) rules can produce disadvantageous outcomes for groups in some circumstances. The key issue is probably the draconian capital injection rules (which reduce the available fraction for an entity) without reference to purpose. The global financial crisis has resulted in many groups having to reduce their level of debt and issue additional equity to appease financiers and other stakeholders. In many cases there is no purpose of enhancing the utilisation of tax losses, but the capital injection rules apply irrespective of motive. This has been a key impediment to groups currently choosing to consolidate.

Some worthwhile enhancements to the tax consolidation loss rules to ameliorate the complexity and disadvantageous outcomes would be to:

- provide an alternative optional loss utilisation test for small to medium sized businesses, say in the form of a simple 1/3 utilisation rule (allow all transferred losses to be utilised over a 3 year period) without regard to the complex available fraction rules
- amend the capital injection rule to introduce a purpose test. That is, the capital injection rule should only apply where the capital injection occurred for a purpose, other than an incidental purpose, of enhancing the utilisation of tax losses by the relevant subsidiary.

Potential traps for MEC groups/consolidated groups with group losses

This issue relates to groups being discouraged from choosing the most optimal MEC group structure due to the inequitable treatment of group losses when a MEC group is joined by a new eligible tier 1 company (ET1C) or a consolidated group has a special conversion event due to a new ET1C.

By way of background, a consolidated group/MEC group with transferred losses (ie losses that are transferred to the group on formation or when a subsidiary joins) must apply the available fraction rules to determine the utilisation of those losses plus apply the general company loss utilisation rules. However, group losses that arise during consolidation need only satisfy the general company loss utilisation tests.

Where a new ET1C joins a MEC group, there is a special rule in section 719-305 which operates to convert all group losses to a transferred loss, simply as a consequence of the new ET1C (there is a limited exclusion for new ET1Cs that were previously members of the consolidated/MEC group). This rule applies irrespective of the extent to which the new ET1C contributes any assets or income earning capacity. It also applies irrespective of the purpose of the new ET1C.

The Explanatory Memorandum to the *New Business Tax System (Consolidation and Other Measures) Act (No 1) 2002* suggests at paragraph 3.75 that the rationale for the provision is that the group"s income producing capacity increases when a new ET1C joins the MEC group or a MEC group is created through a special conversion event and reduces the proportion of the group"s income that the original loss entity (or the MEC group before its expansion) could now be regarded as generating. This may not be the case.

This treatment is also inconsistent with and inequitable when compared to the treatment of an ordinary consolidated group which expands by acquiring another consolidated group or subsidiary with losses. In this situation the joined group's losses incurred post-formation do not become subject to an available fraction restriction.

Section 719-305 is a fundamentally inequitable provision and needs to be either:

- significantly modified to limit its application to situations where the new ET1C was introduced to enhance the utilisation of tax losses by the group (similar to the suggested amendments to the capital injection test discussed above) or
- repealed.

Chapter 3 - Operation of the single entity rule

Question 3.1

The Board seeks stakeholder comment on:

(a) Is the operation of the single entity rule effectively meeting its stated policy intent of simplifying the tax system, reducing taxpayer compliance costs, and increasing the economic efficiency and integrity of the tax system?

(b) If not, in what circumstances is the single entity rule failing to meet its intended policy objectives, and what is the practical impact of this failure on consolidated groups?

(c) How can the operation of the single entity rule be improved to ensure it achieves its intended outcomes?

By way of preliminary comment, we note that the ATO has generally adopted a reasonable interpretation of the law with respect to the operation of the SER in different scenarios which has allowed the provisions to work in a sensible way. In part this has been possible because the SER has been legislated in the principle based style of drafting.

On the whole, we consider that the SER does operate to simplify compliance, reduce compliance costs and enhance the efficiency and integrity of the tax system. This is clearly the case for groups which have all of their dealings with third parties (ie non-group members) and have limited intra-group assets (other than for instance membership interests in subsidiary members). In these circumstances, we would not support any proposal to dispense with the SER as we currently know it.

However there are some anomalous outcomes or difficulties in applying the SER to certain transactions which may warrant specific legislative amendment.

Question 3.2

The Board seeks stakeholder comment on:

(a) Are additional rules needed in the income tax law to support the operation of the single entity rule (section 701-1) to ensure the rule achieves its policy intent? If so, what supporting principles are needed?

(b) Should the income tax law contain specific exceptions to the operation of the single entity rule? If so, what should those exceptions be?

(c) Does section 701-85 of the ITAA 1997, which sets out the approach to the interpretation of the core consolidation provisions, increase uncertainty in the application of the single entity rule? If so, how can this uncertainty be alleviated?

We do not believe that any additional rules are needed to support the basic operation of the SER, having regard to the stated objectives of the consolidation regime as set out in section 700-10. However, as noted in the discussion that follows, there may be room for modifications to existing provisions to ensure appropriate outcomes in applying the consolidation regime to:

- intra-group transactions and
- third parties dealing with consolidated groups.

We acknowledge that section 701-85 operates to limit the application of the core rules in Division 701, including the SER. It states: “The operation of each provision of this Division is subject to any provision of this Act that so requires, either expressly or impliedly.”

Policy considerations may be relevant in determining the extent to which section 701-1 applies or whether its operation is replaced by some other provision, but clearly there is uncertainty and confusion in knowing which provisions will take precedence and when this will occur. Having said this, it seems that it is also inappropriate for the SER to take precedence over all provisions in the law in all cases.

Examples of inappropriate outcomes under the SER

Two situations where the SER may operate inappropriately or uncertainly with other provisions in the income tax law are set out below.

Third party costs incurred in relation to the intra-group transfer of revenue/depreciating assets

In most cases, third party capital expenditure associated with the internal transfer of CGT assets or intra-group assets within a consolidated group will form part of the CGT cost base of the asset or be deductible under section 40-880, depending on whether the head company "holds" the asset.

However, for CGT assets that are also depreciating assets or revenue assets that the group holds, there is no clear mechanism in the law to ensure that third party expenditure incurred in relation to the transfer of the asset within the group (e.g. stamp duty) is always reflected in the cost of the asset when working out resulting gains or losses when the asset is subsequently disposed of to a non-group member. In particular:

- although capital expenditure associated with the internal transfer of depreciating assets (or trading stock) is technically included in the CGT cost base of such assets (under subsection 110-35(10)), any capital gain or loss from their subsequent disposal is disregarded (sections 118-24 and 118-25)

- since there is no equivalent provision to subsection 110-35(10) within Division 40 to allow capital expenditure to be included in the asset's cost for Division 40 purposes, such expenditure is not always able to be taken into account in the cost of the depreciating asset. This affects ongoing entitlements to depreciation deductions and balancing adjustment amounts on the subsequent disposal of assets to a non-group member

- although expenditure incurred in respect of the transfer of the applicable asset would typically meet the positive requirements for deduction under section 40-880, because such expenditure would form part of the CGT cost base of the applicable asset, paragraph 40-880(5)(f) operates to prevent any section 40-880 deduction for third party costs.

This issue could be dealt with by switching off the SER insofar as third party costs are concerned. However, our preferred solution is to amend the law to clarify that third party costs associated with the transfer of revenue assets, depreciating assets and trading stock held by the group are recognised as part of the cost of the asset for trading stock and Division 40 purposes and when working out any resulting assessable income or deduction on the disposal of a revenue asset.

Interaction between the SER and the Subdivision 126-B roll-over provisions

There is an issue in relation to how the SER interacts with Subdivision 126-B (roll-overs between resident and non-resident companies in the same wholly-owned group). In particular, it is not clear how the limitation in subsection 126-50(7) applies in the following scenario:

- SubCo transfers an asset using Subdivision 126-B roll-over relief to its foreign resident parent (ForCo) and
- SubCo then joins a consolidated group as a subsidiary member, and ForCo subsequently transfers the asset back to SubCo.

If the SER applies (ie SubCo is taken to be part of the head company and therefore loses its separate income tax identity), it would appear that roll-over relief under Subdivision 126-B is not available on the second transfer, due to the operation of paragraph 126-50(7)(a). Under this provision, Subdivision 126-B cannot apply if ForCo acquired the asset because of a CGT event giving rise to a roll-over under a previous application of Subdivision 126-B which involved an Australian resident originating company other than the company that is the recipient company in the second transaction.

In this particular scenario, whether or not the SER operates will depend on whether it is considered necessary for entity core purposes. Arguably the SER should not operate in respect of the second transaction as the application of Subdivision 126-B roll-over is relevant for the purposes of determining ForCo's liability to Australian income tax (and ForCo, being a non-group member, is not

subject to the SER). However, it is possible that the requirement that the transferor and transferee agree to apply the roll-over may mean that the SER does apply in working out the Australian tax consequences for ForCo as a result of the transaction.

This demonstrates the uncertainty surrounding triggering the section 701-85 override, that is, does it apply here or not?

Question 3.3

The Board seeks stakeholder comment on:

(a) What concerns, if any, arise in relation to the announced changes to section 711-40 of the ITAA 1997?

(b) In what circumstances, if any, do you consider the taxation outcomes that arise when intra-group assets are acquired or disposed of to be inappropriate? What do you consider the appropriate outcome to be?

Section 711-40

Changes to section 711-40 were announced by the then Assistant Treasurer on 8 May 2007 and said that "The treatment of liabilities under the tax cost setting rules will be modified to ……ensure that liabilities owed to a leaving entity by other members of the group that are added to the allocable cost amount are limited to accounting liabilities".

Since then the Joint Bodies have had an opportunity to comment a Treasury consultation paper on the proposed amendment. Our comments are based on the amendments described more fully in that consultation paper.

In relation to the proposed amendments to subsections 711-40(2) and (3) in respect of third party incidental costs and capital expenditure in relation to intra-group assets, we consider the proposed amendment appropriate. The extension of the rules to deal with certain "blackhole costs" applicable from 1 July 2005 should mean that there is no longer any need to recognise these costs as part of the leaving calculation as such costs will typically have been deducted by the group under section 40-880 or have been included as part of the cost base of any CGT asset that the group holds.

However, we do not support any amendment to limit the step 3 amount of the exit ACA to those intra-group liabilities owed to a leaving entity that are "accounting liabilities". Such assets should be taken into account in the exit ACA calculation to produce appropriate economic outcomes, particularly in relation to intra-group assets created prior to entering the consolidated group. In relation to intra-group assets created within the consolidated group, it is submitted that the limitations imposed by the application of subsection 711-40(3) are a sufficient integrity measure.

Inappropriate outcomes on intra-group assets

CGT on transfer-up of a subsidiary member of a MEC group to become an eligible tier-1 company

After some years of operating in a consolidated environment, it is becoming increasingly common for consolidated groups to consider reorganising their existing ownership structures which have changed as a result of various acquisitions, mergers and takeovers and disposals.

One form of internal reorganisation that is problematic is when an existing subsidiary member of a MEC group is transferred up to be owned directly or indirectly by the non-resident top company ("transfer-up" scenario).

The ATO considered this in its Discussion Paper issued in November 2006 and acknowledged that it is possible that, in the case of a MEC group expansion undertaken by way of a transfer up of an existing subsidiary member, the new ET1C does not leave or join the group.

However, the Paper also flagged that there would still be CGT issues for the group on the transfer of the membership interests to the non-group member, and without the benefit of having a tax cost base determined for such interests (because there is no leaving). A capital gain will arise to the group to the extent of the entire capital proceeds because there is no cost base recognised when the membership interests are transferred to the non-resident.

The ATO's Discussion Paper did note that Subdivision 126-B roll-over may apply in respect of any capital gain from the disposal of the membership interests to the non-resident entity.

It may not always be possible for the transaction to qualify for Subdivision 126-B roll-over relief. For example, in instances in which the transferred-up entity is not an indirect Australian real property interest, it will not represent taxable Australian property and the roll-over conditions will not be met[3].

We note that in cases where a MEC group is created as a result of the transfer-up of a former subsidiary of the consolidated group, amendments proposed in *Tax Laws Amendment (2010 Measures No 1) Bill 2010* ensure that although the general rule to ensure that the conversion of a consolidated group to a MEC group (and vice versa) is to be seamless, an integrity rule *requires* that Division 711 (ie exit) calculations are undertaken to recognise the tax cost of the membership interests of the former subsidiary member[4].

We recommend the legislation be clarified for cases where an existing subsidiary member of a MEC group is transferred up to become an ET1C. This should clarify whether the transferred entity leaves and re-joins or otherwise, and ensure that appropriate CGT outcomes are achieved both for the group and also for the non-resident acquirer (see comments later under question 3.5).

Question 3.4

The Board seeks stakeholder comment on:

(a) Are there any circumstances, in practice, where the history of an intra-group asset (other than its history as a divisional arrangement) is relevant to determine its tax treatment when it ceases to be owned by the group?

(b) If any other history of an intra-group asset is relevant, are any modifications to the income tax law required to allow that history to be recognised?

No specific comment.

Question 3.5

The Board seeks stakeholder comment on:

(a) Are there other situations which are not identified in this Chapter where a third party may be required to reconstruct intra-group transactions?

(b) Should the single entity rule be extended to all third parties who have dealings with a consolidated group? If so, would any exceptions be required?

(c) Alternatively, should the single entity rule be extended to third parties who are directly related to a consolidated group (such as shareholders)? If so, would any exceptions be required?

(d) As a further alternative, should the operation of the single entity rule outside the consolidation provisions be considered on a case by case basis?

In order to achieve an outcome that is equitable, efficient and promotes simplicity, it may be prudent for specific situations to be dealt with on a case by case basis and, to the extent possible, by way of specific legislative amendment. Depending upon the situation, it may be appropriate for the SER to be recognised from a third party perspective.

CGT issues on reorganising investments in subsidiary members of a MEC group

As noted in relation to question 3.3, problems emerge for a MEC group when an existing subsidiary member of a MEC group is transferred up to be owned directly by a non-resident entity ("transfer-up" scenario). This has consequences for the non-resident acquirer (a non-group member) to whom the SER does not extend.

The ATO's preliminary view set out in its November 2006 Discussion Paper is that the cost base of the membership interests in the new ET1C will depend upon whether Subdivision 126-B roll-over relief is chosen by the head company (originating company) of the MEC group and the recipient company.

[3] s126-50(5)

[4] Proposed s719-130(4) (as included in *Tax Laws Amendment (2010 Measures No 1) Bill 2010*)

If Subdivision 126-B roll-over is not chosen, the cost base will be the money paid, or required to be paid, by the non-resident in respect of acquiring the membership interests in the transferred-up entity.

However, if Subdivision 126-B roll-over is chosen, the cost base of the membership interests in the transferred-up entity is nil because the membership interests are disregarded under the SER. This will be the acquiring entity"s first element of cost base for the acquired membership interests. A CGT cost base of nil for the non-resident acquirer does not seem equitable, noting the cost-base pooling rules (Subdivision 719-K) which apply to all of the membership interests in ET1Cs.

There is also potential for double taxation in cases where interests held by a non-resident in an ET1C of a MEC group are transferred to another member of the MEC group ("transfer-down" scenario). This issue was also addressed in an ATO Discussion Paper released in November 2006.

The transfer of the membership interests the non-resident held in the former ET1C constitutes a CGT event A1. This may result in CGT implications to the extent the interests represent taxable Australian property. Subdivision 126-B roll-over relief can be chosen to the extent that a capital gain arises.

Because the transferred-down entity does not "join" the group, there is no adjustment to the tax costs of its assets. On exit of the transferred-down entity from the group, the tax cost of the membership interest is determined in accordance with Division 711 and not by reference to the cost base of the membership interests to the non-resident entity at the time the transferred-down entity ceased to be an ET1C (even if Subdivision 126-B roll-over relief was chosen). The Division 711 tax cost setting amount would not reflect the market value paid by the group to the non-resident for the membership interests in the transferred-down entity. Potentially a capital gain arises to the head company of the MEC group similar to that already paid by the non-resident if Subdivision 126-B roll-over was not chosen at the time of the transfer down and the interest was taxable Australian property.

We recommend that the legislation be clarified in cases where an existing subsidiary member of a MEC group is transferred down. This should clarify whether the transferred entity leaves and re-joins or otherwise, and ensure that appropriate CGT outcomes are achieved for the non-resident and for the group, regardless of the SER.

"Internal straddle" contracts

The ATO has issued three Taxation Determinations[5] dealing with the tax consolidation and CGT implications of straddle contracts, including guidance on whether the asset that is the subject of the contract is recognised for consolidation purposes at the joining or leaving time. The ATO's Consolidation Reference Manual[6] explains how the consolidation cost setting rules apply to these assets identified in relation to a straddle contract. In addition, specific measures are currently before Parliament in relation to straddle sale arrangements entered into on or after 8 May 2007[7].

However there is currently no guidance available in relation to the treatment of "internal straddle" arrangements (the Determinations that have been issued are expressly stated not to apply to internal straddles). Such arrangements arise when the CGT asset that is the subject of a purchase or sale contract is a CGT asset of the same consolidated group that the relevant entity is joining or leaving, at either the contract time or the time just after the contract is completed.
Accordingly, we submit that further consideration needs to be given in relation to the interaction between the consolidation and CGT provisions in relation to internal straddle arrangements, with a view to providing further guidance (which may be guidance from the ATO in the form of Taxation Determinations) or legislative amendments to clarify the operation of the law in these circumstances.

[5] TD 2008/29, TD 2008/30 and TD 2008/31

[6] Part C2-1-080, ATO"s Consolidation Reference Manual

[7] Part 17 of the *Tax Laws Amendment (2010 Measures No 1) Bill 2010*

Chapter 4 - Interaction between the consolidation regime and other parts of the income tax law

Question 4.1

The Board seeks stakeholder comment on:

(a) How should the net income for a trust‟s non-membership period be assessed to beneficiaries and trustees?

(b) Do the current rules need to be amended to achieve an appropriate outcome? For example, are specific provisions needed in the consolidation rules to align the calculation of the income of a trust with the method used for calculating the net income for the trust‟s non-membership period? If so, is there a simple approach that can be used that produces an appropriate outcome?

(c) Should a single set of rules apply to assess all beneficiaries on a share of the trust‟s net income for a non-membership period? If so, what should the rules be?

(d) Are there any other issues which are not identified in this Chapter that arise when a trust joins or leaves a consolidated group part way through an income year? What is the best way of resolving these issues?

Question 4.2

The Board seeks stakeholder comment on:

(a) When working out the allocable cost amount for a trust, should the head company recognise its liability for income tax payable on its share of the net income of the trust as a cost of acquiring the joining entity? If yes, do the current cost setting rules need to be amended to achieve this outcome? If so, how?

(b) Are there any other issues which are not identified in this Chapter that arise with the way the cost setting rules apply to trusts when they join or leave a consolidated group? If so, how can these be overcome?

Question 4.3

The Board seeks stakeholder comment on:

(a) Does a trustee need to be a member of the same consolidated group as the trust? If yes, why? If not, why not?

(b) If a trustee is not a member of the same consolidated group as the trust, do the core rules and other tax rules operate appropriately to deem the income and expenditure of the trust to be that of the head company?

(c) Should a trust be a member of a consolidated group if it has beneficiaries that are not members of the group? If yes, what other issues need to be resolved? If not, why not?

(d) How can the current provisions be altered so they are workable and provide certainty?

At the outset we note that aspects of the income tax law relating to the treatment of trust income needs to be settled before its interaction with the consolidation regime, and the matters raised above, can be properly addressed. In this regard we note that the High Court has recently heard the appeal against the Full Federal Court decision in *Bamford v Commissioner of Taxation* [2009] FCAFC 66. The High Court‟s decision has yet to be handed down. Also relevant to the issues raised may be the Government‟s response to the Board‟s recommendations arising from its review of the tax arrangements applying to managed investment trusts which may impact upon the way the net income of a trust is attributed.

The interaction between Division 6 of the ITAA 1936 and the consolidation regime (and in particular, the operation of section 701-30 when a trust is a member of a group for part of an income year) has been the subject of considerable discussion. We recommend that further work be done to harmonise the consolidation provisions with Division 6 of the ITAA 1936 to the maximum extent possible.

Possible solutions to the interaction problem could include:

- deeming a present entitlement in appropriate cases (this would make use of the existing rules rather than requiring a new set of rules to be designed)
- extending the operation of section 701-30 to the term "income of the trust"
- modifying the joining time of a trust that joins a consolidated group part way through an income year so that the trust is not taken to join the consolidated group until the first day of the income year following the 100% acquisition of the membership interests in the trust.

Question 4.4

The Board seeks stakeholder comment on:

(a) Should non-resident entities that satisfy the foreign hybrid rules be members of a consolidated group? If yes, how is this consistent with the Government"s policy intent that limits the types of entities that become members of a consolidated group?

(b) Would non-resident entities that satisfy the foreign hybrid rules effectively gain or be denied concessional treatment by becoming a member of a consolidated group?

(c) If these entities can become members of a consolidated group, are there any integrity risks that need to be addressed? If so, what are they and what is the best way to resolve them?

(d) If these entities cannot be members of a consolidated group, what is the most efficient way of preventing non-resident entities from being members of a consolidated group?

We submit that the current law operates appropriately with respect to foreign hybrids. In our view, it is appropriate that a non-resident limited partnership or company should continue to qualify as a subsidiary member of a consolidated group if it is a direct or indirect wholly-owned “foreign hybrid” of the head company, within the meaning of that term in section 830-5.

This outcome is consistent with the treatment of wholly-owned foreign partnerships and is therefore not concessional. In other words, if an entity is given flow-through treatment under Division 830, it should be treated in the same way as wholly-owned foreign partnerships (which qualify as subsidiary members).

Question 4.5

The Board seeks stakeholder comment on:

(a) Does the interaction of the consolidation regime and non-resident CGT rules give rise to integrity risks? If so, what are they and what is the most effective way to overcome those risks?

The Board"s Discussion Paper raises concerns about the interaction between the consolidation rules and Division 855 where inherent capital gains (or losses) on assets or entities within a MEC group could be reduced or eliminated without any tax consequences through the transfer or assets within the group prior to any ultimate sale.[8]

It is clear that Division 855 operates to disregard capital gains/losses in respect of non-Australian taxable property if the vendor entity is a foreign resident. For a multinational company operating in Australia through a MEC group, not all Australian entry points will be regarded as taxable Australian property and any attempt to limit the application of Division 855 to MEC group structures would be an impediment to foreign investment into Australia.

We submit that there is no need for any specific new law to be introduced to deal with situations that result in benefits through the application of Division 855.

Specifically, schemes which are put into place with the sole or dominant purpose of accessing the CGT benefits available to foreign residents under Division 855 can be dealt with through the general anti-avoidance provisions in Part IVA of the ITAA 1936.

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[8] Such structuring might take the form of transferring real property assets out of a target ET1C to ensure that the membership interests in the ET1C which are being sold do not constitute “taxable Australian property” for the purposes of Division 855 .

Furthermore, any integrity measure introduced to prevent pre-sale restructuring involving a MEC runs the risk of inappropriately affecting genuine commercial arrangements.

Question 4.6

The Board seeks stakeholder comment on:

(a) Do integrity risks arise from a consolidated group being able reset the cost base of its assets to market value where there has not been a change in ultimate beneficial ownership of the assets before and after the transaction? If so, what is the most effective way to overcome those integrity risks?

We submit that transactions undertaken with the sole or dominant purpose of facilitating the resetting of the tax cost of assets to market value can adequately be dealt with through the general anti-avoidance provisions in Part IVA of the ITAA 1936.

Question 4.7

The Board seeks stakeholder comment on:

(a) Are there circumstances in which CGT event J1 produces undesirable outcomes? If so, how can the income tax law be amended to overcome these concerns?

(b) Are there situations that CGT event J1 does not apply to but should? If so, what are they?

No specific comment.

Question 4.8

The Board seeks stakeholder comment on:

(a) Are there any areas of concern that arise as a result of the interaction between the consolidation regime and the foreign currency gains and loss provisions? If so, what are the issues and how can they be resolved?

(b) Are there any areas of concern that arise as a result of the interaction between the consolidation regime and the taxation of financial arrangement provisions? If so, what are the issues and how can they be resolved?

Foreign currency

There remain concerns around the practicalities for a MEC group to be able to adopt functional currency.

Subdivision 960-D provides that the net income of certain entities, whose accounts are solely or predominately in a particular foreign currency, can be worked out in that currency, with the net amount being translated into Australian currency. Under item 1 of the table in subsection 960-60(1), an Australian resident who is required to prepare financial reports under section 292 of the *Corporations Act 2001* can choose to use the 'applicable functional currency' to work out its taxable income/loss.

In the case of a MEC group, eligibility for functional currency is problematic as there is not one set of financial reports prepared for an Australian MEC group. Even if the reports were aggregated, it may be the case that there is no sole or predominant functional currency across the varying entry points into Australia. Although the ATO has issued a Tax Determination[9] indicating that the “applicable functional currency” for the head company of a consolidated group is determined by looking at the accounts of all the members of the consolidated group, rather than the 'accounts' of the head company only, applying this to a MEC group is not so easy.

Although it may be that not many taxpayers have chosen to use functional currency, those entities which are most likely to use it are those which are owned by non-residents such as MEC groups which encounter the practical difficulties described above.

[9] TD 2007/24

We recommend that the rules for adopting functional currency by a MEC group are clarified or amended in the interests of promoting tax efficiency and reduced compliance costs

Taxation of Financial Arrangements

The tax consolidation regime and taxation of financial arrangements (TOFA) regime are complex. This complexity is exacerbated where an entity joins or leaves a tax consolidated group with financial arrangements that may or may not be within Division 230.

The current law seeks to address some of the issues concerning inconsistent Division 230 elections but in our view more work needs to be done to ensure that these rules operate as intended and apply in a consistent manner.

Some of the areas which we consider require some further consideration and possible legislative refinement relate to:

- specific transitional issues relating to the transitional TOFA year, ie the optional period in which taxpayers may have chosen to have the measures apply to their first income year commencing after 30 June 2009
- inconsistent elections, including the election to bring pre-existing financial arrangements within Division 230
- different treatment applying to financial assets and financial liabilities depending upon whether the arrangement is a Division 230 financial arrangement
- dealing with an entry or exit where there are hedge gains and losses that were subject to the hedge tax-timing election (e.g. realised hedge gains/losses that are deferred in accordance with subsection 230-300(3) and interaction with exit history rule), and
- clarification around the use of any tax cost setting amount for a financial arrangement derivative that is an asset at the joining time, but which subsequently results in a loss on its cessation.

We recommend that some of these issues be first explored and considered through consultation with the ATO.

Question 4.9

The Board seeks stakeholder comment on any other areas of concern that arise as a result of the interaction between the consolidation regime and other provisions in the income tax law. If so, what are the issues and how should they be resolved?

We have a number of concerns with how the consolidation regime interacts with the loss rules, the thin capitalisation rules and the CGT rules. We are also concerned that assets recognised for consolidation but not CGT purposes are treated appropriately.

In particular, the overlay of the complex consolidation loss provisions, including the capital injections/available fraction adjustments, on the complex continuity of ownership (COT)/same business test (SBT) rules results in inordinate compliance costs.

Interaction with loss rules

Expansion of MEC group and limitations on use of group losses and Complexities and inequities in applying loss rules

Refer to our comments in response to Question 2.1 under these headings.

Deemed failure of continuity of ownership test for MEC groups

Sections 719-280 and 719-465 operate to deem the COT to have been failed in a number of cases including when:

- a potential MEC group ceases to exist (e.g. because it converts to a consolidated group or because of some other event that breaks the group)
- the MEC group ceases to exist because it ceases to have a provisional head company.

Similar rules apply in the case of deeming a changeover time (for the purposes of Subdivision 165-CC) and alteration time (for the purposes of Subdivision 165-CD).

In many cases, such deemed COT failures are occurring even though there is no actual change in the ultimate beneficial ownership of the group.

Amendments proposed in *Tax Laws Amendment (2010 Measures No 1) Bill 2010* will switch off section 719-280 (and the associated provisions which deem COT failure and changeover or alteration times) in cases where a MEC group becomes a consolidated group. The Explanatory Memorandum to that Bill observes that as "a group conversion may not result in an actual change of ultimate beneficial ownership, it is inappropriate to deem a continuity of ownership test failure when a MEC group or potential MEC group ceases to exist because of a group conversion".

In our view a residual "savings provision" is required to prevent a deemed COT failure, changeover or alteration time in relation to a MEC group in cases where there is no actual change in its majority beneficial ownership.

Interaction with thin capitalisation rules

In applying the thin capitalisation rules, MEC groups face a range of issues that are not faced by ordinary consolidated groups. The main issue arises because the focus of the thin capitalisation regime is on consolidated accounts using accounting principles and consolidated accounts are not prepared for a MEC group. Nor do accounting standards envisage the consolidation of brother/sister companies.

In practice, except for foreign banking groups which are catered for in the legislation[10], most MEC groups simply "aggregate" the consolidated accounts of each ET1C for the purposes of the safe harbour calculation. However, the legal basis for this approach is far from clear.

In our view the legislation should be amended to make clear what accounting information is to be used by a MEC group for thin capitalisation purposes.

Interaction with CGT rules

Clarification needed as to the treatment of earn-outs at step 1 of entry ACA

Until the release of TR 2007/D10 on 17 October 2007, the treatment of earn-outs was covered by TR 93/15. In effect, the cost base of assets acquired by a purchaser of an asset involving an earn-out arrangement comprised any initial sum paid plus any amounts subsequently paid under the earn-out arrangement.

To ensure that, in a consolidation context, any amounts paid subsequent to the acquisition of a joining entity under an earn-out arrangement were recognised in determining the ACA of a joining entity, subsection 705-65(5B) was introduced *by Tax Laws Amendment (2004 Measures No 2) Act 2004* and applies from the date of commencement of the consolidation regime on 1 July 2002.

The effect of subsection705-65(5B) is to ensure that the step 1 amount is increased by the amount of any deferred acquisition payments actually made.

Draft Taxation Ruling TR 2007/D10 (which is yet to be finalised), takes the view that the cost base of the underlying asset acquired pursuant to an earn-out arrangement comprises any initial amount paid plus the market value of the promise to make an earn-out payment. Any subsequent amounts paid under the earn-out arrangement are regarded as being paid to discharge the purchaser"s obligation under the earn-out and not to acquire the underlying asset.

In the context of a consolidated group, TR 2007/D10 states in footnote 4 that "..such a [earn-out] payment is not therefore considered to be „money paid, or required to be paid, in respect of acquiring a membership interest" for the purposes of subparagraph 705-65(5B)(a)(i). Rather, the creation of the earn-out right is property given in respect of that acquisition."

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[10] Section 820-611

In the event that the draft ruling is finalised in its current form, consolidated groups which have acquired companies after 17 October 2007 under earn-out arrangements will get no recognition for earn-out payments in excess of the market value of the earn out arrangement either in their ACA calculations or as a deduction under the blackhole expenditure rules in section 40-880.

Treasury is currently reviewing whether the treatment of earn-outs in the draft ruling is appropriate and, if not, whether legislative amendments are required to achieve the correct policy outcomes.

In our view subsection 705-65(5B) was clearly intended to include in the joining entity"s ACA the amount of any deferred acquisition payment at the time of payment and this is what it achieves notwithstanding the ATO"s views. This treatment is appropriate and should be preserved. However, if necessary the law needs to be amended to achieve the policy intent.

Limited access to Subdivision 126-B roll-over

A same asset roll-over is only available under Subdivision 126-B between companies which are members of the same wholly-owned group, and only in respect of transfers of assets between two non-residents, or a non-resident and an Australian resident. Furthermore, if either the originating or recipient company is an Australian resident, it must be a member of a consolidated or MEC group, or if it is not, it must not be a member of a consolidatable group.[11]

Thus, a foreign resident with more than one wholly-owned entry point company in Australia may not able to obtain access to Subdivision 126-B roll-over in respect of the transfer of an asset between the Australian resident sister companies.

This seems anomalous given that the Australian companies do not form part of a consolidatable group. The only way that the transfer of assets between the resident companies could occur without tax consequences is if the companies formed a MEC group (which may not be possible if there are cross-shareholdings[12]).

In our view the law should be amended to allow a Subdivision 126-B roll-over between Australian resident companies in these circumstances.

Measures needed to appropriately deal with intangible "economic" assets

There is uncertainty as to the treatment of certain intangible assets of a joining subsidiary member, such as such confidential information, trade secrets, know-how and non-contractual customer relationships. This uncertainty may persist notwithstanding the amendments to subsection 701-55(6)[13] currently before Parliament.

These assets are not "depreciating assets" for Division 40 purposes[14] or "CGT assets" as defined in section 108-5 (ie they are not property, or a legal or equitable right that is not property). However, they are identifiable as assets having economic value and for accounting purposes are treated as being separate from goodwill. Similarly, as explained in the following paragraphs, these intangibles are generally also recognised as separately identifiable "assets" for consolidation purposes to which a tax cost setting amount is allocated at an entity"s joining time.

The term "asset" is not defined for the purposes of the consolidation provisions in Part 3-90, and therefore takes on its ordinary meaning. In Taxation Ruling TR 2004/13, the ATO sets out its view that, for the purposes of the tax cost setting rules in the consolidation regime:

> "5 … an asset is anything recognised in commerce and business as having economic value to the joining entity at the joining time for which a purchaser of its membership interests would be willing to pay. The business or commercial assets of a joining entity would include the things that would be expected to be identified by a prudent vendor and purchaser as having

[11] Section126-50

[12] Refer paragraph 719-15(3)(c) and section 719-65

[13] *Tax Laws Amendment (2010 Measures No 1) Bill 2010*

[14] Specifically, they are not within those intangible assets listed in subsection 40-30(2) as constituting depreciating assets

value in the making of a sale agreement in respect of all the membership interests in an entity and its business….

“12. There are other assets that would be recognised under Part 3-90 because they are things of economic value in commerce and business that are not recognised under other Parts of the ITAA 1936 or the ITAA 1997. An asset within this category would be information or knowledge that can be identified within an entity as a separate commercial or business asset. Where the asset is identifiable as a separate business or commercial asset it is distinguished from the goodwill of the business. Examples of information and knowledge that may constitute commercial or business assets include secret formulae, client lists and mailing lists.”

Having allocated ACA to these types of intangible assets in accordance with TR 2004/13, the question that arises is whether there is any tax relief available in respect of the tax cost setting amount. Although not free from doubt, there is an argument under the current law that the head company should be entitled to claim a deduction under section 40-880 in the form of a write-off over five income years for the intangible�What tax cost setting amount.

The uncertainty arises due to an inconsistency between strict general law concepts of what constitutes goodwill (being a CGT asset), and the requirement under the consolidation provisions to recognise those assets which, according to commerce and business, have economic value to the joining entity at the joining time.

In our view the law should be amended to clearly allow a write-off under section 40-880 for the tax cost setting amount that is required to be allocated to intangible assets of the nature identified above. Such an outcome is appropriate given:

- the requirement in the consolidation regime for the assets of a joining entity to be identified (and given a tax cost setting amount) by reference to the concept of what would be recognised in commerce and business as having economic value and
- the express recognition in TR 2004/13 that these types of intangibles are required to be separately recognised for cost setting purposes.

Chapter 5 – Review of the inherited history rule

Question 5.1(a)

The Board seeks stakeholder comment on:

(a) What difficulties, if any, arise under the inherited history rules?

The inherited history rules, which consist of the entry history rule and the exit history rule, are core rules that support the operation of the SER. These rules identify the income tax history that an entity brings into a consolidated group or takes when it leaves a group.

The inherited history covered by the entry rule[15] is quite broad (it covers everything that happened to a subsidiary before the joining time) whereas the exit rule[16] is more limited (it covers history in relation to an asset, liability, business or R&D registration that the subsidiary takes with it). However, the inherited history rules (and other core rules) may be overridden or modified by another provision of the ITAA that so requires, either expressly or impliedly[17]. For the purpose of this submission other provisions which adopt a modified inherited history approach are also treated as an inherited history rule[18].

The Institute of Chartered Accountants in Australia in its 2009/10 Pre-budget Submission relevantly identified the:

> "need for a separate review into tax consolidation which emanates because the tax consolidation provisions were written mainly with a focus on formation cases. The passage of time has now revealed that a review is required into whether the consolidation provisions are operating appropriately in acquisition cases, and whether certain structural changes are required. By way of example, the review could potentially explore whether there is a case in support of moving to a full acquisition of assets and liabilities model, rather than an entry history model as is currently the case."

The difficulties under the inherited history rules as currently drafted broadly fall into two categories:

- The entry history approach is incompatible in some instances with the overarching policy design objectives of the tax cost setting rules
- Interpretative difficulties and anomalies may arise with the existing inherited history rules and also their interaction with other provisions of the ITAA.

Policy difficulties

From the perspective of corporate groups the asset tax cost setting rules had the potential to address the income tax bias against a share acquisition as compared to an asset acquisition, where the target entity held, in particular, depreciating assets.

In certain respects the current system does not consistently address this design objective. The tax cost of assets is reset but other relevant income tax attributes of those assets are subject to an inherited history rule and this may on one view conflict with the objective described above. For example

- For a reset depreciating asset there is no ability to change the pre-joining time depreciation method, and the effective life may not be able to be changed in some cases[19].

- The mining industry is particularly disadvantaged by a specific inherited history rule which operates to exclude mining, quarrying or prospecting rights or information held before 1 July 2001 from being treated under the uniform capital allowance (UCA) rules notwithstanding that there is

[15] Section 701-5

[16] Section 701-40

[17] Section 701-85

[18] Such as subsection 701-55(2)-certain history is inherited for reset depreciating assets

[19] Ibid

another rule that otherwise deems depreciating assets to be acquired at the joining time for the purpose of applying the UCA rules[20]. Similar to the position with the over-depreciated asset rules, which are proposed to be repealed under amendments contained in *Tax Laws Amendment (2010 Measures No 1) Bill 2010*, these mining transitional rules have long since served their purpose and should be repealed.

- The acquirer of a privatised group has to contend with the potential continued application of the applicable privatised asset rules which may limit depreciation deductions. There is a worthwhile exemption for acquisitions of privatised subsidiaries that are acquired from an unrelated consolidated group after a 2 year holding period[21]. However, ATO Interpretative Decision ATOID 2007/74 highlights that the ATO will apply a technical literal interpretation to deny the benefit of an exemption in circumstances where the privatised entity is acquired through a creeping acquisition which technically results in the acquired entity being an associate of the acquiring group just before the joining time.

  We would encourage the Board to scrutinise the application of the privatised asset rules to consolidated groups, with a view to making appropriate amendments to remedy such issues.

While there is a higher incidence of acquisition scenarios (as opposed to formation scenarios) than in the formation period, the consequences of this has been not fully recognised in some recent Government announcements.

Most notably, the announcement on 8 May 2007 to ensure that the entry history rule applies to determine the time that depreciating assets of a joining entity are acquired when determining eligibility to a 200% gross-up rate used to calculate the depreciation rate where the diminishing value method applies, illustrates a discrepancy between an asset acquisition and share acquisition by a consolidated group. This proposed amendment conflicts with the policy objectives of the tax cost setting rules and should be addressed. We note that this proposal has not been included in the bundle of amendments contained in *Tax Laws Amendment (2010 Measures No 1) Bill 2010*. We submit that a further government announcement should be made to remove the ongoing uncertainty caused by the 8 May 2007 announcement.

Interpretative difficulties, anomalies and interaction issues

A number of difficulties have arisen with the inherited history rules. The following items are some of the more common examples that have been identified, but should not be considered to be an exhaustive list.

Blackhole deductions and the exit history rule

The ATO recently issued Tax Determination TD 2010/1 that provides guidance on the tax treatment of incidental costs related to the divestment of a subsidiary member of a consolidated group. The TD concludes that costs incurred before the joining time may be deductible under section 40-880.

The ATO guidance does not clarify which entity can claim the deduction over 5 years after the subsidiary leaves the group, ie the head company or subsidiary. As noted above, the exit history rule covers history that is related to an asset, liability, business or R&D registration that a subsidiary takes with it. It is unclear how the exit history rule applies in this case – at the time the expenditure was incurred arguably under the SER the shares in the subsidiary may be disregarded for income tax purposes, and the underlying business of the subsidiary may be recognised under the exit history rule. Alternatively, if the relevant expenditure was incurred by the subsidiary but was unpaid at the leaving time resulting in an accounting liability that it takes with it, can the expenditure be recognised by the subsidiary in that case?

Similar issues arise in respect of business cessation expenditure relating to a subsidiary member of a consolidated group. Capital expenditure incurred by a subsidiary while it is a member of the consolidated group in respect of a former business that it operated may cease to have a relevant connection with the subsidiary‟s continuing business. It would appear in that case that the head

[20] See Division 702 of the *Income Tax (Transitional Provisions) Act 1997*

[21] See for example, section 705-47 of the ITAA 1997

company of the consolidated group may claim blackhole deductions on an ongoing basis as it is unclear whether there is a sufficient relationship to an asset or business that the subsidiary takes with it.

These examples illustrate that the exit history rule may not always provide sufficient certainty in instances where the overriding principles do not cover the issue. We recommend that comprehensive guidance on the exit history rule in these kinds of instances be provided.

Entry history interaction issues with R&D rules and limited recourse debt rules

An apparent anomaly arises where there is a sale of (reset cost base) intellectual property held by a subsidiary member, where R&D deductions were claimed on expenditure relating to the creation of the intellectual property, prior to the subsidiary joining the consolidated group. Under the R&D rules, if subsection 73B(27A) of the ITAA 1936 applies the gross consideration received is required to be included in assessable income and no regard is given to the tax cost setting amount of the asset.

In our view such an application produces an inequitable outcome, as it infringes the general principle that the tax cost setting amount of an asset should be taken into account for the purposes of the ITAA. It is unclear whether:

- the potential problem is an inappropriate application of the entry history rule in this case, that is, whether expenditure incurred before the joining time can be overridden by the tax cost setting amount at the joining time (taking into account the proposed amendments to subsection 701-55(6) contained in *Tax Laws Amendment (2010 Measures No 1) Bill 2010* or
- an amendment may be required to give specific recognition to the tax cost setting amount in determining the assessable amount under subsection 73B(27A).

There is an equivalent issue in respect of the ongoing application of the limited recourse debt rules in Division 243, where a subsidiary member that held a depreciating asset had triggered the application of Division 243 before the joining time (termination of debt). An ATO Discussion Paper released in 2006 takes the view that the limited recourse debt provisions can apply[22]. It is unclear whether expenditure incurred before the joining time can now be overridden by the tax cost setting amount at the joining time for the purpose of applying the relevant tests in Division 243, taking into account the effect of the proposed amendments to subsection 701-55(6) contained in *Tax Laws Amendment (2010 Measures No 1) Bill 2010.*

Again, we would encourage the Board to scrutinise these issues further, with a view to making appropriate recommendations to rectify these issues.

Question 5.1(b)

The Board seeks stakeholder comment on:

(b) Should the inherited history rules be modified to address those difficulties? If so, how?

At the outset, we would like to confirm that in our view there is a need for inherited history rules to be retained in the tax consolidation core rules. We do not advocate a repeal or replacement of the inherited history rules.

In our view consideration should, however, be given to addressing the history rules and the various provisions which modify or interact with those rules, to provide appropriate outcomes for assets which are reset under the tax cost setting rules. These possible modifications are considered further in the sections below. In particular:

- Undeducted expenditure that does not relate to an asset (for example undeducted section 40-880 blackhole expenditure deductions, borrowing costs and Subdivision 40-I project amounts) should continue to be capable of being recognised amounts under the entry history rule

[22]Discussion Paper – NTLG Consolidation Subcommittee Meeting 23 November, 2006- Can section 243-55 of the ITAA 1997 apply after the joining time to reduce a head company"s capital allowance deductions?

- Furthermore, where undeducted expenditure relating to an asset is not impacted by the tax cost setting rules, such as undeducted Division 43 capital works deductions, then such expenditure should continue to be recognised under the entry history rule.

The exit history rule rules are required to be retained as there will be an ongoing need for a broad range of tax attributes to be recognised by a leaving subsidiary, including in respect of the tax cost of its assets. Whilst in some cases a leaving subsidiary may join a consolidated group as a subsidiary member and have the tax cost of its assets reset, there will be other situations where the leaving subsidiary does not join a consolidated group (it may be held as a stand-alone company, it may become the head company of another consolidated group or an ET1C of a MEC group-in all these cases the tax cost of its assets would not be reset).

However, as discussed in our response to question 5.1(a) above, there are a number of interpretative issues that need to be resolved in respect of the exit history rule. Failing suitable interpretative guidance from the ATO a legislative clarification may be required.

Question 5.19 (c)

The Board seeks stakeholder comment on:

(c) Alternatively, should the consolidation regime adopt a deemed acquisition model, using clean slate rules?

For reasons outlined in our response to question 5.1(a) above, consideration should be given to adjusting the entry history rule, and the various provisions which modify the entry history rule, to provide appropriate outcomes for assets which are reset under the tax cost setting rules.

The challenge with a clean slate approach is what it would mean for acquisitions of large, existing, mature businesses. In many cases the likely scenario may involve a consolidated group acquiring a former subsidiary member/s of another consolidated group with minimal tax attributes (no tax losses, no franking credits etc). The tax consolidation rules also need to cater for the scenario where there is an acquisition of an entity with a wide range of tax attributes (e.g. acquisition of the head company of another consolidated group). A clean slate approach is probably not the solution as this would require various carve outs and modification rules (as is the current position with the entry history rule).

As stated above, a clean slate approach should not apply to an entity that leaves a consolidated group, as provision needs to be made for it to take its income tax history, to cover attributes that may not be covered by a clean slate rule if it joins a consolidated group or alternatively if it does not have its assets reset if it becomes a member of another consolidated group.

Question 5.1(d)

The Board seeks stakeholder comment on:

(d) How would a deemed acquisition model with clean slate rules work and what exceptions would be needed?

A clean slate/deemed acquisition model for assets may require changes to various parts of the tax cost setting rules. However, many features of the tax cost setting rules could be retained, including the allocable cost amount process.

Question 5.1(e)

The Board seeks stakeholder comment on:

(e) What transitional issues would arise if the inherited history approach was replaced by a deemed acquisition model with clean slate rules?

If major changes are made to the inherited history rules, these should be implemented on a prospective basis.

Given the complexity of the consolidation regime, and its interaction with various provisions of the ITAA, this could require a substantive review of the whole regime to ensure that the clean slate approach operates effectively.

There may be transitional issues but this will very much depend on how any changes are implemented.

If the changes were only to apply to new acquisitions/formations that occur after commencement, this may minimise the impact on existing consolidated groups that could apply existing provisions on an ongoing basis in respect of their pre-commencement subsidiary members. However, in such a case, consolidated groups applying different models to their assets (for pre and post commencement subsidiaries) may give rise to compliance problems.

Consideration would need to be given to allowing existing consolidated groups a transitional choice to apply the clean slate rule and deemed acquisition rule to existing subsidiary members at the date of commencement, for those assets that were reset under the tax cost setting rules when the subsidiary joined the consolidated group and are still held at the date of commencement.

A choice is proposed because we recognise some practical issues with this proposal:

- This approach may require groups to recalculate previous formation or joining case tax cost setting calculations (applying the new rules) which would be a significant exercise for some consolidated groups. As a compliance saving measure consideration could be given to allowing groups to apply the tax cost setting amount for an asset determined under the old rules, but with the clean slate and deemed acquisition rules applying to determine other attributes in respect of the asset.

  For example, if a depreciating asset was reset in say 2008 with a tax cost setting amount of $100 and the terminating value at the time of commencement was $50, the clean slate and deemed acquisition rules could be applied to the asset by reference to that tax value.

- This transitional choice would require groups to identify reset assets that are still held at the date of commencement, and to exclude non-reset assets including the head company‟s own assets, assets held by transitional chosen entities and assets acquired by subsidiaries after the time they joined the tax consolidated group. We query whether tax asset registers maintained by corporate groups would be capable of identifying relevant assets.

- As indicated above not all assets held by a consolidated group will necessarily be subject to the application of the tax cost setting rules, such as assets held by the head company (however, it should be noted that the head company‟s own assets fundamentally reflect a clean slate model).

However, notwithstanding the potential compliance issues that may arise, allowing groups a *choice* to adopt this option would in our view suitably balance such concerns.

Question 5.1(f)

The Board seeks stakeholder comment on:

(f) What compliance cost implications would arise from the adoption of a deemed acquisition model with clean slate rules?

Again potential compliance costs will be dependent on how extensively the changes are implemented. If the changes are limited to new acquisition cases, then this may assist in minimising compliance costs for consolidated groups.

Tax asset registers and tax consolidation calculators and models would need to be modified to be able to appropriately implement a clean slate and deemed acquisition model, and as noted above, the tax registers would need to cater for a variety of different asset models applying to the tax consolidated group:

- Existing tax values for the head company‟s own assets and for any transitional chosen entities‟ assets
- Tax cost setting method for pre-commencement subsidiaries that were not transitional chosen entities; and
- Deemed acquisition and clean slate model for post-commencement subsidiaries

There is likely to be an added compliance burden on affected subsidiaries with significant numbers of depreciating assets, as depreciation methods, effective lives and depreciation rates would need to be determined for all of the depreciating assets at the joining time.

In order to alleviate potential compliance costs, especially for smaller groups, we would recommend an optional existing tax value method for assets. We submit that there would be no integrity concerns that would exceed the compliance benefits gained from such an approach.

Chapter 6 – Operation of the consolidation regime for small business

Question 6.1
The Board seeks stakeholder comment on:
(a) Are any aspects of the consolidation regime causing particular difficulties for small businesses?

The Board"s Discussion Paper highlights the fact that in the majority of cases corporate group structures are not the structure of choice for small businesses, i.e. those that carry on a business and satisfy the $2 million aggregated turnover test in the income tax law. Indeed, it is estimated that less than 30% of such businesses use a corporate group structure which would, on the face of it, be eligible to form a consolidated group.

We suspect that corporate group structures may not the structure of choice for many businesses in the small to medium enterprise (SME) arena and not merely those which satisfy the abovementioned $2 million test.

Two factors identified by the Board as discouraging such small business groups from consolidating are:

- the complexity of the consolidation legislation and cost of keeping up to date with the provisions by accounting and tax professionals operating in this space and
- shortcomings with the treatment of pre-CGT interests under the current legislation.

We agree that these factors discourage small business groups generally from choosing to consolidate.

Complexity and cost

Anecdotal evidence is that the sheer size of the consolidation provisions, their complexity, announced but not legislated changes and the unknown in relation to issues that may arise is a real impediment to smaller practices encouraging their clients to make an irrevocable election to use the tax consolidation regime. These issues are compounded for small practices which have few clients eligible to consolidate. At the same time, clients are deterred because of the costs associated with the choice to consolidate and ongoing costs arising from its complexity.

In particular, we highlight the fact that small proprietary companies[23] are not generally required to prepare financial statements in accordance with the accounting standards. A choice to consolidate by SME corporate groups may therefore require them to prepare accounts which comply with accounting standards when this would not otherwise be the case. This of itself results in additional complexity and compliance costs.

Costs caused by the complexity of the consolidation regime are a greater burden for SMEs than large business. For corporate groups which satisfy the $2 million turnover test, we suspect that cost and complexity alone would deter them from consolidating as any benefits are likely to be outweighed by costs.

Pre-CGT interests

We understand that the dilution of pre-CGT interests which the Bill currently before Parliament seeks to address meant that a number of SME corporate groups opted not to consolidate but instead to better manage the downside of that decision, ie the inability to transfer losses, group franking credits and transfer assets in a tax free manner.

However other factors and, in particular, those listed below may mean that they continue to remain outside the consolidation regime.

[23] Generally speaking, only proprietary companies which satisfy two of three threshold tests are required to prepare financial statements in accordance with the accounting standards. The tests are $25 million in consolidated revenue, $12.5 million in assets and 50 employees.

Lack of transitional concessions

As indicated in response to question 2.1 the absence of choices, like the transitional choices available for groups that chose to consolidate before 1 July 2004 and which provide a more equitable result on formation, may mean fewer SME groups choosing to consolidate despite the proposed amendments to the treatment of pre-CGT interests.

As previously indicated, one solution to this particular issue is to allow consolidatable groups as at 1 July 2004 access to those concessions should they now choose to consolidate.

Interaction between the consolidation and other small business provisions

There are a number of issues with the interaction of the consolidation provisions with other SME provisions, e.g. the CGT discount, small business CGT concessions and Division 7A of the ITAA 1936. We anticipate that these issues will be discussed in detail in submissions to the Board by advisers to SMEs.

Knowledge of the uncertainty surrounding these issues will impact on a SME corporate group‟s decision whether to consolidate.

Question 6.1
The Board seeks stakeholder comment on:
(b) Should the consolidation regime be simplified for small businesses: If so, how?

We would support further work being undertaken to determine the merits of a simplified tax consolidation regime targeted at small to medium sized groups. As noted in response to question 2.1 under the heading “Costs of adopting tax consolidation outweigh perceived benefits”, we would envisage that any simplified system would allow:

- as a permanent measure, the equivalent of the chosen transitional entity option which allows groups to adopt existing tax values on an entity by entity basis. This would overcome the need to obtain costly market valuations
- transferred losses (using existing tests) to be utilised over a 3 year period as an alternative to the burdensome available fraction rules.

Consideration could also be given to reintroducing limited grouping, asset rollover and dividend rebate rules for certain SMEs who are disadvantaged as a result of the consolidation regime.

FOI 2473
Document 2

s 22

From: s 22 @ato.gov.au]
Sent: Friday, 1 October 2010 4:36 PM
To: Regan, Anthony
Cc: s 22
Subject: Company loss recoupment rules: Potential amendments [SEC=IN-CONFIDENCE]
Importance: High

Tony,

Thank you for the opportunity to provide quick reactions to your proposals below and to submit anything that the ATO thinks should be added to the list. We respond to the proposals using your paragraph references:

s 22

(b) these proposals are supported. Please refer attached document which illustrates the scenarios where the ATO believes that the less than 10% stake concessional tracing rules may not work satisfactorily. The issue with the interposition scenario arises where a stakeholder initially has a less than 10% direct stake in the tested company before a holding company is interposed. Subsection 166-230(3) already provides relief where a stakeholder initially has a less than 10% indirect interest in the tested company before a holding company is interposed.

s 22

s 22

Regards,

s 22

Losses & CGT Centre of Expertise
Law & Practice
Latitude East, 52 Goulburn St, Sydney 2000
Ph: s 22

From: Regan, Anthony [mailto:Anthony.Regan@TREASURY.GOV.AU]
Sent: Thursday, 30 September 2010 16:15
To: s 22
Subject: Company loss recoupment rules: Potential amendments [SEC=IN-CONFIDENCE]

s 22

As discussed, we are currently in the early stages of developing proposals to amend the income tax law for consideration in a 2011-12 budgetary context. At this stage, I am proposing to put forward some proposals to modify the company loss recoupment rules to deal with issues raised in submissions we have received on the multiple classes of shares amendments, but which are clearly outside the scope of those amendments.

That is, at this stage we are proposing to amend the company loss recoupment rules by:

s 22

(b) ensuring that widely held companies do not fail the modified COT which applies to those companies solely because a holding company is interposed between the test company and a stakeholder who has an indirect stake of less than 10 per cent in the test company, or because an entity that is interposed between the test company and a stakeholder who has such an indirect stake demerges;

s 22

s 22

We are proposing to apply these changes from the 2011-12 income year.

I should emphasise that the fact that these issues are currently under consideration does not necessarily mean that they will proceed. s 22 We will also consider any ATO views before finalising any of the proposals.

Can you please let me know if you have any quick reactions to the proposals, or if there is anything that you think should be added to the list. However, you will have an opportunity to comment on the proposals as they develop.

From our perspective, the next step will be to get costings on each of the proposals.

Regards

Tony Regan
Manager - Company Tax Unit
Business Tax Division
The Treasury, Langton Crescent, Parkes ACT 2600
phone: (02) 6263 3334
mobile: s 22
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****

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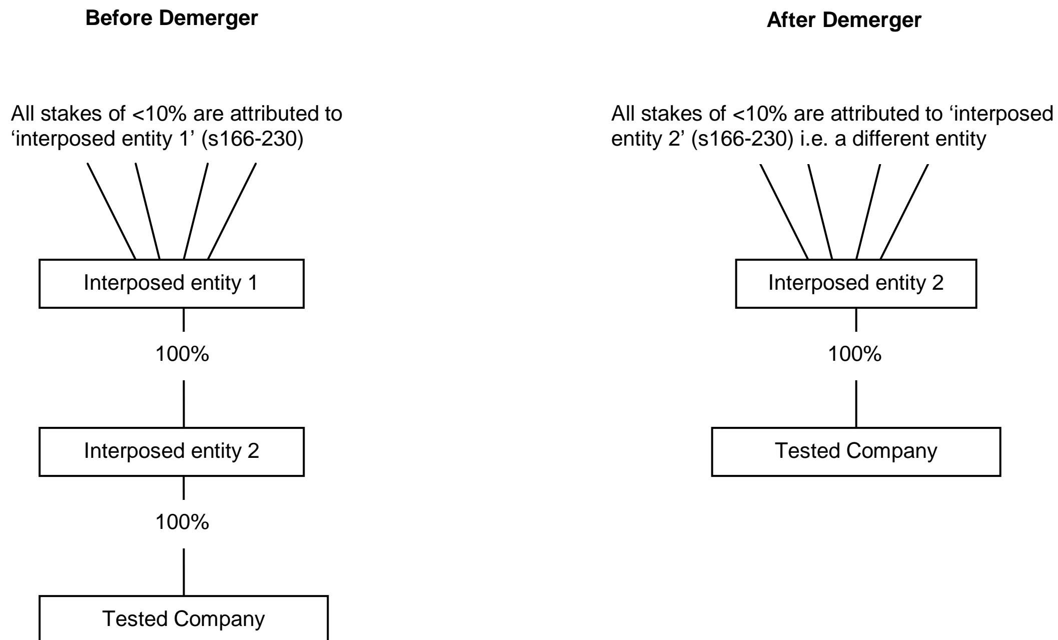
Document 3

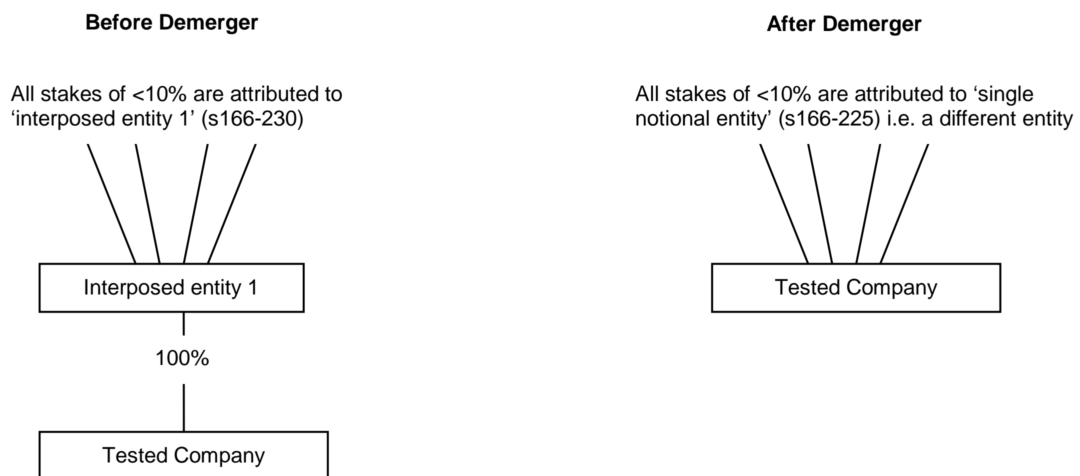
Division 166 issues

Note: In the scenarios, the beneficial owners are the same both before and after the demerger or interposition (done on a pro-rata basis)

(1) Demerger scenario 1



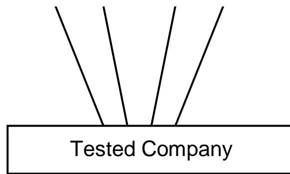
(2) Demerger scenario 2



(3) Interposition scenario

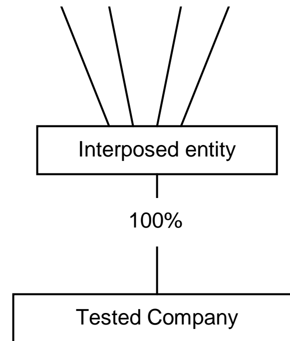
Before Re-structure

All stakes of <10% are attributed to a ‘single notional entity’ (s166-225)



After Re-structure

All stakes of <10% are attributed to ‘interposed entity’ (s166-230) i.e. different entity



FOI 2473
Document 4

Australian Government

The Board of Taxation

POST-IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE CONSOLIDATION REGIME

Position Paper

the board of taxation
www.taxboard.gov.au

The Board of Taxation
October 2010

POST-IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE CONSOLIDATION REGIME

Position Paper

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October 2010

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FOREWORD

The introduction of the consolidation regime in 2002 was a significant business tax reform that allows a wholly-owned corporate group to be treated as a single entity for income tax purposes.

The objective of the regime is to promote business efficiency, improve the integrity of the Australian tax system and reduce ongoing income tax compliance costs for wholly-owned corporate groups that choose to consolidate.

A significant number of amendments have been made to refine the consolidation regime since its introduction, including substantial amendments early this year. The Australian Taxation Office (ATO) has also produced a significant number of rulings relating to the operation of the regime.

The Board's intention in undertaking post-implementation reviews is to focus on whether the consolidation legislation is operating as intended, and in light of feedback received from relevant industry participants, whether its implementation and operation can be improved.

The Board expresses its gratitude to those that have provided submissions and participated in consultations and looks forward to the further involvement of stakeholders in this post-implementation review.

Richard Warburton AO
Chairman, Board of Taxation

CHAPTER 1: INTRODUCTION

BACKGROUND TO THE REVIEW

1.1 The consolidation regime, which was introduced with effect from 1 July 2002, applies primarily to wholly-owned groups of Australian resident entities that choose to form a consolidated group.

1.2 A consolidated group generally consists of an Australian resident head company and all of its wholly-owned Australian resident subsidiaries. Specific rules allow certain resident wholly-owned subsidiaries of a foreign holding company to consolidate by forming a multiple entry consolidated group (MEC group). Unless otherwise specified, references in this Position Paper to a consolidated group include a MEC group.

1.3 Following a choice to consolidate, the members of a consolidated group are treated as a single entity for income tax purposes. Subsidiary members lose their individual income tax identities during the time they are members of the consolidated group and are treated as parts of the head company.

1.4 The primary objectives behind the introduction of the consolidation regime were:

- to promote business efficiency;
- to improve the integrity of the Australian tax system; and
- to reduce ongoing income tax compliance costs for wholly-owned corporate groups that choose to consolidate.

1.5 On 3 June 2009, the Government announced that the Board of Taxation would undertake a post-implementation review of certain aspects of the consolidation regime.

1.6 Conducting post-implementation reviews is consistent with one of the Board's functions, namely to advise the Treasurer on 'the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design'.[1]

---

1 The Charter of the Board of Taxation.

SCOPE OF THE REVIEW

1.7 As it is not feasible to review the whole of the consolidation regime, the Board of Taxation was asked to focus on the following three key elements of the consolidation regime:

- the operation of the single entity rule;
- the interaction between the consolidation provisions and other parts of the income tax law; and
- the operation of the inherited history rules.

1.8 In addition, in light of empirical evidence which indicates a relatively poor take-up of the consolidation regime by eligible small business groups, the Board also considered the effectiveness of the consolidation regime for these small business groups.

THE REVIEW TEAM

1.9 The Board has appointed a Working Group of its members to oversee the review. The members of the Working Group are Richard Warburton AO (Chairman), Chris Jordan AO (Deputy Chairman), Keith James and Curt Rendall. Geoffrey Lehmann continues to be engaged as a consultant to assist with the review. The Board has also appointed an Expert Panel to provide further specialist assistance to the Board in understanding the complex operation of the relevant taxation law and its practical application.

1.10 The Working Group is being assisted by members of the Board's Secretariat and by staff from the Treasury and the ATO.

REVIEW PROCESS

1.11 Following the announcement of the review, the Board conducted some targeted consultations with key stakeholders. Drawing on these consultations and other information, the Board developed a Discussion Paper, which was released on 9 December 2009.[2] The paper canvassed issues that were brought to the attention of the Board and posed questions to be addressed as part of the consultation process.

1.12 Following the release of the Discussion Paper, the Board conducted further consultation forums in Sydney and Melbourne in February 2010 as an additional

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2 The Discussion Paper can be accessed from the Board's website. See: www.taxboard.gov.au.

mechanism for obtaining views and to assist stakeholders in preparing written submissions.

1.13 The Board received 12 submissions in respect of the issues raised in the Discussion Paper. A list of submissions, other than confidential submissions, is provided in Appendix A.[3]

OUTCOMES OF THE CONSULTATION PROCESS

1.14 The overall consensus from stakeholders is that the existing framework behind the consolidation regime is working effectively in the majority of circumstances. This has lead to overall increased business efficiency and integrity of the tax system, as well as a reduction in ongoing tax compliance costs experienced by consolidated groups.

1.15 However, stakeholders suggested that the operation of the regime is often overly complex. This is primarily due to the focus of the regime on formation cases, where the measures operate to ensure taxpayers achieve appropriate outcomes when no change in the economic ownership of the group has occurred.

1.16 The incidence of formation cases has clearly declined since the consolidation regime was introduced in 2002. As acquisition cases are now the more common transaction being undertaken by consolidated groups, stakeholders suggested that significant improvement could be made by adjusting the current policy framework for the consolidation regime.

1.17 In addition, stakeholders highlighted that the operation of the consolidation regime could be improved by resolving the issues that were raised in the Board's Discussion Paper.

1.18 Given the breadth and complexity of issues associated with this review, the Board considers that stakeholders should be given an opportunity to comment on the positions reached before making final recommendations.

1.19 Therefore, this Position Paper sets out the Board's considered views on the issues raised in the Discussion Paper and in stakeholder submissions. In this regard:

- Chapter 2 considers the policy framework for the consolidation regime (including the operation of the inherited history rules);
- Chapter 3 considers issues relating to the operation of the single entity rule;

3 Submissions are provided in full on the Board's website. See: www.taxboard.gov.au.

- Chapter 4 considers issues relating to interactions between the consolidation regime and other parts of the income tax law; and
- Chapter 5 considers the operation of the consolidation regime for small business corporate groups.

1.20 Appendix B contains a list of the Board's positions and questions on which feedback is being sought. The Board will settle on final recommendations arising from the review after receiving submissions on the Position Paper.

MAKING SUBMISSIONS

1.21 The Board welcomes submissions on the issues raised in this Position Paper. The closing date for submissions is 26 November 2010. It is not expected that each submission will necessarily address all of the proposed positions and questions raised. Submissions can be sent:

By email to:

taxboard@treasury.gov.au

By facsimile to:

(02) 6263 4471

By post to:

Post-implementation Review into Certain Aspects of the Consolidation Regime
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600
AUSTRALIA

1.22 Submissions should include a brief summary of major points and recommendations. They should also include contact details so that the Board can contact those making the submission to discuss points raised if required. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

1.23 Submissions will be published on the Board's website (www.taxboard.gov.au) unless it is clearly stated that the submission is confidential.

CHAPTER 2: POLICY FRAMEWORK FOR THE CONSOLIDATION REGIME

2.1 Treating wholly-owned corporate groups as a single entity for income tax purposes is the cornerstone principle of the consolidation regime.

2.2 Following a choice to consolidate, the members of a consolidated group lose their individual income tax identities during the time they are members of the consolidated group and are treated as parts of the head company. This means that:

- a single income tax return is lodged by the group and the group pays a single set of pay as you go instalments;
- losses, franking credits and foreign income tax offsets are pooled in the head company;
- the assets and liabilities (other than intra-group assets and liabilities) of the subsidiary members are treated as if they were assets and liabilities of the head company;
- the actions of the subsidiary members (for example, acquisition or disposal of assets) are treated as if they had been undertaken by the head company; and
- intra-group transactions (for example, the transfers of assets between group members) are treated as arrangements between divisions of a single company.[4]

2.3 In addition to the single entity rule, supporting provisions determine the treatment of assets when an entity joins a consolidated group, including what history is relevant to the consolidated group, and re-create the tax cost of membership interests when an entity leaves a consolidated group. These supporting provisions provide the framework within which the single entity rule is applied to consolidated groups.

---

4 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.5 and 2.7.

Framework of the consolidation regime

Design principles

2.4 The consolidation regime was developed based on the following six framework design principles[5]:

- Principle 1 — Consolidation to be optional, but if a group decides to consolidate, all of its wholly owned Australian resident group entities must consolidate;
- Principle 2 — Consolidated groups to be treated as a single entity;
- Principle 3 — Current grouping provisions to be repealed;
- Principle 4 — Individual entity losses and franking account balances able to be brought into the consolidated group;
- Principle 5 — Carry-forward losses and franking balances to remain with the consolidated group on an entity's exit; and
- Principle 6 — Provisions to be established for determining the cost bases on exit.

Asset-based model

2.5 In relation to Principle 6, an asset-based model was ultimately adopted. The asset-based model allows assets to move freely within a consolidated group with no income tax consequences and removes the need for complex value shifting rules and loss duplication rules for intra-group transactions.

2.6 The asset-based model, in effect, tracks the costs to a consolidated group of acquiring a joining entity through to the time that the entity leaves the group, and was originally described in the following terms:

> The asset-based model dispenses entirely with tax recognition of group entities in consolidation. Upon the entry of an entity into consolidation, the group's cost base for its equity in the entity is transferred to the assets the entity brings with it ... The cost base for the equity, when transferred to the individual assets, replaces existing asset cost bases. Where a group sells equity, the group's cost base for that equity is reconstructed equal to the sum of the cost bases of the assets that go with it.
>
> The intuition underlying this approach is that on entry to the consolidation regime the equity cost base is transferred to the assets of the entity as a representation of the actual cost on consolidation of the assets to the overall group. On exit from the group

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5 Commonwealth of Australia, *Tax Reform: Not a new tax, a new tax system*, August 1998, pages 122-123; Review of Business Taxation, *A Platform for Consultation*, February 1999, pages 545—567.

the process is reversed and the cost base of the equity is derived from the assets of the entity at that time, as this is what is actually being taken out of consolidation.[6]

2.7 These key elements of the asset-based model are reflected in the income tax law by the single entity rule and the tax cost setting rules.

Inherited history rules

2.8 As highlighted in the Board's Discussion Paper, the asset-based model was originally developed using an asset acquisition approach, with clean slate rules. Under the clean slate rules, an entity would not bring any income tax history with it when it joins a consolidated group. Similarly, an entity would not take any income tax history with it when it leaves the group.

2.9 The clean slate approach was subsequently replaced with an inherited history approach, which is reflected by the entry history and exit history rules (inherited history rules). The inherited history approach identifies the income tax history that an entity brings with it when it joins a consolidated group or takes with it when it leaves the group

2.10 Consequently, while the asset-based model resets the tax values of a subsidiary member's assets when it joins a consolidated group, the inherited history rules apply to determine the history that the group can take into account when determining the tax consequences of subsequent transactions relating to those assets.

2.11 The Board understands that the clean slate approach was replaced with the inherited history approach to overcome concerns that the clean slate approach created significant compliance costs, particularly in formation cases. In particular, concerns were raised that the clean slate approach may have resulted in certain assets and expenditure changing character from being on revenue account to capital account simply because a consolidated group was formed.

2.12 Although the consolidation regime broadly applies the inherited history approach, the Board notes that a number of modifications have been made to ensure certain outcomes are achieved. The tax treatment of a joining entity's depreciating assets is one example where a modified approach has been utilised, primarily to ensure inappropriate outcomes do not arise on the initial formation of a consolidated group.[7]

2.13 Therefore, in practice, the consolidation regime applies a 'hybrid' approach. In this regard, the submission from Deloitte Touche Tohmatsu (Deloitte) states:

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6 Review of Business Taxation, *A Platform for Consultation*, February 1999, pages 574—575.

7 Appendix C discusses the current treatment of depreciating assets held by an entity that joins a consolidated group

> ... in our view, the current model is not a pure inherited history model as there are significant elements of an acquisition model scattered throughout the provisions.

VIEWS IN EXPRESSED SUBMISSIONS

2.14 The general consensus in submissions received by the Board was that the existing framework behind the consolidation regime is, for the most part, working effectively and has lead to increased business efficiency and integrity within the tax system for consolidated groups.

2.15 However, stakeholders suggested that the operation of the regime is often overly complex. This is primarily due to the focus of the regime on formation cases, where the measures operate to ensure taxpayers achieve appropriate outcomes when no change in the economic ownership of the group has occurred.

2.16 The consolidation provisions were introduced with effect from 1 July 2002. Eight years on, the incidence of formation cases has clearly declined, with the more common transaction now undertaken by consolidated groups being acquisition cases.

2.17 Unlike formation cases, acquisition cases require some degree of change in the economic ownership of the entity being acquired, i.e. the consolidated group could be acquiring as much as 100 per cent of the joining entity or, alternatively, the last remaining membership interests in the joining entity in order for it to become eligible to join the group.

2.18 In light of the increased incidence of acquisition cases, business and professional groups have questioned whether the current policy framework behind the consolidation regime remains the most appropriate model going forward.

2.19 In this regard, some submissions suggested that adoption of a clean slate model, as originally proposed in the 2002 Exposure Draft, may be a simpler or more intuitive framework, at least in relation to acquisition cases. For example, the supplementary joint submission from the Corporate Tax Association/Minerals Council of Australia (CTA/MCA) stated:

> … the principle concern back in 2002 was the potentially dramatic implications of adopting a system which would immediately disregard the history related to every asset owned by major corporate groups in Australia when determining subsequent tax outcomes. These concerns were compounded by the fact that many groups intended to utilise the transitional option whereby the pre-existing tax bases of assets of nominated subsidiaries could be retained….
>
> These factors are understood to be the major reason why, ultimately, a decision was made to utilise an entry history rule approach rather than the CSR [clean slate rule].

> Therefore, eight years on these particular compliance factors that led to the decision not to adopt the CSR are no longer relevant.

2.20 The Deloitte submission highlighted that, as a result of the current framework, differences remain which can impact on whether a consolidated group chooses to acquire or dispose of an individual asset, or the entity holding the asset:

> An inherited history model provides for a different outcome as compared to an acquisition model. This difference can sometimes influence whether an entity chooses to dispose of the underlying assets or the membership interests relating to those underlying assets.[8]

2.21 This concern was also raised in the CTA/MCA submission, which stated:

> From the perspective of corporate groups the asset cost setting rules had the potential to address the income tax bias against a share acquisition as compared to an asset acquisition, where the target entity held, in particular, depreciating assets.
>
> In certain respects the current system does not consistently address this design objective. The tax cost of assets is reset but other relevant income tax attributes of those assets are subject to an inherited history rule and this may on one view conflict with the objective described above.

2.22 In light of these issues, the CTA/MCA submission urged the Board to take the opportunity to re-examine the framework behind the current regime, with a view to further clarifying the 'basic policy outcomes that the Consolidation Regime should in future be seeking to replicate'.

ALTERNATE POLICY APPROACHES

2.23 Clear evidence exists which suggests that the more common transaction today, and going forward, is the acquisition by, rather than formation of, a consolidated group.

2.24 In light of this evidence and having regard to the views expressed in submissions, particularly in relation to the treatment of depreciating assets, the Board considers that there is some merit to examining a shift from the current inherited history approach.

2.25 In this regard, the Board has considered the following options:

- adopting an acquisition approach; or

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8 The reference to an 'acquisition model' in this quote is taken to be a reference to the 'asset acquisition approach'.

- adopting an asset acquisition approach.

2.26 Broadly, both these alternate models adopt as the base case the acquisition of an entity, rather than the formation of a consolidated group.

2.27 In this regard, the acquisition approach replicates as closely as possible, outcomes that would arise under a direct acquisition of the underlying assets and liabilities of the joining entity for their market value.

2.28 In light of concerns expressed in certain submissions as to additional complexity or transitional issues that could arise from adopting an alternate framework, the asset acquisition approach attempts to replicate direct acquisition outcomes, but only in relation to assets. Where such outcomes are not possible or would require major changes to the current legislative framework, the asset acquisition approach articulates a clear policy principle as to the tax treatment afforded by the consolidation regime.

2.29 The key impacts from adopting these alternate approaches are discussed more fully below. Appendix D contains a high level comparison of these two approaches and the existing inherited history approach.

Acquisition approach

Objective

2.30 The objective of the acquisition approach would be to replicate, as closely as possible, the outcomes that would arise if there was a direct acquisition or disposal of the underlying assets and liabilities of an entity by a consolidated group, rather than the acquisition or disposal of membership interests in the entity.

2.31 Under the acquisition approach, the history of a joining entity's assets and liabilities would be irrelevant to the consolidated group going forward. Therefore, the inherited history rules would be removed.

2.32 The joint CTA/MCA submission outlined the objectives of the acquisition approach as follows:

> The objectives of the asset transaction model [that is, the acquisition approach in this Paper] would be that in the context of an entity acquisition or disposal to replicate, as closely as possible, the tax outcomes in respect of assets that would have arisen if the transaction had been undertaken as a direct acquisition or disposal of the underlying assets (and liabilities) of the relevant subsidiary.
>
> The conceptual underpinning of an asset transaction model approach would be to reflect the economic substance of a group's acquisition of 100 per cent of the shares in a joining entity, being that the group is economically acquiring full ownership of the

underlying assets of the joining entity, and that this should be recognised for all go-forward income tax purposes in respect of such assets.

Therefore, the asset transaction model is totally consistent with, and in effect further supports, the operation of the single entity rule. However, the asset transaction model would render redundant the entry history rule, because in the context of a direct asset acquisition the past history of the asset in the hands of the vendor is of no relevance to the purchaser.[9]

Entity joining a consolidated group

2.33 Under the acquisition approach, when an entity joins a consolidated group, the group would be taken to acquire all the assets and liabilities of the joining entity at the joining time.

2.34 Key implications that would arise are:

- pre-capital gains tax (CGT) assets held by the joining entity at the joining time would become post-CGT assets[10];
- assets held by the joining entity that become intra-group assets of the group would come to an end at the joining time for a payment equal to the allocable cost amounts allocated to the assets[11];
- liabilities held by the joining entity would be assumed by the group based on their market value at the joining time;
- non-asset tax attributes of the joining entity (such as undeducted business related expenditure and other inherited deductions) would not be transferred to the group — this would simplify the calculation of the allocable cost amount for the joining entity as the step 7 adjustment for inherited deductions could be removed; and
- consistent with the high level design principles on which the consolidation regime is based, tax losses and franking credits held by a joining entity would continue to be transferred to the group.

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9 There are some very limited exceptions, the two principle ones being where assets are acquired from an associate or related party, and where assets are acquired from a Government agency

10 Under the inherited history approach, this change in status of pre-CGT assets is likely to arise in an acquisition (as opposed to formation) case due to the operation of Division 149 of the *Income Tax Assessment Act 1997* (ITAA 1997), which changes the status of pre-CGT assets when there is a change in the majority underlying ownership of an entity.

11 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

2.35 Modifications could be made to alter these outcomes if necessary, having regard to other policy considerations.[12]

Operating as a consolidated group

2.36 Under the acquisition approach, the tax outcomes that arise in relation to an asset held by a consolidated group would be determined solely by the group's treatment of the asset, on the basis that the group has directly acquired the asset at the joining time. Therefore, as the joining entity's history in relation to the asset would be irrelevant, the entry history rule would be removed.

2.37 Key implications that would arise are:

- asset-based deductions (such as capital allowances) would be determined on the basis that the consolidated group acquired the asset at the joining time for an amount equal to its tax cost setting amount — as a consequence, for example, the effective life of an asset for capital allowance purposes would be determined at the joining time;
- the capital/revenue character of the amount received on the disposal of an asset would be determined on the basis of the consolidated group's treatment of the asset;
- intra-group assets that emerge from the group would be taken to be created at the time they emerge[13];
- the consolidated group could deduct trade debts held by a joining entity that are written-off as bad only if the group is a money lender[14]; and
- the consolidated group could not rely on private binding rulings issued to a joining entity prior to the joining time to the extent that those rulings relate to the assets and liabilities of the joining entity.

2.38 Modifications could be made to alter these outcomes if necessary, having regard to other policy considerations.[15]

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12 For example, modifications may be required for the treatment of pre-CGT assets and depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

13 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

14 A consequential amendment may be required to ensure that trade debts are not retained cost base assets.

15 For example, modifications may be required for the treatment of depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

Leaving a consolidated group

Implications for the consolidated group

2.39 Under the acquisition approach, when an entity leaves a consolidated group, the consolidated group would be taken to dispose of the assets and liabilities that the leaving entity takes with it at the leaving time. The calculation of the allocable cost amount for the leaving entity would be simplified as the step 2 adjustment for inherited deductions could be removed.

2.40 In addition, the capital/revenue character of any gain or loss made by the group on the disposal of the membership interests in the leaving entity would need to reflect the character of the underlying assets. As a result, a leaving entity's assets would need to be valued prior to it leaving a consolidated group.

2.41 Alternatively, to reduce compliance costs and complexity, a proxy could be developed. For example, a percentage approach could be used. However, the use of such a proxy would not necessarily reflect the current values and gains made on the assets. That is, if the revenue/capital split was determined using the cost bases of the assets, the outcome would not reflect the actual gains or losses made on the assets.

2.42 Therefore, additional compliance costs would arise under the acquisition approach when an entity leaves a consolidated group. In this regard, the Deloitte submission states:

> If a pure acquisition model were to be used in an exit scenario, we agree that the Division 711 calculation would split the gain between revenue and capital gains. While this may, theoretically, provide a neutral outcome, there are significant practical problems associated with adopting such a model on exit.
>
> That is, in order for such a proposition to work, the sales proceeds for the shares would need to be matched to the underlying sale of assets. This would require a thorough identification of assets, irrespective of whether they have a tax cost. This is because an asset with a nil tax cost may have some value and may be a revenue asset as compared to a capital asset. This identification of assets would greatly increase the level of compliance, as currently taxpayers only need to identify assets with a tax cost.

2.43 In addition, consistent with the high level design principles on which the consolidation regime is based, tax losses and franking credits held by the consolidated group would continue to be retained by the group.

Implications for the leaving entity

2.44 Under the acquisition approach, the leaving entity would be taken to acquire all the assets and liabilities that it takes with it at the leaving time. Therefore, as the prior history of the asset would be irrelevant, the exit history rule would be removed.

2.45 Key implications that would arise (assuming that the leaving entity does not join another consolidated group) are:

- the leaving entity would be taken to acquire all the assets that it takes with it (including CGT assets and depreciating assets) at the leaving time;
- asset-based deductions (such as capital allowances) would be determined on the basis that the leaving entity acquired the asset at the leaving time for an amount equal to its terminating value — as a consequence, for example, the effective life of an asset for capital allowance purposes would be determined at the leaving time;
- the capital/revenue character of the amount received on the disposal of an asset would be determined on the basis of the leaving entity's group's treatment of the asset;
- liabilities that the leaving entity takes with it would be assumed by the leaving entity based on their market value at the leaving time; and
- non-asset tax attributes of the consolidated group (such as undeducted business related expenditure and other inherited deductions) would not be transferred to the leaving entity.

Advantages and disadvantages of the acquisition approach

2.46 A key advantage of the acquisition approach is that it would offer a clear policy benchmark against which the outcomes of the consolidation regime can be compared. That is, outcomes from entering into the regime would replicate as closely as possible outcomes that would arise under a direct asset acquisition.

2.47 As a result, the acquisition approach would reduce tax induced distortions in the decision making process of a consolidated group and increase efficiency in the tax system.

2.48 However, the acquisition approach would represent a significant change to the existing consolidation framework and would be likely to lead to greater complexity and compliance costs for consolidated groups. For example, when an entity leaves a consolidated group, it would be necessary to determine the characterisation of any gain or loss made on the disposal of the entity.

2.49 In addition, difficulties would arise as to the market value of liabilities that would need to be determined when an entity joins or leaves a consolidated group. At present the entry and exit process recognises liabilities at their accounting value. While new legislative measures, for example the taxation of financial arrangements (TOFA)

provisions[16] and the foreign currency gains and losses (FOREX) provisions[17], have introduced a concept of requiring liabilities to be market valued for certain purposes, the Board recognises that requiring groups to undertake this process for all liabilities would increase compliance costs that arise when entity leaves a consolidated group.

Asset acquisition approach

Objective

2.50 The objective of the asset acquisition approach would be similar to the acquisition approach for assets. That is, the outcomes for assets would broadly replicate the outcomes that would arise if there was a direct acquisition or disposal of the underlying assets of an entity by a consolidated group, rather than the acquisition or disposal of membership interests in the entity.

2.51 Under the asset acquisition approach, the inherited history rules would be retained. However, a modification would be made to specifically exclude assets from the scope of those rules.

2.52 In addition, in light of the difficulties with valuing liabilities, a key difference (compared to the acquisition approach) is that the existing treatment of liabilities would be maintained.

Entity joining a consolidated group

2.53 Key implications that would arise under the asset acquisition approach when an entity joins a consolidated group are:

- when an entity joins a consolidated group, the group would be taken to acquire all the assets of the joining entity at the joining time;
- pre-CGT assets held by the joining entity at the joining time would become post-CGT assets[18];
- assets held by the joining entity that become intra-group assets of the group would come to an end at the joining time for a payment equal to the allocable cost amounts allocated to the assets[19];

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16 Division 230 of the ITAA 1997.

17 Division 775 of the ITAA 1997.

18 Under the inherited history approach, this change in status of pre-CGT assets is likely to arise in an acquisition (as opposed to formation) case due to the operation of Division 149, which changes the status of pre-CGT assets when there is a change in the majority underlying ownership of an entity.

19 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

- the entry history rule would be retained so that liabilities would be transferred to the group at the leaving time based on their accounting value;
- non-asset tax attributes of the joining entity (such as undeducted business related expenditure and other inherited deductions) would be aligned with the treatment of tax losses and franking credits and therefore transferred to the group — the entry history rule would achieve this outcome; and
- consistent with the high level design principles on which the consolidation regime is based, tax losses and franking credits held by a joining entity would continue to be transferred to the group.

2.54 Modifications could be made to alter these outcomes if necessary, having regard to other policy considerations.[20]

Operating as a consolidated group

2.55 Under the asset acquisition approach, the tax outcomes that arise in relation to an asset held by a consolidated group would generally be determined by the group's treatment of the asset, on the basis that the group has directly acquired the asset at the joining time. However, the joining entity's history would be relevant for the purposes of transferring the joining entity's liabilities to the group, usually at their accounting value.

2.56 Key implications that would arise are:

- asset-based deductions (such as capital allowances) would be determined on the basis that the consolidated group acquired the asset at the joining time for an amount equal to its tax cost setting amount — as a consequence, for example, the effective life of an asset for capital allowance purposes would be determined at the joining time;
- the capital/revenue character of the amount received on the disposal of an asset would be determined on the basis of the consolidated group's treatment of the asset;
- intra-group assets that emerge from the group would be taken to be created at the time they emerge[21];

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20 For example, modifications may be required for the treatment of pre-CGT assets and depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

21 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

- the consolidated group could deduct trade debts held by a joining entity that are written-off as bad only if the group is a money lender[22]; and
- the consolidated group could not rely on private binding rulings issued to a joining entity prior to the joining time to the extent that those rulings relate to the assets of the joining entity.

2.57 Modifications could be made to alter these outcomes if necessary, having regard to other policy considerations.[23]

Leaving a consolidated group

Implications for the consolidated group

2.58 Under the asset acquisition approach, when an entity leaves a consolidated group, the consolidated group would be taken to dispose of the membership interests held in the leaving entity — that is, the outcomes that currently apply when an entity leaves a consolidated group would be retained. Consequently, in most circumstances the consolidated group would make a capital gain or loss on the disposal of the membership interests held in the leaving entity, as those membership interests would usually be held on capital account.

2.59 However, consistent with the treatment of tax losses and franking credits, non-asset tax attributes of the joining entity (such as undeducted business related expenditure and other inherited deductions) would not be transferred to the leaving entity. Consequently, the calculation of the allocable cost amount for the leaving entity would be simplified as the step 2 adjustment for inherited deductions could be removed.

2.60 In addition, consistent with the high level design principles on which the consolidation regime is based, tax losses and franking credits held by the consolidated group would continue to be retained by the group.

Implications for the leaving entity

2.61 Key implications that would arise when an entity leaves a consolidated group under the asset acquisition approach (assuming that the leaving entity does not join another consolidated group) are:

- the leaving entity would be taken to acquire all the assets that it takes with it (including CGT assets and depreciating assets) at the leaving time;

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22 A consequential amendment may be required to ensure that trade debts are not retained cost base assets.

23 For example, modifications may be required for the treatment of depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

- asset-based deductions (such as capital allowances) would be determined on the basis that the leaving entity acquired the asset at the leaving time for an amount equal to its terminating value — as a consequence, for example, the effective life of an asset for capital allowance purposes would be determined at the leaving time;
- the capital/revenue character of the amount received on the disposal of an asset would be determined on the basis of the leaving entity's treatment of the asset; and
- the exit history rule would be retained so that liabilities would be transferred to the leaving entity at the leaving time, usually based on their accounting value.

Advantages and disadvantages of the asset acquisition approach

2.62 The asset acquisition approach would significantly clarify the policy benchmark against which the outcomes of the consolidation regime can be compared. That is, outcomes from entering into the regime for assets would substantially replicate as closely as possible outcomes that would arise under a direct asset acquisition.

2.63 As a result, the asset acquisition approach may reduce tax induced distortions in the decision making process of a consolidated group and increase efficiency in the tax system.

2.64 Although the asset acquisition approach would represent a change to the existing consolidation regime, in practical terms that change would be relatively insignificant (compared to the acquisition approach). That is, the fundamental change would be to ensure that:

- the assets of a joining entity are acquired by the consolidated group at the joining time for an amount equal to the tax cost setting amounts allocated to the assets; and
- the assets that a leaving entity takes with it are acquired by the leaving entity at the leaving time for an amount equal to the terminating values of the assets.[24]

2.65 A key advantage of the asset acquisition approach is that it would substantially retain:

- the existing treatment of liabilities; and
- the consequences that arise for a consolidated group when an entity leaves the group (as distinct from the consequences that arise for the leaving entity).

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24 In technical terms, this would primarily involve an amendment to section 701-55 of the ITAA 1997. However, it would also require numerous consequential amendments.

THE BOARD'S VIEW

2.66 The current inherited history framework underlying the consolidation regime is working effectively in the majority of cases to achieve the primary objectives of the consolidation regime.

2.67 One of the primary drivers behind the introduction of the consolidation regime was to reduce compliance costs for corporate groups in undertaking their tax affairs.

2.68 As highlighted in the Deloitte submission, the consolidation regime has required a significant investment of time and resources from both advisors and taxpayers. In this regard, familiarity with the operation of the regime is beginning to result in decreased compliance costs over time. This investment could be jeopardised if radical changes are made to the operation of the regime:

> While we agree that the tax consolidation regime has contributed to an improvement in the business efficiency and integrity of the tax system, we also consider that it has resulted in significant compliance costs for taxpayers over the period of introduction. We note that such compliance costs are reducing over time as groups become more familiar with the operation of the provisions.

2.69 Therefore, the Board considers that a fundamental change to the existing consolidation model could be justified only if the case for change is compelling and is strongly supported by the business community.

2.70 In this regard, the current inherited history framework was developed in an environment where the focus of stakeholders was on formation cases. The consolidation regime has now matured so that, at least for large businesses, the focus has now shifted to acquisition cases.

2.71 The Board acknowledges that the acquisition approach offers a clear policy benchmark against which the outcome of the consolidation regime can be compared. That is, outcomes from entering into the regime would replicate as closely as possible outcomes that would arise under a direct asset acquisition. However, the acquisition approach would give rise to increased compliance costs, particularly in relation to the treatment of liabilities and the consequences that arise when an entity leaves a consolidated group.

2.72 In relation to liabilities, the Board notes that the historical value of liabilities is generally used throughout the income tax law, with the notable exceptions of the recently introduced TOFA and FOREX provisions. Therefore, the Board considers that a broader review of the treatment of liabilities in the income tax law would be required

before the acquisition approach (requiring market valuation of liabilities) could be adopted.[25]

2.73 As acquisition cases are now the primary focus of consolidation, the Board considers that the adoption of the asset acquisition approach would be a significant improvement for the consolidation regime. This would provide greater consistency between the treatment of assets acquired directly or indirectly. However, the existing treatment of liabilities and the consequences that arise for a consolidated group when an entity leaves the group would be retained.

2.74 Therefore, the Board considers that the asset acquisition approach should be adopted.

2.75 However, the Board notes that the application of the asset acquisition approach may need to be modified in some cases to ensure that the income tax law applies consistently to consolidated groups and other taxpayers having regard to the policy underlying other parts of the law.

2.76 For example, adopting the asset acquisition approach in formation cases, or in cases where there is a change in ownership of a joining entity, would cause different outcomes to arise for consolidated groups and other taxpayers in some cases. Therefore, although the proposals outlined in Chapter 5 of this Position Paper will significantly address these concerns, the Board seeks stakeholder comments on whether the asset acquisition approach should be modified in some cases.[26]

Position 2.1

The Board considers that the asset acquisition approach should be adopted.

25 An acquisition approach is currently adopted for TOFA liabilities that are subject to certain elections. That approach could be extended to a broader range of TOFA liabilities and to FOREX liabilities.

26 For example, modifications may be required for the treatment of pre-CGT assets and depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

Question 2.1

The Board seeks stakeholder comment on:

(a) Do you agree with the Board's view to adopt the asset acquisition approach? If not, why not?

(b) Should the asset acquisition approach be modified for formation cases, or in cases where there is a change in ownership of a joining entity? If so, how?

(c) Do you consider that there are other circumstances in which the asset acquisition approach should be modified? If so, what are the issues?

(d) What compliance cost implications would arise from the adoption of the asset acquisition approach?

CHAPTER 3: OPERATION OF THE SINGLE ENTITY RULE

3.1 The single entity rule operates to treat a wholly-owned corporate group as a single taxpayer. The objective of the single entity rule was specified in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 as follows:

> The single entity treatment, coupled with the inherited history rules and special rules for setting the cost for tax purposes of assets of entities joining and leaving consolidated groups, will:
>
> - simplify the tax system and reduce on-going compliance costs;
> - promote economic efficiency by providing a taxation framework that allows Australian businesses to adopt organisational structures based more on commercial rather than tax considerations; and
> - promote equity by improving the integrity of the tax system.[27]

VIEWS EXPRESSED IN SUBMISSIONS

3.2 Submissions generally supported the view advanced in the Board's Discussion Paper that, in most cases, the single entity rule works effectively and produces appropriate outcomes.

3.3 The joint submission received from the ICAA/TIA contained the following:

> On the whole, we consider that the SER [single entity rule] does operate to simplify compliance, reduce compliance costs and enhance the efficiency and integrity of the tax system. This is clearly the case for groups which have all of their dealings with third parties (i.e. non-group members) and have limited intra-group assets (other than for instance membership interests in subsidiary members).

3.4 In addition, the submission received from CPA Australia states:

> The single entity rule and the inherited history rules have increased business efficiency in that they have removed tax impediments to business, and have reduced

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27 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.4.

> the need to consider the tax implications of group reorganisations and other transactions within groups. In relation to the integrity of the tax system, the treatment of consolidated groups as a single entity for certain purposes has removed opportunities to cascade losses in a chain of group companies, as well as the double taxation and loss duplication that previously occurred on the disposal of assets followed by a disposal of equity interests.
>
> However, the rules have also given rise to uncertainty, particularly in the context of various issues identified in the Discussion Paper such as the application of the SER to intra-group assets, and the interaction between the SER and inherited history rules and other areas of the income tax laws. This uncertainty has reduced the overall business efficiency gains that would otherwise have resulted from the introduction of the consolidation rules.

3.5 The CPA Australia submission highlights a common concern that was raised in submissions received by the Board. That is, although the single entity rule has gone some way to achieving its stated policy objectives, the ability of the regime to achieve these objectives has been hampered by the significant uncertainty and delay associated with providing resolution to key issues surrounding the application of the single entity rule.

3.6 Further, the Deloitte submission acknowledged that:

> Broadly, we believe that the single entity rule operates appropriately and as intended in the majority of cases. However, there are a number of cases where the single entity rule does not appear to operate appropriately.

3.7 In this regard, the primary areas of uncertainty associated with the operation of the single entity rule relate to:

- intra-group assets;
- intra-group liabilities;
- integrity issues; and
- dealings by third parties with a consolidated group.

Intra-group assets

3.8 Intra-group assets primarily relate to contractual rights between group members. These assets are disregarded by the head company under the single entity rule. Broadly, there are three types of intra-group assets:

- membership interests in subsidiary members of the group;

- rights relating to intra-group debt interests; and
- rights relating to intangible intra-group assets (e.g. options, rights or licences).

3.9 Intra-group assets that constitute membership interests are appropriately dealt with specifically under the tax cost setting processes that apply when an entity joins or leaves a consolidated group.[28] Accordingly, this Chapter focuses on intra-group assets other than intra-group membership interests.

3.10 Intra-group assets (other than membership interests) can either be:

- created within the group;
- brought into the group through the direct acquisition of the asset; or
- brought into the group through the acquisition of the membership interests in the entity holding the asset (that is, an indirect acquisition).

3.11 An intra-group asset acquired under a direct acquisition does not have its tax cost reset under the consolidation rules. Nevertheless, a real cost is often incurred by the head company of the consolidated group to bring the asset into the group.

3.12 Where an indirect acquisition of an intra-group asset occurs, the tax cost setting process applies to set a tax cost for the asset.

3.13 The contractual rights that give rise to an intra-group asset (other than a membership interest) will usually have associated obligations. Therefore, where a consolidated group holds an intra-group asset, it will usually have a corresponding liability. In some cases this corresponding liability will not be recognised as an accounting liability.

Current divisional company model

3.14 The ATO currently adopts a 'divisional company' model for dealing with intra-group assets (other than membership interests). This model has been adopted because the ATO considers that it best achieves the intent of the consolidation regime.

3.15 Under the divisional company model, the following outcomes arise.

- If both the rights and obligations relating to an asset are held within the group, the asset becomes an intra-group asset and is no longer recognised for income tax purposes.[29]

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28 Divisions 705 and 711 of the ITAA 1997.
29 Taxation Ruling TR 2004/11, paragraph 8.

- If an intra-group asset (other than an intra-group debt interest) is disposed of to a third party, it is treated for income tax purposes as a disposal of an asset and CGT event A1 applies. However, only incidental costs associated with the asset's disposal are included in the asset's cost base.[30]
- If an intra-group asset is disposed of indirectly as part of an entity disposal, the tax cost setting rules that apply when an entity leaves a consolidated group operate to re-create the tax cost of the leaving entity's membership interests for the head company.[31]

3.16 However, at the 2009 Consolidation Symposium, the ATO acknowledged that, in some cases, the divisional company model creates issues when applying the single entity rule.[32] These issues usually arise where an equivalent transaction cannot be undertaken by 'divisions' within a consolidated group.

3.17 The ATO departs from the divisional company model for their treatment of intra-group debts. Where an intra-group debt is transferred to a non-group entity, the transfer is treated, in substance, as the equivalent to borrowing money or obtaining credit (i.e. the creation of a loan). As such, no CGT event occurs to the consolidated group. In effect, the ATO applies an 'ending/creation model' to intra-group debt interests and a 'disposal model' to other intangible intra-group assets.

3.18 Stakeholders have criticised this dual approach as it creates uncertainty and there is no legislative basis for treating of intra-group assets differently. Stakeholders also question whether the divisional company model is the most appropriate model for dealing with intra-group assets.

3.19 On this point, the Deloitte submission says:

> … we question whether ... the treatment of debt like instruments is an exception, or is in fact the way such arrangements should be seen under the single entity rule. That is, if there is an intra-group option that is disposed of to a third party, it is questioned whether the single entity rule in fact results in CGT event A1, or instead results in a creation of a new asset. In our view, the inconsistent treatment of intra-group arrangements results in a fundamental question as to whether the ATO view is indeed technically correct, giving rise to uncertainty of application.

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30 Taxation Ruling TR 2004/11, paragraph 11. Taxation Determinations TD 2004/34 (about intra-group options) and TD 2004/35 (about intra-group licences).

31 Division 711 of the ITAA 1997.

32 Des Maloney and Peter Walmsley, *ATO Perspective on Consolidation — Unravelling the Mysteries of the Single Entity Rule*, pages 14 — 15.

Ending/creation model

3.20 A number of submissions received by the Board suggested an ending/creation model may be a more appropriate model for determining the tax treatment of intra-group assets. Under an ending/creation model, intra-group assets would be treated as effectively coming to an end when they come into the group and re-created when they emerge from the group.

3.21 Stakeholders submitted that this treatment accords with both an asset acquisition approach and the operation of the single entity rule, as assets are deemed to have been acquired by the head company at the joining time and cease to be recognised when they become intra-group assets.

3.22 The CTA/MCA submission said:

> Prima facie, the ATM [asset transaction model] would deal directly with this issue by regarding the ACA [allocable cost amount] allocated to an intra-group asset as being a payment made by the joined group to terminate the intra-group asset. … Such an approach would reflect the economic reality that from the group's perspective the acquisition of the joining entity has had the result of negating the commercial and legal obligations associated with the intra-group asset owned by the joining entity.[33]

3.23 This approach would also mirror the tax treatment that applies to intra-group membership interests under the consolidation regime, as membership interests cease to exist when an entity joins a consolidated group and are re-created, with their tax cost reset, when an entity leaves a consolidated group.

3.24 Practically, under the ending/creation model, when an entity joins a consolidated group, the cost incurred to acquire an intra-group asset would be deemed to be a payment made by the head company to terminate the asset. However, when an intra-group asset leaves the group, the asset would be 're-created', as opposed to being 'disposed of' (as is the case under the current divisional company model, apart from intra-group debt interests).

The Board's view

3.25 The Board considers that the consolidation regime could be improved by making the treatment of intra-group assets more consistent and certain.

3.26 In determining the most appropriate treatment for dealing with intra-group assets, the Board considered the following questions:

- should the tax costs of intra-group assets be recognised for tax purposes?

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33 Note the reference to an asset transaction model in this submission refers to the acquisition approach, as outlined in Chapter 2.

- when should the tax costs of intra-group assets be recognised?
- what history, if any, is relevant for intra-group assets?

3.27 In this regard, the tax costs of intra-group assets include:

- if the intra-group asset is acquired directly by the consolidated group, the actual cost of the asset and any other outlays or expenditure incurred to third parties in acquiring or holding the asset; or
- if the intra-group asset is held by an entity that becomes a member of a consolidated group (and therefore is acquired indirectly by the group), the tax cost setting amount for the asset and any other outlays or expenditure incurred to third parties in relation to holding the asset.

Should the tax costs of intra-group assets be recognised for tax purposes?

3.28 The taxation outcomes that arise when intra-group assets are recognised by the head company of a consolidated group depend on whether the asset is:

- acquired or disposed of directly by the consolidated group, including where the asset is brought to an end within the consolidated group; or
- acquired or disposed of indirectly by the consolidated group, because the consolidated group acquires an entity (thereby creating an intra-group asset) or an entity leaves the group taking the intra-group asset with it.[34]

Intra-group assets acquired or disposed of directly by a consolidated group

3.29 An asset acquired by a consolidated group directly from a third party entity may become an intra-group asset. This could happen, for example, if the head company of a consolidated group acquires rights from a third party entity that arise under a contract between the third party entity and a subsidiary member of the group.

3.30 An asset acquired under a direct acquisition does not have its tax cost reset under the consolidation rules. Nevertheless, a real cost is often incurred by the head company of the consolidated group to bring the asset into the group.

3.31 In addition, a consolidated group may incur economic outlays in relation to an intra-group asset during the period that it is held within the group or when it is disposed of or comes to an end (for example, third party legal expenses or stamp duty).

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34 An ATO discussion paper titled *What is the income tax treatment of expenditure incurred by a consolidated group to acquire an asset that becomes an intra-group asset which is then disregarded due to the single entity rule?* was released to the National Tax Liaison Group Consolidation Sub-group on 23 November 2006. The paper, which compared the economic and tax effects of the differing disposal options for a consolidated group, sought to determine the tax cost that should be recognised for intra-group assets.

3.32 In the Board's view, actual economic outlays to third parties that relate to intra-group assets directly acquired, or disposed of, by a consolidated group should be recognised for income tax purposes. Recognition of these outlays ensures that the tax outcome mirrors the economic cost to the group from acquiring or disposing of an asset, thereby reducing any disparity in outcomes that arise to the group.

Intra-group assets acquired indirectly by a consolidated group

3.33 When a consolidated group acquires a subsidiary entity, it indirectly acquires the subsidiary entity's assets. Any of those assets which arise under contractual arrangements with another member of the group will become intra-group assets that are acquired indirectly by the group.

3.34 Where an intra-group asset is acquired indirectly, the tax cost of the asset is reset under the consolidation tax cost setting rules. However, due to the operation of the single entity rule, the tax cost of an intra-group asset acquired indirectly by a consolidated group is not recognised for income tax purposes.[35]

3.35 However, it is apparent that for the tax outcome to mirror the true economic position of the consolidated group, the tax cost setting amount allocated to an asset that is acquired indirectly should be recognised for income tax purposes.

3.36 Therefore, the Board considers that the tax cost setting amount allocated to these intra-group assets should be recognised for income tax purposes.

When should the tax costs of intra-group assets be recognised?

3.37 Under the divisional company model, the fact that the single entity rule commences to apply to an intra-group asset is not sufficient to trigger income tax recognition of the tax cost of that asset. Accordingly, the head company cannot recognise the tax cost of the asset until the group disposes of the asset.

3.38 In contrast, submissions received by the Board argued that a consolidated group should be able recognise the tax cost associated with an intra-group asset when the single entity rule commences to apply to the asset, i.e. when the asset comes into the group and becomes an intra-group asset. This is consistent with the treatment that would arise under an ending/creation model.

3.39 Although there are valid reasons for recognising the tax costs associated with intra-group assets when the assets are brought into the group, adopting such a model would have the effect of bringing forward the point of recognition of such tax costs. This could have an adverse impact on the revenue if the asset remains in the group indefinitely.

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35 Section 701-58 of the ITAA 1997

3.40 The Board acknowledges that, where recognition of the tax cost of an intra-group asset is deferred until the asset subsequently emerges from the group or lapses intra-group, the consolidated group would be required to 'track' the asset and tag it with its tax cost.[36] This is contrary to policy intent underlying the consolidation regime (which results in intra-group assets ceasing to be recognised) and therefore would impose additional compliance costs.

3.41 However, the Board notes that these assets continue to exist within the consolidated group up until the time they are disposed of or lapse.

3.42 Therefore, the Board considers that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or the asset lapses, provided that there is no corresponding accounting liability for the asset that has been taken into account elsewhere in the consolidated group. In this regard, if another member of the group recognises an accounting liability which corresponds to the intra-group asset and that was taken into account under the tax cost setting rules that applied when that other member joined the group, the accounting liability effectively increases the tax costs of the other member's assets that are now taken to be held by the head company of the group.[37]

What history, if any, is relevant for intra-group assets?

3.43 Under the asset acquisition approach proposed by the Board in Chapter 2, a consolidated group would be taken to acquire all the assets at the joining time. Therefore, the capital/revenue character of the amount received on the disposal of the asset would be determined on the basis of the consolidated group's treatment of the asset. As a result, the income tax history that an intra-group asset had prior to coming into the consolidated group would be irrelevant when it is subsequently disposed of or lapses.

3.44 This outcome is broadly consistent with views expressed in submissions made to the Board, which stated that, depending on the nature of the transaction being undertaken between the two contracting parties, the tax treatment of the payment made by the head company of the group (i.e. the tax cost) to acquire/terminate the asset should be determined in accordance with the ordinary provisions of the income tax law.

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36 Paragraph 3.27 outlines the tax costs of intra-group assets.

37 Accounting liabilities of a joining entity increase the allocable cost under step 2 of section 705-60 of the ITAA 1997.

Position 3.1:

The Board considers that:

(a) the tax cost of an intra-group asset[38] that does not have a corresponding accounting liability which is recognised elsewhere in the consolidated group should be recognised for income tax purposes;

(b) this tax cost should be recognised when the consolidated group subsequently disposes of the asset or when the asset lapses intra-group; and

(c) the income tax history the intra-group asset had prior to coming into the consolidated group is irrelevant when the consolidated group subsequently disposes of the intra-group asset or the asset lapses.

Question 3.1

Do stakeholders agree with Position 3.1? If not, please provide examples where the recognition of the proposed tax cost would result in inappropriate outcomes?

INTRA-GROUP LIABILITIES

3.45 When an entity leaves a consolidated group, the allocable cost amount for the leaving entity is adjusted to reflect intra-group liabilities — that is liabilities owed by members of the old group to the leaving entity.[39]

3.46 The Government announced that the income tax law would be amended so this intra-group liability adjustment applies to accounting liabilities.[40] Submissions received by the Board highlighted significant stakeholder concerns with the proposal to restrict the operation of the adjustment to accounting liabilities.

3.47 Both stakeholders and the ATO consider that there may be situations involving intra-group assets where there is no corresponding liability owed by members of the old group to the leaving entity.

3.48 The problems experienced by consolidated groups which undertake indirect disposals of intra-group assets could be compounded if the intra-group liability adjustment is restricted to accounting liabilities.

38 Paragraph 3.27 outlines the tax costs of intra-group assets.

39 Section 711-40 of the ITAA 1997.

40 Media release No. 053 of 13 May 2008 issued jointly by the Treasurer and the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs

3.49 However, if an adjustment could be made for a corresponding liability, situations can arise where recognising the market value of that liability could result in a gain not being recognised for tax purposes. This outcome would also seem inappropriate.

3.50 Accordingly, the Board considers that the Government should give further consideration to amending the intra-group liability adjustment so that:

- the adjustment is triggered when an intra-group asset that does not have a corresponding liability owed to it by a member of the old group leaves a consolidated group with a leaving entity; and
- the adjustment applies to liabilities and to other similar types of obligations.

Position 3.2

The Board considers that the intra-group liability adjustment should be modified so that:

(a) the adjustment is triggered when an intra-group asset that does not have a corresponding liability owed to it by a member of the old group leaves a consolidated group with a leaving entity; and

(b) the adjustment applies to liabilities and to other similar types of obligations.

Question 3.2

Do stakeholders agree with Position 3.2? If not, why not?

INTEGRITY ISSUES RESULTING FROM INTRA-GROUP TRANSACTIONS

3.51 The Board had been advised that integrity issues can arise from the use of intra-group transactions that could lead to inappropriate tax outcomes.

3.52 In particular, ignoring the taxation consequences of intra-group dealings may result in some value shifts not being recognised by the tax system. This could occur where rights are created in respect of an asset (the encumbered asset) of the consolidated group and the parties to the rights agreement are members of the same consolidated group (that is, the rights are created intra-group).

3.53 As the rights agreement is an intra-group dealing, there are no tax consequences when the rights are created because of the operation of the single entity rule.

3.54 If the market value of the encumbered asset is diminished because of the rights that have been created, the cost base of the asset will be unaffected and an accounting liability might not arise in relation to the right.[41]

3.55 In addition, the encumbered asset could then be disposed of with the potential for the following outcomes.

- direct disposal of the asset — the group makes a capital loss or reduced capital gain on disposal and may maintain economic use of the asset (via the right); and
- indirect disposal of the asset by disposal of the entity holding the asset:
  - the group makes a capital loss or reduced capital gain on disposal of the membership interests and may maintain economic use of the asset (via the right); and
  - the cost base (undiminished by the encumbrance) of the asset is included in the tax costs of the membership interests in the entity and there may not be any accounting liability recognised in relation to the leaving entity's obligations under the right created in favour of the old group member.

3.56 If the rights agreement results in an asset consisting of a non-accounting liability owed to a member of the consolidated group by the leaving entity, then the head company is given a market value cost base for the right.[42] Consequently, a permanent difference to the revenue would arise (as the capital loss or reduced capital gain on the disposal of the membership interests would not be recouped if the asset created by the rights agreement was subsequently disposed of by the head company).

3.57 The Board notes that for non-consolidated groups, the general value shifting rules would generally apply to impact the value shift generated by creating the encumbrance over the asset.

3.58 Therefore, the Board considers that additional integrity provisions are required so that, if an intra-group asset or liability is taken out of a consolidated group, any value shift effected intra-group is appropriately reflected:

- in the case of a direct disposal of the asset or liability, in working out the amount of capital gain or capital loss made by the group; or
- in the case of an indirect disposal of the asset or liability, under the tax cost setting rules that apply when an entity leaves a consolidated group.

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41 Where no accounting liability is created, the allocable cost amount worked out when an entity leaves a consolidated group will not be reduced by the value of the accounting liability (as only accounting liabilities are recognised at step 4 of tax cost setting process that applies when an entity leaves a consolidated group).

42 Section 701-20 of the ITAA 1997.

Position 3.3

The Board considers that additional integrity provisions are required to address inappropriate outcomes that arise from the use of intra-group transactions to create value shifts.

Question 3.3

Do stakeholders agree with Position 3.3? If not, why not?

EXTENSION OF THE SINGLE ENTITY RULE TO THIRD PARTIES THAT DEAL WITH CONSOLIDATED GROUPS

3.59 The single entity rule does not apply to an entity outside of a consolidated group (a third party) which deals or transacts with a member of the consolidated group. In these circumstances, the single entity rule can cause uncertainty for third parties where the income tax position of the third party is affected by the transaction, but the income tax position of the consolidated group is not.

3.60 The Government has announced that the income tax law will be amended to extend the operation of the single entity rule for the purposes of certain CGT integrity provisions.[43]

3.61 Therefore, the Board's Discussion Paper sought views on whether the single entity rule should be extended to third parties in a broader range of circumstances. The Board also sought comments on whether the extension of the single entity rule should be reflected in a general principle or determined on a case by case basis.

Views expressed in submissions

3.62 Stakeholders who responded to this issue were unanimous in the view that the single entity rule should be extended to third parties in a broader range of circumstances than currently proposed. However, a 'broad-brush' approach to extend the single entity rule to all third parties who transact with a consolidated group was not supported.

3.63 In particular, a number of stakeholders were concerned that a blanket extension of the rule would place additional and onerous obligations on consolidated groups in ensuring that all third parties who transact with the group are fully informed of the correct tax status of the group. Further, it was generally acknowledged that a blanket

43 Media release No. 053 of 13 May 2008 issued jointly by the Treasurer and the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs.

extension of the single entity rule to all third parties may not produce an appropriate outcome in all circumstances.

3.64 Accordingly, the majority of submissions were in favour of an extension of the single entity rule on a case by case basis, having regard to the specific circumstances and operation of the income tax legislation.

3.65 The operation of the single entity rule and the inherited history rules is already extended to third parties for the purposes of applying the conduit foreign income rules[44], the value shifting rules[45] and the loss integrity provisions[46].

3.66 Some submissions expressed concerns that further extending the single entity rule on a case by case basis may create additional uncertainty and complexity for taxpayers when applying the consolidation legislation. This uncertainty may arise, for instance, where the legislation is not clear on the specific circumstances in which third parties can rely on the single entity rule in determining their tax affairs. Also, there were concerns that additional complexity may result where provisions extending the operation of the single entity rule are scattered throughout the consolidation legislation rather than centralised in one specific place.

3.67 To address this uncertainty, the Deloitte submission proposed:

> As Division 701 contains the single entity rule, it would seem logical that an extension to the single entity rule to third party dealings and other provisions should be contained in Division 701 (e.g. section 701-100).
>
> In our view, the provision would require two parts. The first part would identify relevant provisions of the Tax Act requiring an extension of the single entity rule outside core purposes. Essentially this section would contain a list of provisions where it is considered necessary to extend the operation of the single entity rule (e.g. Division 115, Division 152, Division 974, etc). Expansion of this list could be done via amendment or by regulations. The second part would then be needed to turn on the single entity rule in respect of all provisions contained in the first part.

3.68 Stakeholders generally agreed that the single entity rule should be extended to third parties transacting with a consolidated group in the circumstances outlined in the

44 Section 715-875 of the ITAA 1997.
45 Section 715-410 of the ITAA 1997.
46 Section 715-75 and section 715-215 of the ITAA 1997.

Board's Discussion Paper.[47] Some stakeholders identified other areas where the extension of the single entity rule could be considered.[48]

The Board's view

3.69 It is clear that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who transact with a consolidated group in a broader range of circumstances than those announced by the Government.

3.70 The Board considers that it would be preferable to develop a principle that could be applied to extend the single entity rule to third parties who transact with a consolidated group to third parties, rather than dealing with the issues purely on a case by case basis.

3.71 In this regard, a clear principle that emerges from the examples raised is that the single entity rule should be extended to third parties who are:

- shareholders of the head company of a consolidated group; and
- liquidators appointed to the head company of a consolidated group.

3.72 In both these scenarios the third party clearly sees the group as a single entity. Therefore, the Board considers that the single entity rule should be extended to these third parties and invites stakeholder comments on whether any exceptions are required.

3.73 The Board also considers that there may be a case for extending the single entity rule so that it applies to the dealings of a related third party with a consolidated group. The Board seeks stakeholder comments on whether this would be appropriate.

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47 The issues covered in the Board's Discussion Paper were CGT event K6, the CGT discount rules, distributions by liquidators and the commercial debt forgiveness rules.

48 These included the dividend imputation system, the small business CGT concessions, the debt/equity provisions, private company distributions and qualifying securities.

Position 3.4

The Board considers that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who are:

(a) shareholders of the head company of a consolidated group; or

(b) liquidators appointed to the head company of a consolidated group.

Consideration should also be given to extending the single entity rule (together with other parts of the consolidation provisions) so that it applies to the dealings of a related third party with a consolidated group.

Question 3.4

(a) Do stakeholders agree with Position 3.4? If not, why not?

(b) Are there circumstances where an exception should be made to the principles proposed in Position 3.4?

(c) Do stakeholders agree with the proposal to extending the single entity rule so that it applies to the dealings of a related third party with a consolidated group?

CHAPTER 4: INTERACTION BETWEEN THE CONSOLIDATION REGIME AND OTHER PARTS OF THE INCOME TAX LAW

4.1 Chapter 4 of the Discussion Paper identified areas where issues and uncertainties arise as a result of the interaction between the consolidation regime and other parts of the income tax law. The Board asked stakeholders to comment on the issues identified and to advise on any other areas of uncertainty or inequity that arise as a result of such interactions.

4.2 The issues and uncertainties fall into five broad but overlapping categories:

- taxation of trusts;
- consolidation membership rules;
- international tax issues;
- CGT roll-overs; and
- other issues.

TAXATION OF TRUSTS

4.3 Issues relating to the interactions between the trust provisions and the consolidation provisions mainly arise because of the way trusts are taxed. These issues relate to:

- determining how much of a trust's net income is assessed to each beneficiary and/or trustee when the trust is a member of a consolidated group for part of an income year; and
- calculating the allocable cost amount of a trust that joins a consolidated group part way through an income year.

Determining the net income of a trust that is a member of a consolidated group for part of an income year

4.4 Several issues arise when determining the amount of a trust's net income that should be assessed to beneficiaries and/or trustees where the trust is a member of a consolidated group for part of an income year.

4.5 The Government announced a new tax regime for managed investment trusts in the 2010-11 Budget.[49] The new regime is to commence on 1 July 2011. These changes may overcome some of the interaction issues that arise when a managed investment trust is a member of a consolidated group for part of an income year. Consequently, the Board considers that the consolidation interactions relating to managed investment trusts should be considered during the development of the new regime.

4.6 In addition, as the Board recommended that a broader review be undertaken on the way other trusts are taxed,[50] alternative models for determining the net income for other trusts during the non-membership period have not been considered as part of this review.

4.7 The Board has, however, considered the trust interaction issues using the existing framework[51] for taxing beneficiaries and trustees, taking into account the following principles included in Deloitte's submission:

> Ensure that all of the net income of the relevant trust is assessed to a party for the income year.
>
> Provide a mechanism that allows the net income of the trust to be allocated on a fair and reasonable basis, having regard to entitlements to the income of the trust during the relevant periods.
>
> Ensure that the mechanism used to allocate the net income of the trust does not result in the occurrence of double taxation or duplication of losses.
>
> Ensure that trustees and beneficiaries are not penalised inappropriately at the top marginal tax rate in circumstances where they would not otherwise be penalised if the non-membership period were instead an income year.

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49 Assistant Treasurer's media release No 086 of 7 May 2010, in response to the Board's Report on its Review of the Tax Arrangements Applying to Managed Investment Trusts.

50 See Recommendation 48 in the Board's Report on its Review of the Tax Arrangements Applying to Managed Investment Trusts.

51 Division 6 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936).

Calculating the trust's net income and trust law income for a non-membership period

4.8 Stakeholders agree that the income tax law should be clarified to provide certainty on how the trust's net income and trust law income should be calculated when a trust joins or leaves a consolidated group part way through an income year.

4.9 In this regard it is clear that:

- the net income and trust law income should be worked out appropriately for each non-membership period; and
- the trust's exempt income and non-assessable non-exempt income should be allocated appropriately between the periods.

4.10 To address these issues, the Board considers that the net income and trust law income should be apportioned between the membership and non-membership periods using similar principles to those currently used to allocate the income and deductions of a trust between the head company and a beneficiary when a beneficiary is a subsidiary member of a consolidated group for part of the year.[52]

4.11 That is, the trust's net income for the non-membership period should be calculated by reference to the income and expenses that are reasonably attributed to the period and a reasonable proportion of such amounts that are not attributable to any particular period within the income year.

4.12 In addition, to the extent income and expenses are apportioned in calculating the trust's net income for the non-membership period, similar adjustments may be appropriate when calculating the trust law income.

4.13 The Board acknowledges that taxpayers would need to be aware of the terms of the trust deed when determining the trust law income for the non-membership period. For example, some trust deeds may define income as equating to, or calculated by reference to, the trust's net income for tax purposes.

4.14 However, as noted in the Deloitte submission, it is unclear if these clauses automatically modify the calculation of trust law income for the purposes of the deed and how they apply to trusts that have more than one non-membership period in an income year.

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52 See Subdivision 716-A of the ITAA 1997.

Position 4.1

The Board considers that:

(a) a trust's net income for the non-membership period be calculated by reference to the income and expenses that are reasonably attributable to the period and a reasonable proportion of such amounts that are not attributable to any particular period within the income year; and

(b) to the extent income and expenses are apportioned in calculating the trust's net income for the non-membership period, similar adjustments are appropriate when calculating the trust law income.

Question 4.1

Do stakeholders agree with Position 4.1? If not, why not?

Calculating the beneficiaries and the trustee's share of the trust's net income

4.15 The Board considers that beneficiaries of a trust who have benefited from the trust law income during the non-membership period should be assessed on their share of the net income calculated for that period. Therefore, to overcome the uncertainty and issues that currently arise, the share of net income should be determined by taking into account events that happen after a trust joins or leaves a consolidated group.

4.16 For example, assume a trust and its two beneficiaries join a consolidated group part way through an income year. The income of the trust for the income year is $10,000 — $4,000 relates to the non-membership period and $6,000 for the membership period. Disregarding the single entity rule, each beneficiary becomes presently entitled to 50 per cent of the income of the trust — that is, $5,000 at the end of the income year.

4.17 Provided the beneficiaries' entitlements relate to the income of the trust derived during the non-membership period, they should be presently entitled to $2,000 of the income of the trust during the non-membership period. The amount of the trust's net income the beneficiaries are assessed on is based on their percentage of the entitlement to the income of the trust. If the trust's net income is the same as the income of the trust, each beneficiary should be assessed on $2,000.

4.18 In coming to this view, the Board acknowledges that this proposal could have a compliance impact on taxpayers as they would need to determine whether a beneficiary's income entitlement relates to the trust income derived during the non-membership period or to some other period.

Position 4.2

The Board considers that a beneficiary's and the trustee's share of the trust's net income should be determined by taking into account events that happen after a trust joins or leaves a consolidated group.

Question 4.2

Do stakeholders agree with Position 4.2? If not, why not?

Calculating the allocable cost amount of a trust that joins a consolidated group part way through an income year

4.19 When a consolidated group acquires a trust part way through an income year, it might adjust the price it pays to reflect any tax that the group expects to pay on its share of the net income for the trust's non-membership period.

4.20 Currently, the tax cost setting rules do not recognise the tax for which the group may be liable on the net income of the trust's non-membership period as a cost to the group of acquiring the trust. It is only the trust's liabilities that are taken into account in calculating its allocable cost amount at the joining time. This can result in anomalous outcomes.

4.21 The Board agrees with stakeholder views that the group's tax liability in relation to the net income of a trust's non-membership period should be included as a liability in working out the allocable cost amount when the trust joins a consolidated group. However, the adjustments required to the tax cost setting calculations to reflect this change will depend on how the net income relating to the trust's non-membership period is determined.

Position 4.3

The Board considers that the group's tax liability in relation to the net income of a trust's non-membership period be included in the allocable cost amount calculation.

Question 4.3

Do stakeholders agree with Position 4.3? If not, why not?

CONSOLIDATION MEMBERSHIP RULES

4.22 The Board's Discussion Paper considered the application of the consolidation membership rules as they relate to:

- trusts; and
- non-resident entities that satisfy the foreign hybrid rules.

Applying the consolidation membership rules to trusts

Membership of a consolidated group — the trustee

4.23 In relation to the membership requirements of trusts, stakeholders were of the view that it was not necessary for the trustee to be a member of the same consolidated group as the trust.

4.24 In this regard, the CTA/MCA submission said :

> ... many trusts employ external trustees and many trustees act as trustees for more than one trust and as such it would not be possible for many trusts to form part of a tax consolidated group. Further, individuals can be trustees of trusts and as such any such trusts would not be eligible to be part of a tax consolidated group.
>
> … changing trustees would also likely lead to significant integrity risk as trusts could be taken in and out of tax consolidated groups with no economic change of ownership.
>
> Therefore, … it would be inappropriate to require the trustee to be a member of the same consolidated group as the trust.

4.25 Although stakeholders considered it was unnecessary for the trustee to be a member of the same consolidated group as the trust as a condition of the trust's membership, they agreed that the technical issues identified in the Board's discussion paper can arise when this is not the case. For example, it is unclear how the tax cost setting rules apply to a trust when it joins or leaves a consolidated group as the trust's assets are those of the trustee — not the trust.

4.26 Although stakeholders suggested some alternative approaches to address these issues, the Board considers that requiring the trustee, in its capacity of trustee, to be a member of the same group as the trust is a systemic and straight forward method resolving the issues. In this regard, provided the trustee is only a member of a consolidated group in its capacity as trustee for that trust, the concerns raised by stakeholders should be overcome.

Position 4.4

The Board considers that a trustee, in its capacity of trustee for a trust that is a member of a consolidated group, be treated as a member of the same consolidated group as the trust.

Question 4.4

Do stakeholders agree with Position 4.4? If not, why not?

Membership of a consolidated group — beneficiaries

4.27 Stakeholders generally agreed that a trust should qualify as a member of a consolidated group only if all of its beneficiaries are members of the group.

4.28 However, BDO suggested that debt beneficiaries (that is, beneficiaries whose interests in the trust are classified as debt interests) should be excluded from the membership requirements. That is, a trust should qualify as a member of a consolidated group if all of its beneficiaries, other than debt beneficiaries, are members of the group.

4.29 In contrast, CPA Australia and Deloitte's recognised that difficulties could arise if debt interests in trusts are outside the group. For example, it is unclear how the net income of the trust would be allocated between the consolidated group and the debt beneficiaries outside the group as the trust does not have any net income for tax purposes once it joins the group.

4.30 Consequently, the Board considers that all beneficiaries, including debt beneficiaries, unit holders or objects of a trust must be subsidiary members of the consolidated group for the consolidation rules to work as intended.

Position 4.5

The Board considers that all beneficiaries, including debt beneficiaries, unit holders or objects of a trust, should be subsidiary members of the consolidated group.

Question 4.5

Do stakeholders agree with Position 4.5? If not, why not?

Application of the membership rules to non-resident entities that satisfy the foreign hybrid rules

4.31 Prior to the introduction of the foreign hybrid rules, a foreign hybrid entity was effectively treated for foreign tax purposes as a partnership (i.e. the partner or member is subject to tax) but was taxed in Australia as a non-resident company. As a result, they could not become members of a consolidated group.

4.32 The foreign hybrid rules allow these non-resident entities to be treated as a partnership for Australian tax purposes. As a result, these entities could become members of a consolidated group.

4.33 Stakeholders were of the view that non-resident entities that satisfy the foreign hybrid rules should be entitled to become members of a consolidated group.

4.34 As the changes to allow foreign hybrids to be treated as partnerships are relatively new, it is unclear if there are any risks associated with allowing these entities to become members of a consolidated group.

4.35 Therefore, the Board considers that foreign hybrids should be eligible to become members of a consolidated group. However, this should be reviewed if evidence suggests that integrity risks arise as a result of this outcome.

Position 4.6

The Board considers that:

(a) foreign hybrids should be eligible to become members of a consolidated group; and

(b) this should be reviewed if evidence suggests that integrity risks arise as a result of this outcome.

Question 4.6

Do stakeholders agree with Position 4.6? If not, why not?

INTERNATIONAL TAX ISSUES

4.36 The Board's Discussion Paper outlined concerns that the interaction between the consolidation regime and the foreign resident CGT rules enables:

- Australian assets to be moved within a MEC group and disposed of without recognising a capital gain; and

- the cost base of Australian assets to be uplifted where there is no change in the economic ownership of the corporate group and without recognising a capital gain.

4.37 The Discussion Paper included some simplified examples to highlight situations where the interaction of the consolidation regime with the non-resident CGT rules produce outcomes that, when viewed from the perspective of the overall outcome, are detrimental to the revenue.

4.38 Stakeholders were of the view that the general anti-avoidance rules[53] would apply to the arrangements outlined in these examples. They were also concerned that additional integrity measures may inhibit genuine commercial transactions.

4.39 The ATO agree that, in respect of the examples presented in the Discussion Paper, the general anti-avoidance rules could apply to strike down the tax benefit identified. However, commercial transactions are more sophisticated than the examples shown and it is unclear whether these rules could apply in all situations.

4.40 In this regard, Justice Richard Edmonds noted in his article in Lawyer's Weekly:

> It is not in the interests of the ATO to have to fall back, as a matter of last resort, on Part IVA and taxpayers certainly don't embrace such resort. Part IVA cases are never easy and the outcome is, in many cases, tinged with uncertainty.[54]

4.41 The Board is keen to ensure that the tax law operates efficiently, is easy to interpret and apply with certainty for both taxpayers and the ATO and produces equitable outcomes, having regard to the overall policy objectives of both the consolidation and the foreign resident CGT rules.

4.42 The consolidation rules allow consolidated groups, including MEC groups, to transfer assets between members of the group without giving rise to any tax consequences.

4.43 The foreign resident CGT rules, which limit Australia's CGT tax base to real property held by non-residents, were introduced as part of an ongoing process to ensure that Australia has a competitive international tax system.

4.44 The Board recognised in its review of the foreign source income anti-deferral regime's that, as a net capital importer, Australia needs to have an international tax regime that gives better access to international markets. If Australia's taxation treatment is less generous or flexible than that of other countries, this could reduce the competitiveness of our companies. The Board also acknowledged that international

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53 Part IVA of the ITAA 1936.

54 Justice Richard Edmond, Lawyer's Weekly — Law's taxing sham, 12 March 2010, pages 14 and 15.

competitiveness needs to be considered in the context of our domestic revenue raising requirements.

4.45 Viewed in isolation, the policy of allowing tax-free movements of assets within a consolidated group and MEC group and limiting Australia's CGT tax base to real property held by non-residents is justifiable — it's the interaction of these policies that creates distortions.

4.46 Therefore, to assess the merits of the outcomes that arise as a result of the interactions between the consolidation regime and the foreign resident CGT rules, the Board considered the following objectives:

- ensure foreign owned entities do not have a comparative advantage over Australian owned entities that cannot be justified;
- ensure Australia remains an attractive place to do business;
- as far as possible, minimise the economic distortions of commercial choices; and
- ensure the revenue does not bear an unacceptable level of risk.

4.47 The Board is also of the view that, as far as possible, similar entities should be taxed consistently. The extent to which the taxation treatment favours particular types of entities has an impact on horizontal equity. This allows certain entities to receive benefits at a cost to the taxation revenue and can create inappropriate investment distortions.

Moving Australian assets within a MEC group then disposing of them without recognising a capital gain

4.48 The policy objectives underlying the foreign resident CGT rules have an impact on horizontal equity when comparing the tax treatment of resident entities and non-resident entities. However, the ability of MEC groups to move taxable CGT assets within the group, and then dispose of them without tax consequences, provides MEC groups with a further comparative advantage over other taxpaying entities — including other consolidated groups that are wholly-owned by a foreign resident.

4.49 Wholly-owned resident entities that form a consolidated group, and Australian resident entities that do not form a consolidated group, must recognise any gain or loss on the disposal of non-taxable Australian real property assets for Australian income tax purposes regardless of whether the asset is disposed of directly to a third party or indirectly through the disposal of the membership interests in the subsidiary that holds the asset.

4.50 However, a MEC group can use its structure to move assets within the group so that capital gains and losses made on assets that are non-taxable Australian real

property are disregarded. The difficulty arises because, when an entity (including an eligible-tier-1 company) leaves a MEC group, the principal asset test in Division 855[55] focuses solely on the leaving entity.

4.51 This gives foreign owned entities that form a MEC group an advantage over Australian owned entities and foreign owned entities that form a consolidated group and increases distortions in commercial choices as the current CGT exemption may create incentives for entities to modify their structures to take advantage of the current rules.

4.52 Therefore, to overcome these concerns, the Board considers that all the assets of a MEC group or consolidated group (rather than only the assets of the leaving entity) should be taken into account for the purpose of applying the principal asset test in Division 855.

Position 4.7

The Board considers that all the assets of a MEC group or consolidated group (rather than the assets of the leaving entity) should be taken into account for the purpose of applying the principal asset test in Division 855.

Question 4.7

Do stakeholders agree with Position 4.7? If not, why not?

Uplifting the cost base of Australian assets without recognising a capital gain

4.53 The Board also considers that the interaction between the consolidation regime and the foreign resident CGT rules is inequitable to the extent that it allows consolidated groups that are wholly-owned by a non-resident entity and MEC groups to uplift the cost base of Australian assets without recognising a capital gain and without changing the underlying beneficial ownership of assets.

4.54 In this regard, the consolidation tax cost setting rules were developed to prevent double taxation — that is, tax payable by the vendor on the disposal of membership interests and on the unrealised gains on assets of the joining entity by the consolidated group or MEC group. Where a vendor is not taxable on the disposal of membership interests, an uplift in the joining entity's assets is not justified.

55 See section 855-30 of the ITAA 1997.

4.55 Therefore, the Board considers that, where Division 855 applies to an asset, the consolidation tax cost setting rules should not apply to the asset unless there is a change in the underlying beneficial ownership of the asset.

Position 4.8

The Board considers that, where Division 855 applies to an asset, the consolidation tax cost setting rules should not apply to the asset unless there is a change in the underlying beneficial ownership of the asset.

Question 4.8

Do stakeholders agree with Position 4.8? If not, why not?

CAPITAL GAINS TAX

4.56 Anomalous outcomes arise when CGT assets are rolled over between members of a wholly owned group and subsequently sold. Stakeholders have raised concerns about the appropriateness of the outcomes that arise when:

- a subsidiary member leaves a MEC group;
- an eligible tier-1 company (that is, a non-resident company's first tier of investment in Australia) leaves a MEC group; or
- the head company of a consolidated group leaves the group.

Subsidiary member leaves a MEC group

4.57 Stakeholders raised concerns that capital gains or capital losses made on the disposal of rolled over assets are effectively double counted when a subsidiary member leaves a MEC group. The tax cost setting rules that apply when an entity leaves a consolidated group capture any deferred capital gains or capital losses made on rolled over assets when a subsidiary member leaves a MEC group. In addition, CGT event J1[56] may also apply to include the deferred capital gain or capital loss in taxable income.

4.58 Blake Dawson pointed out that CGT event J1 does not apply when a subsidiary company leaves a consolidated group with a rolled over asset. In their view, this modification should also apply when subsidiary members leave a MEC group.

56 CGT event J1 broadly operates to end the deferral that happened under the roll-over.

4.59 The Board agrees that the current provisions create inequities and could result in capital gains or capital losses being included twice in taxable income. Consequently, CGT event J1 should not apply when subsidiary members leave a MEC group with assets that were rolled over prior to the entity joining the group.

Position 4.9

The Board considers that CGT event J1 should not apply when subsidiary members leave a MEC group with assets that were rolled over prior to the entity joining the group.

Question 4.9

Do stakeholders agree with Position 4.9? If not, why not?

Eligible tier-1 company leaves a MEC group

4.60 The Deloitte and joint CTA/MCA submissions raised concerns that double taxation may arise when an eligible tier-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group because of the pooling rules.

4.61 The pooling rules apply when an eligible tier-1 company leaves a MEC group. These rules indirectly capture some or all of the deferred capital gains or capital losses made on rolled over assets when an eligible tier-1 company leaves a MEC group. CGT event J1 may also apply to include the deferred capital gain or capital loss in taxable income.

4.62 Although the CTA/MCA submission included several examples to demonstrate that double taxation arises, they acknowledged that further consideration is needed to develop a solution.

4.63 The Board agrees that double taxation may arise when an eligible tier-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group because of the pooling rules. However, as stakeholders have highlighted, there is no clear solution to address these concerns. Therefore, the Board is seeking stakeholder views on a potential solution.

Position 4.10

The Board agrees that double taxation may arise when an eligible tier-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group because of the pooling rules.

Question 4.10

(a) Do stakeholders agree with Position 4.10? If not, why not?

(b) What changes can be made to ensure deferred capital gains and losses are not taxed twice when an eligible tier-1 company leaves a consolidated group with assets that were rolled over?

Head company of a consolidated group leaves the wholly-owned group

4.64 CGT event J1 arises when, broadly, a company ceases to be a member of a wholly-owned group following a CGT roll-over. However, the operation of the provision is uncertain and may result in inequitable outcomes where the membership interests in a subsidiary are rolled over to the head company of a consolidated group that is owned by a non-resident and the head company subsequently leaves the wholly-owned group.

4.65 Stakeholders are generally of the view that CGT event J1 should apply in these circumstances. However, it is unclear if CGT event J1 can apply to the membership interests when the non-resident entity disposes of its interests in the head company of the consolidated group. This is because the membership interests cease to be recognised for income tax purposes under the single entity rule.

4.66 In addition, the cost base of the membership interests in the subsidiary member is difficult to determine. However, further work is needed to determine how the cost base of the membership interests in the subsidiary member should be calculated.

Position 4.11

The Board considers that:

(a) CGT event J1 should apply to rolled over membership interests when a non-resident owner disposes of its interests in the head company; and

(b) further work is needed to determine how the cost base of these membership interests in the subsidiary member should be calculated.

Question 4.11

(a) Do stakeholders agree with Position 4.11? If not, why not?

(b) How should the cost base of the membership interests in the subsidiary member of the consolidated group be determined?

(c) Is there another method that could be used to determine the capital gain or capital loss made on the disposal of those membership interests, including for a partial disposal of membership interests?

Other changes to the operation of CGT event J1

4.67 Submissions included other examples where anomalous outcomes arise when CGT assets are rolled over between members of a wholly-owned group and are subsequently sold.

4.68 The CTA/MCA submission suggested that the issues could be overcome if CGT event J1:

- included a time limit (for example it would only apply if the relevant break-up time occurred within three years);
- exempted minority interest divestments (for example, CGT event J1 would not apply if less than 10 per cent of the membership interests are disposed of); and
- allowed the sub-group break-up exemption to apply where less than 100 per cent of the interests in the sub-group is disposed of to non-group entities.

4.69 The Board is of the view that these suggestions involve broader changes to the CGT rules. However, because of the significance and the uncertainty that current exists with CGT event J1, the Board is interested in stakeholders views on whether these suggestions could reduce the anomalies and compliance costs that currently arise.

Question 4.12

Do stakeholders consider that issues which currently arise because of CGT event J1 could be resolved if:

- a time limit applied the provision;
- minority interest divestments were exempted from the provision; and
- the sub-group break-up exemption applied where less than 100 per cent of the interests in the sub-group is disposed of to non-group entities?

OTHER ISSUES

4.70 The Board's Discussion Paper sought views on issues that arise as a result of the interaction between the consolidation regime and the provisions relating to FOREX and TOFA.

4.71 Stakeholders were also asked to submit any other areas of concern that arise a result of the interaction between the consolidation regime and other provisions in the income tax law that were not included in the Discussion Paper.

4.72 Some of these issues are discussed below. Other issues are outside the scope of this Review. However, some of these other issues are currently being considered outside the Board's process. A list of these issues, and the processes for dealing with them, are outlined in Appendix E.

4.73 In relation to issues not included as part of this Review or currently being considered by another process, the Board considers that Treasury and the ATO take the necessary action to consider and, where appropriate, resolve these issues as soon as practicable.

Consideration of consolidation interactions during the development of new measures

4.74 A number of stakeholders raised concerns about the interaction between the consolidation regime and recently introduced legislation (for example, the TOFA provisions and the managed investment trust provisions). Although the Board is aware that the interaction issues raised are being dealt with by Treasury and the ATO outside the Review process, the Board considers that interaction issues are important and should be taken into account as part of the initial design process.

4.75 The Board also acknowledges the complexities involved in developing new regimes and the time needed to identify issues and develop views. In some cases, interaction issues can only be identified and dealt with after the new regime has been settled. Therefore, the Board considers that stakeholders have a critical role in assisting Treasury to identify consolidation interaction issues when new policy proposals that affect the taxation of companies are being developed.

Interactions between the consolidation regime and double tax agreements

4.76 Double tax agreements relieve double taxation by allocating taxing rights between the country of residence and the country of source. The main methods of allocation are either:

- the country of residence is granted sole taxing rights, or

- both countries are given the right to tax the income, with the country of residence providing relief for tax paid in the country of source.

4.77 It is unclear how Australia's double tax agreements apply to consolidated groups. In particular, it is not clear whether:

- Australia's double tax agreements apply to a consolidated group, its head company, subsidiary members or a combination of these (a treaty interpretation issue); and

- for double tax agreement purposes, the single entity rule applies to attribute the actions of subsidiary members of a consolidated group to the head company of the group (a single entity rule interpretation issue).

4.78 In view of these uncertainties, the Board considers that Treasury and the ATO should undertake a review to clarify how Australia's double tax agreements apply to a consolidated group.

Position 4.12

The Board considers that Treasury and the ATO should undertake a review to clarify how Australia's double tax agreements apply to a consolidated group.

Question 4.13

Do stakeholders agree with Position 4.12? If not, why not?

Deferred tax assets and liabilities

4.79 When an entity joins or leaves a consolidated group, deferred tax assets and liabilities impact on the allocable cost amount calculation and allocation process.

4.80 Deferred tax assets and deferred tax liabilities are accounting concepts that measure a future tax asset or liability. Accounting Standard AASB 112 prescribes the accounting treatment of income taxes, including the recognition and measurement of deferred tax assets and deferred tax liabilities.

4.81 Deferred tax assets represent the amount of income tax recoverable in future periods on temporary differences between what a company can deduct for income tax purposes and what can be expensed, depreciated or otherwise written off before tax for accounting purposes. They can also result from carry forward unused tax losses and unused income tax credits.

4.82 Deferred tax liabilities represent the amount of income tax payable by an entity in future periods on temporary differences between accounting and tax.

4.83 The ATO released a discussion paper on the inclusion of deferred tax assets and liabilities in the allocable cost amount and the tax cost setting process to the National Tax Liaison Group Consolidation Sub-group on 26 February 2009. The paper raised a number of issues, complexities and inequities that arise as a result of the current treatment.

4.84 To overcome these issues, the paper included three options:

- amend the tax law to deal with specific circumstances where policy objectives are not met or where inappropriate outcomes arise;
- remove deferred tax liabilities from the consolidation tax cost setting process; and
- remove both deferred tax assets and deferred tax liabilities from the consolidation tax cost setting process.

4.85 The Board has not reached a view on the best approach for dealing with this issue at this stage.

4.86 However, the Board is keen to reduce compliance costs associated with the consolidation regime and to reduce complexity where possible. Therefore, the Board is seeking stakeholder's views on the above options, together with any other suggestions that will simplify the current treatment of deferred tax assets and deferred tax liabilities.

Question 4.14

The Board seeks stakeholder's comments on:

(a) Whether the inclusion of deferred tax assets and deferred tax liabilities in the tax cost setting process results in unnecessary complexity?

(b) How can the tax treatment of deferred tax assets and deferred tax liabilities be simplified?

(c) Should deferred taxes assets and deferred tax liabilities be removed from the tax cost setting process?

(d) If not, in what circumstances should deferred tax assets and liabilities be recognised in the tax cost setting process?

CHAPTER 5: OPERATION OF THE CONSOLIDATION REGIME FOR SMALL BUSINESS CORPORATE GROUPS

5.1 Stakeholders have confirmed that many small business and medium sized corporate groups which are eligible to form a consolidated group have elected to remain outside the consolidation regime.

5.2 The Board's Discussion Paper identified two primary factors that have contributed to the low take-up of the consolidation regime by small business and medium sized corporate groups.

5.3 First, anecdotal evidence suggests that the cost and complexity associated with acquiring the requisite knowledge to confidently apply the consolidation legislation was too high to justify, from the perspective of both the small business and medium sized corporate groups and their usual accounting and tax advisors.

5.4 Second, small business and medium sized corporate groups have been concerned about the operation of the rules aimed at preserving the pre-CGT status of membership interests of an entity that joins a consolidated group. These rules have recently been amended to ensure that the pre-CGT status of these membership interests is not eroded when the entity subsequently leaves the consolidated group.[57]

VIEWS EXPRESSED IN SUBMISSIONS

5.5 The Board's Discussion Paper sought stakeholder feedback on aspects of the existing regime that are viewed as particularly problematic for small business corporate groups and suggestions on changes that could be made to encourage a greater take-up of consolidation within the smaller business sector.

5.6 All submissions received by the Board that addressed small business issues suggested that, from a small business perspective, any potential benefits that could be achieved under the regime were, on the whole, outweighed by the costs associated with the uptake of the regime. In particular, submissions focused on:

- the structure of small business groups;
- the operation of the tax cost setting rules; and

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57 See *Tax Laws Amendment (2010 Measures No 1) Act 2010.*

- the consolidation transitional concessions.

Structure of small business groups

5.7 Submissions suggested that small business groups have significantly different needs to larger corporate groups. Consequently, the structure of small business and closely-held groups tends to differ to that of larger business groups. These differences impact on the ease with which small business groups can enter into the consolidation regime. They also highlight that the benefits associated with the consolidation regime are often not as relevant to these groups in conducting their tax affairs.

5.8 In this regard, the CPA Australia submission states:

> Many SME's have very small corporate groups (as few as 2 or 3 entities) with limited intra-group transactions. The compliance cost savings that might be achieved through the treatment of those groups as a single entity for tax purposes often have not outweighed the additional compliance costs involved in considering the consolidation rules, performing entry and exit calculations, calculating available fractions, etc.

5.9 The BDO submission highlights the following points of differentiation between smaller and larger business groups:

> Two of the most compelling reasons as to why larger groups elect to consolidate are:
>
> - the ability to ignore intra-group transactions (such as asset transfers) and to pool losses, franking credits and foreign tax credits. Many small business groups are structured in a manner which does not require frequent access to these benefits. For example, assets are often held in separate entities for asset protection and succession planning purposes. The requirements to transfer assets between entities arises infrequently, if at all; and
>
> - in relation to tax losses, subject to the satisfaction of certain tax loss and anti-avoidance rules, small business groups are able to utilise the benefits of discretionary trusts to distribute profits among the group.

Operation of the tax cost setting rules

5.10 A key feature of the consolidation regime is that, when an entity becomes a subsidiary member of a consolidated group, the tax costs of the subsidiary entity's assets are generally reset under the tax cost setting rules. The tax cost setting rules ensure that, broadly, the group's cost of acquiring the subsidiary entity is pushed down into the tax costs of the underlying assets of the joining entity.

5.11 Concerns were raised that the tax cost setting rules cause difficulty for many small business groups, particular on the formation of a consolidated group. In this regard, the submission from Blake Dawson states:

> In our experience, the consolidation regime is generally unattractive to small business because its benefits are outweighed by the compliance costs of (for example) preparing entry and exit 'allocable cost amount' calculations.
>
> These costs are more than usually significant for small business because their usual tax and accounting advisors often need to call on the help of specialist advisors to handle consolidation issues. Such specialist advice is often considerably more expensive, per hour, than their usual advisor's fees. The client therefore finds it difficult to see the 'value proposition'.

5.12 A similar view was expressed by CPA Australia in their submission:

> The complexity of, and uncertainty associated with, the rules has, in many instances, outweighed the benefits. The need to perform complex entry and exit calculations, uncertainty around the interaction between the consolidation rules and other areas of the law such as Division 152, anomalous outcomes that arose under the rules designed to preserve the pre-CGT status of membership interests are some examples of reasons why SMEs chose not to form consolidated groups. Although this meant the loss of the ability to transfer intra-group losses, SMEs have, to an extent, overcome this through management services arrangements.

5.13 Further, the submission from MGI Melbourne Pty Ltd states that:

> The tax cost setting rules are complex and many in the SME and larger family business sector cannot afford to pay advisors to advise on the impact of these rules.
>
> Of particular concern for many groups in the SME and larger family business sector which have been in existence for a long period of time is the detrimental impacts that the tax cost setting process can have to the tax cost of the underlying assets. This is particularly an issue where their shares in the relevant subsidiaries were acquired a long time ago and have a low cost base, compared to the value of the underlying assets (goodwill). On formation of a consolidated group, in some circumstances this may result in the tax cost of assets being eroded, and even a capital gain being made.

5.14 Several submissions highlighted that these detrimental outcomes under the tax cost setting rules typically arise for small business groups which have utilised CGT roll-overs to restructure their business to form a corporate group. This detriment arises because of the difference between the market value of the shares in the relevant companies and the cost base of those shares (which is determined under the relevant CGT roll-over provisions).

5.15 Another issue raised in submissions is that the tax cost setting rules utilise concepts, such as accounting standards, which may not be applicable to smaller business groups. This results in smaller groups experiencing higher compliance costs when applying the consolidation regime, as opposed to larger groups who are more familiar with these types of concepts.

5.16 In this regard, the ICAA/TIA submission states:

> In particular, we highlight the fact that small proprietary companies are not generally required to prepare financial statements in accordance with the accounting standards. A choice to consolidate by SME corporate groups may therefore require them to prepare accounts which comply with accounting standards when this would not otherwise be the case. This of itself results in additional complexity and compliance costs.

5.17 Finally, concerns were also raised that the valuation requirements under the tax cost setting rules are onerous and costly for small business groups.

Consolidation transitional concessions

5.18 When the consolidation regime was introduced, transitional concessions allowed wholly-owned groups that elected to consolidate the choice to retain the existing tax costs of a joining entity's assets (rather than apply the tax cost setting process to reset the tax costs of those assets). Additional concessions applied to simplify the rules for the utilisation of a joining entity's losses. These concessions ceased to apply from 31 December 2005.

5.19 These transitional concessions significantly reduced the compliance burden experienced by groups, particularly on formation of a consolidated group. For example, the option to retain the existing tax values of an entity's assets largely alleviated the need for costly valuations to be undertaken on formation of a consolidated group.

5.20 The transitional concessions were a temporary measure because they did not align with the broader policy objectives of the consolidation regime. In particular, the consolidation regime was introduced as a means to address key integrity issues inherent in the taxation of wholly-owned groups, which included the ability of groups to cascade losses through multiple ownership layers, as well as the potential duplication of taxable gains and tax losses within such groups. Requiring groups to undertake the tax cost setting process is an integral step in achieving these outcomes.

5.21 Many submissions suggested the re-introduction of these transitional concessions, at least for a temporary period, would assist small business and medium sized corporate groups to transition into the consolidation regime. The submissions suggested that the re-introduction of these measures could be justified in light of the significant complexity and uncertainty that has surrounded the operation of the consolidation provisions since their introduction.

5.22 In this regard, the CPA Australia submission states:

> ... many SME's adopted a 'wait and see' approach and, therefore, missed out on the transitional concessions that were initially available...

> In summary, the reintroduction of a transitional period for SMEs from say, 1 July 2011, might provide them with an incentive to form consolidated groups. The concessions would be the same as those originally offered (e.g. stick and spread, COT concessional loss treatment, value and loss donor rules, etc).

THE BOARD'S VIEW

5.23 The Board is concerned that the upfront cost and complexity associated with entering into the consolidation regime discourages wholly-owned small business and medium sized corporate groups from forming a consolidation group. In some cases, this is compounded by the adverse outcomes that can arise under the tax cost setting process that applies when an entity becomes a member of a consolidated group.

5.24 To address these concerns, the Board considers that on-going formation concessions, which are broadly similar to the original transitional concessions, should be introduced for wholly-owned small business and medium sized corporate groups that elect to form a consolidation group.

5.25 The Board also considers that these concessions should be open to all wholly-owned corporate groups that are consolidatable groups at the time of announcement for a limited period of time.

5.26 However, these concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

Formation concessions for eligible corporate groups

5.27 Stakeholder feedback and ATO statistical analysis clearly demonstrates that a significant proportion of potentially eligible wholly-owned corporate groups have chosen to remain outside of the regime.

5.28 The Board is concerned that many of these groups are small businesses that are closely-held and have grown to a stage that they would benefit from forming a consolidated group. By forming a consolidated group, a wholly-owned corporate group can move assets around the group and rationalise its structure with minimal tax consequences. In addition, consolidation facilitates better utilisation of group losses.

5.29 However, the Board appreciates that the costs associated with forming a consolidated group, together with adverse outcomes that can sometimes arise under the tax cost setting rules in formation cases, operate as a barrier to the group consolidating.

5.30 Therefore, the Board considers that on-going concessions should be introduced for wholly-owned small business and medium sized corporate groups that wish to

form consolidated groups. However, the concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

5.31 These formation concessions will provide eligible wholly-owned corporate groups a relatively low-cost alternative on formation of a consolidated group and achieves the objectives of simplicity and reduced compliance costs for these groups. The Board expects that the introduction of these concessions would also boost participation by these groups in the consolidation regime.

Key features of the formation concessions

5.32 The Board proposes to allow eligible corporate groups to elect to access the formation concessions, but only upon the initial formation of a consolidated group. The tax cost setting rules will continue to apply when an entity joins or leaves the consolidated group after the initial formation.

Election to apply the formation concessions

5.33 A significant criticism of the consolidation regime is that specialist skills are required to undertake the tax cost setting process when a consolidatable group forms. The Board considers that eligible wholly-owned corporate groups that elect to apply the formation concessions should be able to remain with their usual accounting and tax advisors, thereby removing a key barrier which currently discourages these groups from entering the consolidation regime.

5.34 Consequently, if a wholly-owned corporate group elects to access the formation concessions, the Board proposes that the election will apply to all of the members of the group.

5.35 The Board acknowledges that an election to apply the original transitional consolidation concessions was made on an entity-by-entity basis. However, the primary drivers for introduction of the proposed formation concessions are simplicity and reduced compliance costs associated with forming a consolidated group. If an entity-by-entity election was available, most groups would need to undertake tax cost setting calculations to determine the most advantageous outcome. This would result in additional complexity and cost, and therefore is not the Board's preferred option.

Eligible corporate groups

5.36 The Board considers that the formation concessions should be available to wholly-owned corporate groups with an aggregated turnover of less than $100 million and assets of less than $300 million in an income year (the threshold test). This is

consistent with the small and medium sized business threshold contained in the TOFA provisions.[58]

5.37 However, to ensure that groups do not inadvertently exceed the threshold test without taking advantage of the concessions, a wholly-owned corporate group should be able to access the concessions provided that it forms a consolidated group by the end of the income year following the income year that it exceeds the threshold test.

5.38 This threshold test will allow wholly-owned groups to experience a significant level of growth prior to their entry into the consolidation regime, thereby providing a clear path and opportunity to form a consolidated group at minimal cost.

Nature of concessions

5.39 The Board considers that the formation concessions should allow eligible wholly-owned groups to:

- retain the existing tax cost bases of assets for all subsidiary members; and
- allow losses held by subsidiary members that are transferred to the consolidated group to be utilised over three years.[59]

5.40 Therefore, a key simplification benefit of the proposed formation concessions is that eligible wholly-owned groups will be able to avoid the cost and complexity associated with the tax cost setting process on formation of a consolidated group by electing to retain the existing tax costs of a subsidiary member's assets.

5.41 In addition, the proposed concessions will allow certain losses held by a joining entity that are transferred to the consolidated group to be utilised over three years. This will allow eligible wholly-owned groups that elect to apply the concessions to avoid the complex 'available fraction' calculations that apply to regulate the utilisation of transferred losses.

5.42 The Board notes that the original transitional consolidation concessions provided a broader range of concessions in relation to, for example, foreign interposed entities, foreign loss treatment and value donor and loss donor rules.

5.43 The Board considers that many of these concessions would not be applicable to smaller, relatively simple group structures. In addition, concessions such as loss and value donor rules are extremely complex and are inconsistent with the objectives of simplicity and reducing compliance costs underlying the on-going concession. Therefore, it is not proposed to replicate these features in the proposed formation concessions.

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58 Section 230-5 of the ITAA 1997.

59 Similar to the loss utilisation treatment under the original transitional concessions.

Position 5.1

The Board considers that on-going formation concessions should be available for wholly-owned corporate groups with an aggregated turnover of less than $100 million and assets of less than $300 million in an income year.

The formation concessions should be available to an eligible wholly-owned corporate group that forms a consolidated group by the end of the income year following the income year that it exceeds the threshold test. The concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

If a group elects to apply the concessions, the election should apply to all subsidiary members of the group. If an election is made:

- the existing tax costs of assets for all subsidiary members should be retained; and
- losses held by subsidiary members that are transferred to the consolidated group should be able to be utilised over three years.

Question 5.1

(a) Do stakeholders agree with the Board's Position 5.1? If not, why not?

(b) Do stakeholders agree with the removal of the 'entity-by-entity' election for eligible wholly-owned groups? Are there situations where such an approach may unfairly disadvantage these groups?

Extension of the formation concessions to all wholly-owned groups for a limited period of time

5.44 In addition to the low take-up of the consolidation regime by wholly-owned small business and medium sized groups, the Board understands that many larger consolidatable corporate groups have not yet elected into the consolidation regime.

5.45 While reasons for the decision to remain outside of the consolidation regime may vary, the Board understands that many groups have resisted entry into the regime due to significant uncertainty with its operation and concerns about inequitable outcomes that can arise under the tax cost setting rules in certain circumstances.

5.46 Following the recent enactment of *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, many of the identified problems which resulted in business groups choosing to remain outside of the consolidation regime have been legislatively resolved. In addition, as the consolidation regime has been operating for several years, many uncertainties relating to the operation of the regime have also been resolved.

5.47 Accordingly, the Board considers that all consolidatable groups which have chosen to remain outside of the regime should be given the opportunity to take advantage of the proposed formation concessions for a specified period of time — that is, for, say, a 12 month period. However, the concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

5.48 As an additional integrity measure, the Board considers that this concession should be available only to those groups which are eligible to form a consolidated group at the date of any announcement of this proposal. This would prevent corporate groups from restructuring following the announcement to gain access to the formation concessions.

5.49 In making this proposal, the Board acknowledges that affected consolidatable groups will need to choose to apply the concessions or adopt the normal tax cost setting rules. This will increase the complexity of the consolidation regime for, and impose additional compliance costs on, those groups.

Position 5.2

The Board considers that, as a transitional rule, the formation concessions proposed in Position 5.1 should be available to all groups which are eligible to form a consolidated group at the date of announcement of the measure for a specified period time. The concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

Question 5.2

(a) Do stakeholders agree with the Board's Position 5.2? If not, why not?

(b) Are stakeholders concerned about the increased complexity and additional compliance costs caused by the adoption of Position 5.2?

APPENDIX A: LIST OF SUBMISSIONS

The following is a list of submissions, excluding confidential submissions, made to the Board as part of the post-implementation review of certain aspects of the consolidation regime. Submissions can be viewed in full on the Board's website at www.taxboard.gov.au.

Table A.1: List of organisations providing public submissions

Organisation
BDO (Australia) Ltd
Blake Dawson
Corporate Tax Association and Minerals Council of Australia
Corporate Tax Association and Minerals Council of Australia (supplementary submission)
CPA Australia Ltd
Deloitte Touche Tohmatsu Ltd
Group of 100 Inc
MGI Melbourne Pty Ltd
PricewaterhouseCoopers
The Institute of Chartered Accountants in Australia and Taxation Institute of Australia

Appendix B: Positions and questions

Chapter 2: Policy framework for the consolidation regime

Position 2.1

The Board considers that the asset acquisition approach should be adopted.

Question 2.1

The Board seeks stakeholder comment on:

(a) Do you agree with the Board's view to adopt the asset acquisition approach? If not, why not?

(b) Should the asset acquisition approach be modified for formation cases, or in cases where there is a change in ownership of a joining entity? If so, how?

(c) Do you consider that there are other circumstances in which the asset acquisition approach should be modified? If so, what are the issues?

(d) What compliance cost implications would arise from the adoption of the asset acquisition approach?

Chapter 3: Operation of the single entity rule

Position 3.1

The Board considers that:

(a) the tax costs of an intra-group asset that does not have a corresponding accounting liability which is recognised elsewhere in the consolidated group should be recognised for income tax purposes;

(b) this tax cost should be recognised when the consolidated group subsequently disposes of the asset or when the asset lapses intra-group; and

(c) the income tax history the intra-group asset had prior to coming into the consolidated group is irrelevant when the consolidated group subsequently disposes of the intra-group asset or the asset lapses.

Question 3.1

Do stakeholders agree with Position 3.1? If not, please provide examples where the recognition of the proposed tax cost would result in inappropriate outcomes?

Position 3.2

The Board considers that the intra-group liability adjustment should be modified so that:

(a) the adjustment is triggered when an intra-group asset that does not have a corresponding liability owed to it by a member of the old group leaves a consolidated group with a leaving entity; and

(b) the adjustment applies to liabilities and to other similar types of obligations.

Question 3.2

Do stakeholders agree with Position 3.2? If not, why not?

Position 3.3

The Board considers that additional integrity provisions are required to address inappropriate outcomes that arise from the use of intra-group transactions to create value shifts.

Question 3.3

Do stakeholders agree with Position 3.3? If not, why not?

Position 3.4

The Board considers that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who are:

(a) shareholders of the head company of a consolidated group; or

(b) liquidators appointed to the head company of a consolidated group.

Consideration should also be given to extending the single entity rule (together with other parts of the consolidation provisions) so that it applies to the dealings of a related third party with a consolidated group.

Question 3.4

(a) Do stakeholders agree with Position 3.4? If not, why not?

(b) Are there circumstances where an exception should be made to the principles proposed in Position 3.4?

(c) Do stakeholders agree with the proposal to extending the single entity rule so that it applies to the dealings of a related third party with a consolidated group?

Chapter 4: Interaction between the consolidation regime and other parts of the income tax law

Position 4.1

The Board considers that:

(a) a trust's net income for the non-membership period be calculated by reference to the income and expenses that are reasonably attributable to the period and a reasonable proportion of such amounts that are not attributable to any particular period within the income year; and

(b) to the extent income and expenses are apportioned in calculating the trust's net income for the non-membership period, similar adjustments are appropriate when calculating the trust law income.

Question 4.1

Do stakeholders agree with Position 4.1? If not, why not?

Position 4.2

The Board considers that a beneficiary's and the trustee's share of the trust's net income should be determined by taking into account events that happen after a trust joins or leaves a consolidated group.

Question 4.2

Do stakeholders agree with Position 4.2? If not, why not?

Position 4.3

The Board considers that the group's tax liability in relation to the net income of a trust's non-membership period be included in the allocable cost amount calculation.

Question 4.3

Do stakeholders agree with Position 4.3? If not, why not?

Position 4.4

The Board considers that a trustee, in its capacity of trustee for a trust that is a member of a consolidated group, be treated as a member of the same consolidated group as the trust.

Question 4.4

Do stakeholders agree with Position 4.4? If not, why not?

Position 4.5

The Board considers that all beneficiaries, including debt beneficiaries, unit holders or objects of a trust, should be subsidiary members of the consolidated group.

Question 4.5

Do stakeholders agree with Position 4.5? If not, why not?

Position 4.6

The Board considers that:

(a) foreign hybrids should be eligible to become members of a consolidated group; and

(b) this should be reviewed if evidence suggests that integrity risks arise as a result of this outcome.

Question 4.6

Do stakeholders agree with Position 4.6? If not, why not?

Position 4.7

The Board considers that all the assets of a MEC group or consolidated group (rather than the assets of the leaving entity) should be taken into account for the purpose of applying the principal asset test in Division 855.

Question 4.7

Do stakeholders agree with Position 4.7? If not, why not?

Position 4.8

The Board considers that, where Division 855 applies to an asset, the consolidation tax cost setting rules should not apply unless there is a change in the underlying beneficial ownership of assets.

Question 4.8

Do stakeholders agree with Position 4.8? If not, why not?

Position 4.9

The Board considers that CGT event J1 should not apply when subsidiary members leave a MEC group with assets that were rolled over prior to the entity joining the group.

Question 4.9

Do stakeholders agree with Position 4.9? If not, why not?

Position 4.10

The Board agrees that double taxation may arise when an eligible tier-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group because of the pooling rules.

Question 4.10

(a) Do stakeholders agree with Position 4.10? If not, why not?

(b) What changes can be made to ensure deferred capital gains and losses are not taxed twice when an eligible tier-1 company leaves a consolidated group with assets that were rolled over?

Position 4.11

The Board considers that:

(a) CGT event J1 should apply to rolled over membership interests when the non-resident owner disposes of its interests in the head company; and

(b) further work is needed to determine how the cost base of these membership interests in the subsidiary member should be calculated.

Question 4.11

(a) Do stakeholders agree with Position 4.11? If not, why not?

(b) How should the cost base of the membership interests in the subsidiary member of the consolidated group be determined?

(c) Is there another method that could be used to determine the capital gain or capital loss made on the disposal of those membership interests, including for a partial disposal of membership interests?

Question 4.12

Do stakeholders consider that issues which currently arise because of CGT event J1 could be resolved if:

- a time limit applied to the provision;
- minority interest divestments were exempted from the provision; and
- the sub-group break-up exemption applied where less than 100 per cent of the interests in the sub-group is disposed of to non-group entities?

Position 4.12

The Board considers that Treasury and the ATO should undertake a review of how Australia's double tax agreements apply to a consolidated group.

Question 4.13

Do stakeholders agree with Position 4.12? If not, why not?

Question 4.14

The Board seeks stakeholder's comments on:

(a) Whether the inclusion of deferred tax assets and deferred tax liabilities in the tax cost setting process results in unnecessary complexity?

(b) How can the tax treatment of deferred tax assets and deferred tax liabilities be simplified?

(c) Should deferred taxes assets and deferred tax liabilities be removed from the tax cost setting process?

(d) If not, in what circumstances should deferred tax assets and liabilities be recognised in the tax cost setting process?

Chapter 5: Operation of the consolidation regime and small business corporate groups

Position 5.1

The Board considers that on-going formation concessions should be available for wholly-owned corporate groups with an aggregated turnover of less than $100 million and assets of less than $300 million in an income year.

The formation concessions should be available to an eligible wholly-owned corporate group that forms a consolidated group by the end of the income year following the income year that it exceeds the threshold test. The concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

If a group elects to apply the concessions, the election should apply to all subsidiary members of the group. If an election is made:

- the existing tax costs of assets for all subsidiary members should be retained; and
- losses held by subsidiary members that are transferred to the consolidated group should be able to be utilised over three years.

Question 5.1

(a) Do stakeholders agree with the Board's Position 5.1? If not, why not?

(b) Do stakeholders agree with the removal of the 'entity-by-entity' election for eligible wholly-owned groups? Are there situations where such an approach may unfairly disadvantage these groups?

Position 5.2

The Board considers that, as a transitional rule, the formation concessions proposed in Position 5.1 should be available to all groups which are eligible to form a consolidated group at the date of announcement of the measure for a specified period time. The concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

Question 5.2

(a) Do stakeholders agree with the Board's Position 5.2? If not, why not?

(b) Are stakeholders concerned about the increased complexity and additional compliance costs caused by the adoption of Position 5.2?

APPENDIX C: DEPRECIATING ASSETS

Submissions raised concerns that the policy underlying the inherited history rules has been compromised in some cases. The prime example relates to the treatment of depreciating assets.

Under the current regime, the entry history rule is effectively overridden for depreciating assets held by an entity that becomes a subsidiary member of a consolidated group.[60] The depreciating assets of a subsidiary are taken to be acquired by the head company of a group at the joining time for their tax cost setting amount, consistent with an asset acquisition approach. However, specific rules reinstate history in certain circumstances.

Table C.1, which is based on a table in the CTA/MCA submission, summarises the current outcomes.

Table C.1: Current treatment of depreciating assets

Nature of depreciating asset of joining entity	Treatment accords with inherited history approach	Treatment accords with asset acquisition approach
Rate of depreciation based on effective life		
Prime cost method		
(a) Asset's tax cost not increased under cost setting rules; or	Asset's effective life retained	
(b) Asset's tax cost increased under cost setting rules		Asset's effective life determined at the joining time
Diminishing value method	Asset's effective life retained	
Accelerated rates of depreciation[61]		
(a) Asset's tax cost not increased under cost setting rules; or	Accelerated rate continues to apply	
(b) Asset's tax cost increased under cost setting rules		Accelerated rate ceases to apply

60 Subsection 701-55(2) of the ITAA 1997

61 Generally, accelerated rates of depreciation applied to assets acquired before 21 September 1999.

Table C.1: Current treatment of depreciating assets (continued)

Nature of depreciating asset of joining entity	Treatment accords with inherited history approach	Treatment accords with asset acquisition approach
Privatised assets		
(a) asset held by an earlier consolidated group for at least 24 months and the head company of that earlier group is not an associate of the head company of the joined group; or		Depreciable value limitations cease to apply
(b) otherwise	Depreciable value limitations apply	

The Board understands the policy rationale for this approach is that the asset acquisition approach applies to the depreciating assets of the subsidiary. However, exceptions apply where, broadly:

- the outcomes from applying the asset acquisition approach are inequitable; or
- the outcomes from applying the asset acquisition approach are inconsistent with broader policy objectives[62].

62 For example, in the case of privatised assets, the inherited history approach operates as an integrity measure to maintain the objectives of the privatised asset provisions (which is, broadly, to prevent inappropriate tax benefit transfers).

APPENDIX D: HIGH LEVEL COMPARISON OF POLICY FRAMEWORK OPTIONS

Table D.1: Alternative consolidation approaches

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
1. Objective			
	Future tax outcomes of assets and liabilities based on history.	Replicate the outcomes that would arise if the consolidated group had acquired the assets and liabilities of the joining entity. Disregard history for all purposes.	Replicate the outcomes that would arise if the consolidated group had acquired the assets of the joining entity. Retain existing treatment of liabilities and inherited history rules.
2. Entity joining a consolidated group			
CGT assets[63]	Acquired by the group at the time the joining entity acquired the asset — therefore pre-CGT status is retained	Acquired by the group at the joining time — therefore all assets are post-CGT assets	Acquired by the group at the joining time — therefore all assets are post-CGT assets
Intra-group assets[64]	Absorb allocable cost amount	Allocable cost amount for the asset taken to be a payment to terminate the asset	Allocable cost amount for the asset taken to be a payment to terminate the asset

63 Modifications may be required for the treatment of pre-CGT assets in formation cases, or in cases where there is a change in ownership of a joining entity.

64 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

Table D.1: Alternative consolidation approaches (continued)

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
2. Entity joining a consolidated group (continued)			
Liabilities	Transferred to the group based on accounting value	Assumed by the group based on market value at the joining time	Transferred to the group based on accounting value
Other non-asset tax attributes (eg, undeducted business related expenditure and other inherited deductions)	Transferred to the group Allocable cost amount reduced for inherited deductions	Not transferred to the group Allocable cost amount not reduced for inherited deductions	Transferred to the group Allocable cost amount reduced for inherited deductions
Tax losses[65]	Transferred to the group if certain tests satisfied	Transferred to the group if certain tests satisfied	Transferred to the group if certain tests satisfied
Franking credits[66]	Transferred to the group	Transferred to the group	Transferred to the group

65 Consistent with design principles of the consolidation regime

66 Consistent with design principles of the consolidation regime

Table D.1: Alternative consolidation approaches (continued)

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
3. Operating as a consolidated group			
Asset-based deductions (eg, capital allowances)[67]	Based on a hybrid of inherited history and asset acquisition outcomes	Based on asset acquisition outcomes — therefore effective life reset	Based on asset acquisition outcomes — therefore effective life reset
Capital/revenue status of assets	History of joining entity relevant to determine capital/revenue character of an asset	Capital/revenue character based on group's treatment of an asset	Capital/revenue character based on group's treatment of an asset
Intra-group assets[68]	Tax costs recognised when an asset emerges from the group in some circumstances	Assets taken to be created when they emerge from the group	Assets taken to be created when they emerge from the group
Pre-joining trade debt written off as bad	Deductible based on assessable history	Deductible only if the group is a money lender	Deductible only if the group is a money lender
Status of prior tax rulings of the joining entity	Generally continue to apply	To the extent they relate to assets and liabilities, they would cease to apply	To the extent they relate to assets, they would cease to apply

67 Modifications may be required for the treatment of depreciating assets in formation cases, or in cases where there is a change in ownership of a joining entity.

68 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

Table D.1: Alternative consolidation approaches (continued)

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
4. Entity leaving a consolidated group			
Allocable cost amount for leaving entity	Tax values of leaving assets plus non-asset deductions (eg, undeducted business related expenditure)	Tax values of leaving assets	Tax values of leaving assets
Nature of gain/loss made by group on disposal of leaving entity	Based on revenue/capital status of membership interests held in the leaving entity (generally all shares given capital status)	Revenue/capital split based on the status of underlying assets.	Based on revenue/capital status of membership interests held in the leaving entity (generally all membership interests given capital status)
Other non asset tax attributes (eg, undeducted business related expenditure and other inherited deductions)	Transferred to the leaving entity	Retained by old group	Retained by old group
Tax losses[69]	Retained by old group	Retained by old group	Retained by old group
Franking credits[70]	Retained by old group	Retained by old group	Retained by old group
CGT assets taken by the leaving entity	Acquired by the leaving entity at the time the joining entity acquired the asset, therefore pre-CGT status is retained	Acquired by the leaving entity at the leaving time	Acquired by the leaving entity at the leaving time

69 Consistent with design principles of the consolidation regime

70 Consistent with design principles of the consolidation regime

Table D.1: Alternative consolidation approaches (continued)

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
4. Entity leaving a consolidated group (continued)			
Asset-based deductions (eg, capital allowances)	Based on a hybrid of inherited history and asset acquisition outcomes	Based on asset acquisition outcomes — therefore effective life reset	Based on asset acquisition outcomes — therefore effective life reset
Capital/revenue status of assets taken by leaving entity	History of joining entity relevant to determine capital/revenue character of an asset	Capital/revenue character based on leaving entity's treatment of an asset	Capital/revenue character based on leaving entity's treatment of an asset
Liabilities	Transferred to the leaving entity based on accounting value	Assumed by the leaving entity based on market value at the leaving time	Transferred to the leaving entity based on accounting value

APPENDIX E: INTERACTION BETWEEN THE CONSOLIDATION REGIME AND OTHER PARTS OF THE INCOME TAX LAW — ADDITIONAL ISSUES

The Board's Discussion Paper sought views on issues that arise as a result of the interaction between the consolidation regime and the provisions relating to FOREX and TOFA.

Stakeholders were also asked to submit any other areas of concern that arise a result of the interaction between the consolidation regime and other provisions in the income tax law that were not included in the Discussion Paper.

Many of the issues raised are outside the scope of this Review. However, a number of these other issues are currently being considered outside the Board process.

ISSUES CURRENTLY BEING DEALT AS PART OF ANOTHER PROCESS

Issues raised by stakeholders that are currently being dealt with outside the review process, and the process for dealing with them, are outlined in Table E.1 below.

Table E.1: Issues and processes outside the review

Issue	Process for dealing with issue
Interactions with the new managed investment trust regime	Consolidation issues are being considered as part of the new managed investment trust regime announced in the 2010-11 Budget
Practical issues that arise when a public trading trust or a corporate unit trust becomes the head company of a consolidated group	Consolidation issues are being considered as part the amendments to remove the corporate unit trust rules
Clarification of the treatment of amounts paid under earnout arrangements in the entry allocable cost amount calculation	Consolidation issues are being considered as part of the amendments to the treatment of earnout arrangements announced in the 2010-11 Budget
Interactions with FOREX and TOFA provisions	The ATO National Tax Liaison Group Finance and Investment Subgroup is prioritising issues relating to these provisions
Treatment of intra-group transactions that straddle the time an entity joins or leaves a consolidated group	The ATO is considering whether recent amendments relating to transactions that straddle the time an entity joins or leaves a consolidate group apply to intra-group transactions

ISSUES TO BE CONSIDERED OUTSIDE THE REVIEW PROCESS

Issues raised by stakeholders that are outside the Review process and which are not currently being dealt with under another process are:

- various issues relating to MEC groups including:
  - the treatment of transfers-up and transfers-down of eligible tier-1 companies;
  - MEC pooling rules relating to functional currency;
  - interaction between MEC groups and loss rules including issues relating to the available fraction;
  - deemed failure of the continuity of ownership test for MEC groups where there is no actual change in majority beneficial ownership; and
  - interaction with the thin capitalisation rules;
- access to the Subdivision 126-B CGT roll-over by a foreign resident with more than one wholly-owned entry point company in Australia that has not formed a MEC group;
- application of CGT event L5 to subsidiary members that are deregistered;
- allowing the modified tax cost setting rules in Subdivision 705-C to apply in additional cases where a consolidated group is acquired;
- clarification of whether the foreign hybrid tax cost setting rules contained in Division 830 apply before or after the cost setting rules in Division 705;
- inclusion of a principle in the tax law to allow inconsistent elections to be cancelled or ignored when an entity joins a consolidated group;
- clarification of how the consolidation rules apply to intangible economic assets (that is, non-CGT assets such as customer relationships, know-how and similar assets); and
- disclosure of Division 7A amounts on income tax returns.

The Board considers that Treasury and the ATO take the necessary action to consider and, where appropriate, resolve these issues as soon as practicable.

FOI 2473
Document 5

TREASURY EXECUTIVE MINUTE

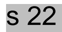
Minute No. 20112043

28 June 2011

Assistant Treasurer and Minister for Financial Services and Superannuation

cc: Deputy Prime Minister and Treasurer

LOSS RECOUPMENT RULES FOR COMPANIES WITH MORE THAN ONE CLASS OF SHARES: EXPOSURE DRAFT LEGISLATION



s 22

s 22

- Some submissions on the exposure draft legislation sought additional changes to address several other technical difficulties which arise under the company loss recoupment rules. A measure to address these concerns was included in the 2011-2012 Budget. We expect to release a Treasury consultation paper in respect of this Budget measure in the first week in July.

Tony Regan
Manager
Company Tax Unit

Contact Officer: Tony Regan Ext: 3334

FOI 2473
Document 6

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29 August 2011

The General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
By email: companylosses@treasury.gov.au
Attention: Tony Regan

Dear Mr Regan

Improvements to the company loss recoupment rules
Consultation paper

s 22

- The proposed interposed holding company amendment to section 166-225 should apply to the interposition of a trust or a company where any of the CGT rollover provisions applying to reorganisations is applicable. The rule should therefore apply where Subdivision 124-Q exchange of stapled ownership interests for units in an interposed unit trust rollover applies and modifications to the conditions will be necessary to accommodate this.

s 22

s 22

- The proposed section 166-265 demerger by a top interposed entity amendments will need to interact appropriately with the concessional testing integrity rules and an alternative to testing demerged stakes should be considered.

s 22

s 22

Holding company interposed between a direct stakeholder and the tested company

There are various detailed policy issues which would arise from the drafting of the paper and we have not considered exhaustively every single policy issue at this stage; we might identify further issues when the eventual draft law emerges. However we have identified some policy issues which need consideration. These include references which do not appear to align with our understanding of the intent of the measures including, for example, the condition that "an entity that was, before the interposition, a less than 10 per cent direct stakeholder acquires, directly or indirectly, all the shares or other interests in the interposed entity".

Interposition of entities

The proposed insertion of a new "rollover" provision where an entity is interposed between a section 166-225 notional <10% direct interests shareholder and a test company should apply to the interposition of a trust or a company. We consider that such an approach would be consistent with the various CGT rollover provisions applying to reorganisations, as it would similarly provide Australian businesses with the flexibility to restructure without incurring a tax cost.

Adopting this approach, the new section 166-225 "rollover" concession should therefore apply where an entity is interposed in each the following circumstances:

- company is interposed - Subdivision 124-G exchange of shares in company for shares in an interposed company rollover would apply

- company is interposed - Subdivision 124-M scrip-for-scrip rollover would apply
- trust is interposed - Subdivision 124-Q exchange of stapled ownership interests for units in an interposed unit trust rollover would apply

The inclusion of circumstances where Subdivision 124-Q rollover has applied is in accordance with the policy of providing continuity of membership interests where there has merely been the interposition of a new holding entity. The conditions for Subdivision 124-Q rollover are similar to Subdivision 124-G rollover where the interposed entity is a company, in that they require:

- the interposed entity to own all of the ownership interests in the original entity immediately after the rollover (sections 124-365(1) and 124-1045(1)(e));
- each exchanging member to have the same percentage of ownership interests in the interposed entity as they had in the original entity (sections 124-365(2) and 124-1050(1)); and
- each exchanging member to have the same proportionate market value of ownership interests in the interposed entity as they had in the original entity (sections 124-365(3).

However the consultation paper's reference in the proposed changes to the condition that "the new interposed entity has the same class of shares or other interests in the company" appears to be problematic where the replacement interests are in a trust. Prima facie a unit holder in a unit trust or holder of other interests in a trust may not have the same class of interests as a shareholder in a company due to the legal differences between a trust and a company including for example differences between each entity's constituent documents.

We submit that this condition is not required on the basis that the other conditions to the concession are sufficient to protect the integrity of the provision. In particular, the concession is proposed to include a condition requiring each stakeholder to have the same proportion of total voting stakes, dividend stakes or capital stakes in the new interposed entity. This condition should ensure that the concession is only available in intended circumstances. We note also that the condition as to proportionality will need to be carefully drafted so that the reference to "voting, dividend and capital stakes" can be applied to the comparison of stakes in a trust and/or a company.

Less than 100% proportional continuity reorganisations

The rollover should also be available in cases where there is less than 100% continuity of proportional underlying stakeholder stakes following an interposed entity reorganisation.

We do not see any policy reasons why the company loss testing rollover rule should be restricted to holding entity cases with 100% continuity of proportional stakes in dividend, capital and voting rights. Such a limitation denies the benefit of the improved concessional tracing rules in cases where for non-tax reasons the restructure does not meet these conditions but there is still underlying majority continuity of a concessional class of stakeholders.

This concession could also apply for example where the CGT Subdivision 124-M scrip for scrip rollover rules apply. The deemed continuity of notional shareholder interests could be limited to the extent that the original <10% shareholders elected for the CGT scrip rollover to apply. For example, if the notional shareholder is 40% before the scrip for scrip and of the 40% three quarters rollover into the new company (ie. 30% of the shareholders) and they represent 20% of that company afterwards, then a notional shareholder of 20% should be taken to continue.

This will require test entities to obtain information from the interposed entity as to the extent that scrip rollover was chosen which may be difficult in some cases to obtain. The rule should therefore allow test companies to determine the extent of the scrip rollover chosen based on a reasonable approximation determined using information known or readily available to the test company.

However the concession should also apply where there is a share for share exchange in a foreign jurisdiction to affect a reorganisation and there is substantial continuity of underlying interests.

Foreign restructures undertaken by inserting a new parent holding company occur for a variety of non-tax reasons including to affect the transfer of the stock exchange listing from one country to another. It is common in such foreign restructures that there is not a 100% continuity of interests as for example a minor shareholding may be retained in the old parent entity. Such reorganisations would not meet the proposed continuity of proportional underlying stakeholder stakes.

In other cases where there is the interposition of a new 100% parent and all interests are exchanged it may be difficult to determine if the underlying proportional stakes have been maintained due to the different regulatory regimes involved and potentially different rights. The strict 100% requirement may be too onerous to test and significant costs of compliance may result if legal advice in respect of the rights as between the two foreign jurisdictions must be obtained.

The rule for non-Australian parent reorganisations could be relaxed to instead require a substantial continuity of underlying interests of stakeholders before and after the new entity is interposed.

On-going testing

We are uncertain how Treasury propose for the proposed rules to operate following the reorganisation. However we submit that the rules for ongoing testing should be designed to be simple to apply, both for practical reasons and also to limit the costs of compliance for tracking stakes in the test company.

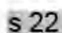
It would appear at first straightforward to deem the replacement stake held by the new top interposed entity to be the same stake as that held by the notional shareholder as at the time immediately after the relevant reorganisation (this treatment is suggested in the paper). However we are concerned that as soon as there is some subsequent change to the direct

and/or indirect shareholdings in the test company the tracking of the extent of the rolled over interest may become difficult.

That is, the rules should contemplate how testing is impacted where either the top interposed entity acquires further interests in the test company and either does or does not continue to have interests held in it which represent a <10% stake in the test company and/or there are further interests acquired in the top interposed entity which would represent a <10% stake in the test company.

The amendments will also need to interact appropriately with the section 166-265 single notional entity minimum voting rights restriction and section 166-272 same shares or interest rules which prima facie apply to stakes held by a top interposed entity. We submit that only one of these two rules should apply.

We recommend that Treasury also consider how the rule might operate if in the alternative the post-reorganisation prima facie new section 166-230 stakeholder (indirect <10% shareholders) was taken to have always held a stake equal to that of the notional section 166-225 shareholder as the top interposed entity. In this case any subsequent changes in the indirect membership interests through the interposed entity will be treated as a change in the top interposed entity in accordance with the usual application of the section 166-230 rules. However any drafting which seeks to track the ownership of the entities which previously made up the notional <10% shareholder would be unworkable other than perhaps for a test company with only a handful of shareholders.



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Demerger by a top interposed entity

Where the relevant conditions for the demerger "rollover" are met, the paper proposes to continue treating the demerging top interposed entity as the section 166-230 stakeholder following the demerger. This approach would appear to require the test company to identify the entities which held the indirect stake and to continue to track them as part of this parcel of deemed stakes. Our initial concern is whether companies may have some difficulty in continuing to track those stakes in particular where there are less than 10% stakeholders.

We recommend that Treasury also consider how the rule might operate if in the alternative the post-demerger stakeholders were taken to have always held a stake equal to that of the indirect stake they held in the top interposed entity. For example, a post-demerger <10% direct stake notional shareholder would be tested on the basis that it had always held a notional shareholder stake equal to its previous stake in the top interposed entity.

The proposed demerger continuity amendments will also need to interact appropriately with the section 166-265 single notional entity minimum voting rights restriction and section 166-272 same shares or interest rules which apply to stakes held by a top interposed entity. However we cannot see how the same share and interest test could continue to apply to the deemed section 166-230 stakeholder where interests are now potentially held directly in the test company.

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Yours sincerely

Andrew Woollard

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FOI 2473
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25 August 2011

Dear Sir

s 22

Summary

Overall position

We support the overall thrust of the changes in relation to application of the COT rules to demerger situations and believe that they will go some way to improving the operation of the COT rules. We consider that the proposals can be improved in three respects, outlined below.

1. *Problem with the definition of "demerger"*

There is a problem with the drafting approach that has been adopted in relation to the proposed amendment to section 166-230 of the ITAA 97 in relation to demerger transactions. The proposed amendments incorporate the terminology used in relation to the demerger provisions in section 125-70 of the ITAA 97. In doing this, they have also introduced into the COT the demerger condition that there be a disposal of at least 80% of the shares in the demerging entity.

While this condition has an appropriate logic in the context of the demerger rules it is not at all relevant to the proper operation of the COT rules. In essence, as the proposed rules are currently drafted a demerger of, say, 60% of an entity would cause an automatic breach of COT whereas a demerger of 80% of an entity would not – *whereas in both situations there would be no*

change in the underlying ownership of the entity.

We recommend that the drafting be amended to eliminate the 80% requirement which, while relevant to the operation of the demerger rules, is not relevant to determining whether there has been a change in the underlying ownership of a company.

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Detailed comments

1. Problems with the definition of "demerger"

The Consultation Paper at paragraph 36 states that it is proposed to amend section 166-230 of the ITAA 97 where amongst other requirements "a demerger (as defined in subsection 995-1(1)) happens to a demerger group, of which the top interposed entity is the head entity (as defined in subsection 995-1(1))".

Section 995-1(1) of the ITAA 97 defines a demerger by reference to the meaning given by section 125-70 of the ITAA 97. Section 125-70(1)(a) and (b) of the ITAA provides that:

(1) A "demerger" happens to a demerger group

(a) if there is a restructuring of the demerger group; and

(b) under the restructuring:

(i) members of the demerger group *dispose of **at least 80%** of their total *ownership interests in another member of the demerger group to owners of original interests in the *head entity of the demerger group; or

(ii) **at least 80%** of the total ownership interests of members of the demerger group in another member of the demerger group end and new interests are issued to owners of original interests in the head entity; or

> (iii) the demerged entity issues sufficient new ownership interests in itself with the result that owners of original interests in the head entity own **at least 80%** of the total ownership interests in the demerged entity, or
>
> (iv) some combination of the processes referred to in (i), (ii) and (iii) happens with the effect that members of the group stop owning **at least 80%** of the total ownership interests owned by members of the group in another member of the group.
>
> (emphasis added)

The 80% threshold test in the definition of demerger in section 125-70 of the ITAA 97 (relevant to demerger relief for capital gains tax purposes) should not be used in the proposed amendments to section 166-230 of the ITAA 97. This is because it is not relevant in the COT context.

What is relevant and important in the context of COT is that the same owners hold more than 50% of the voting power, rights to more than 50% of dividends and rights to more than 50% of the capital distributions in the loss company, both before and after the demerger. If the top interposed entity demerges shares in the loss company, or an interest in another entity interposed between itself and the loss company and the demerger is on a pro rata basis, there will be no change in the ultimate beneficial ownership of the loss company regardless of the percentage of shares that are demerged.

Accordingly, given that the 80% threshold (or any other threshold) has no relevance as to whether COT should be satisfied or not, we submit that there should be no threshold test in the definition of demerger in the proposed amendments to section 166-230 of the ITAA 97.

2. Making the proportionate interest requirement clear

The Consultation Paper at paragraph 36 states that the proposed amendment to section 166-230 of the ITAA 97 will apply where "*each stakeholder holds the same proportion of total voting stakes, dividend stakes or capital stakes in the demerged entities immediately after the demergers as the stakeholder held in the top interposed entity immediately before the demerger*".

We assume that, when this proposed amendment to section 166-230 is drafted, it will draw on the wording used in section 125-70(2) in relation to demerger relief - that is:

> Each owner (**original owner**) of original interests in the *head entity of the *demerger group must:
>
> (a) *acquire, under the *demerger, the same proportion, or as nearly as practicable the same proportion, **of new interests** in the *demerged entity as the original owner owned in the head entity just before the demerger; and
>
> (b) just after the demerger, have the same proportionate total *market value of *ownership interests in the head entity and demerged entity as the original owner owned in the head entity just before the demerger.
>
> (emphasis added).

In this regard it will be important for the requirement in the proposed changes to section 166-230 to include the words "*of new interests*". The insertion of these words can avoid any uncertainty in the interpretation of this proportionate interest requirement. The uncertainty of interpretation if these words are not used can be illustrated in the following example.

Assume that 90% of the interests in a loss company are demerged, so that the original shareholder would retain a 10% stake in the demerged entity. Without the words "of the

new interests" it may be argued that the stakeholders do not hold the same proportionate interest *in the demerged entity* as they held in the top interposed entity because they held 100% in the top interposed entity while they now only hold 90% in the demerged entity.

When regard is had to proportionate holdings in relation *the new interests in the demerged entity*, the proportionate requirements would be met provided each stakeholder is issued new interests on pro-rata basis.

3. Expanding the proposed amendments to deal with additional (similar) technical problems involving demergers

Preliminary comments

Blake Dawson has previously made submissions to Treasury in relation to certain technical problems in the operation of the COT rules in the context of demergers. In particular, we made submissions in this regard in relation to the Exposure Draft *Tax Laws Amendment (2009 Measures No4) Bill* 2009 (Cth).

Aside from dealing with section 166-230 (which is being addressed in the current consultation paper), our previous submissions also focused on two other problems:

- ensuring that the concessional tracing rules in section 166-255 of the ITAA 97 work in demerger situations; and
- limiting the operation of section 719-280 of the ITAA 97 so that it does not operate to deem a COT failure in certain demerger situations where no change of underlying ownership occurs.

We wish to stress that these problems are of the same nature as those that are being addressed in the current process. Accordingly, we would urge Treasury to deal with them as part of this current process - they are relatively easy to solve and, if dealt with, will ensure that the current changes deal with all relevant problems.

We outline the problems and our suggested solutions below.

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- A large proportion (more than 50%) of the shareholders in the Foreign Holding Company held a direct interest of less than 10% in that company in the Loss Year, and hold that interest by way of bearer shares;
- Sometime after the Loss Year, an interposed foreign company (**Demerged Holding Company**) was demerged to shareholders of the Foreign Holding Company on a pro rata basis and separately listed; and
- Loss Company seeks to utilise its previous year losses after the demerger occurs.

Before the demerger, subsection 166-255(2) deems the single notional entity to hold the bearer shares in Foreign Holding Company. After the demerger, however, subsection 166-255(2) deems the single notional entity to hold the bearer shares in Demerged Holding Company, a different company. As the shares held by the single notional entity change, the single notional entity before the demerger is a different single notional entity after the demerger. This causes the Loss Company to fail COT.

(c) Submission

To deal with this problem, we submit that the same changes as proposed for section 166-230 of the ITAA 97 should also be made for section 166-255 ITAA 97.

3.2 Section 719-280

(a) Background

Subdivision 719-F of the ITAA 97 modifies how the COT rules apply to MEC groups taking into account the special characteristics of those groups in contrast to consolidated groups.

Section 719-280, however, deems a head company to fail COT in certain circumstances, irrespective of whether the ultimate beneficial shareholding in the head company is unchanged. These circumstances are where:

- a potential MEC group ceases to exist: subsection 719-280(2);
- a thing happens to the membership interests in one or more entities in a MEC group that does not cause the potential MEC group to cease to exist but does cause a change in the identity of the top company: subsection 719-280(3);
- the MEC group ceases to exist because there ceases to be a provisional head company for that group: subsection 719-280(4).

When these rules are applied in demerger cases, COT can be deemed to have been failed even though the ultimate beneficial shareholding in the head company of the MEC group is the same before and after the demerger. We set out an example below to illustrate the problem.

(b) Example

- A foreign listed company (**Foreign Holding Company**) indirectly held 100% of an Australian loss making company (**Loss Company**) via one or more other foreign interposed companies in the income year when a loss resulted to the Loss Company (**Loss Year**);
- Loss Company (and its wholly owned subsidiaries) were members of a MEC group of which Foreign Holding Company was top company and Loss Company was the eligible tier-1 company (**ETOC**);

- Sometime after the Loss Year, an interposed foreign company (**Demerged Holding Company**) was demerged to shareholders of the Foreign Holding Company on a pro rata basis and was separately listed; and
- Loss Company seeks to utilise its previous year losses after the demerger occurs.

When the modified COT rules in Subdivision 719-F are applied to this example, the head company (Loss Company) is deemed to fail COT by virtue of section 719-280.

This is because section 719-280 deems a test company to fail COT if certain events occur after the start of the "ownership test period" which is the start of the "loss year" (refer sections 165-12 and 36-10) for the head company in relation to the relevant group of which it is a member.

In the example there is a change to the top company and this is sufficient for section 719-280 to apply. We note that it is unclear whether the demerger would cause the Foreign Holding Company's MEC group to cease under subsection 719-10(7) or whether there ceases to be a potential MEC group of the top company.

Section 719-280 would deem the head company (Loss Company) to fail COT because an event described in subsection 719-780(3) happens after the start of the "ownership test period", irrespective of the fact that the ultimate beneficial shareholding of the head company is the same before and after the demerger.

This example illustrates that a deemed COT failure in these circumstances, among others involving changes and conversions that result from demergers, is unreasonable and inequitable given the objective of the COT rules more generally.

The result that the Loss Company will fail COT in a demerger situation when applying the special modifications in Subdivision 719-F is an inequitable result, particularly where the demerger is on a pro rata basis, because the ultimate beneficial ownership in the Loss Company will be the same before and after the demerger. Consequently, conceptually and in reality, it should satisfy the "substantial continuity of ownership" requirement and COT.

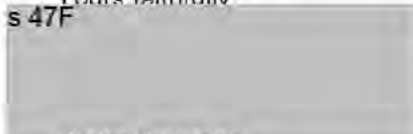
(c) Submission

To deal with this problem, we submit that section 719-80 should be amended to prevent COT from being failed in demerger situations involving MEC groups where ultimate beneficial ownership is unchanged as a result of the demerger.

* * * *

Please do not hesitate to contact Peter McCullough on (02) 9258 6078 of Janice Lo on (02) 9258 5817 if you have any questions in relation to this submission.

Yours faithfully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Blake Dawson

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Australian Government

The Board of Taxation

POST IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE CONSOLIDATION REGIME

A report to the Assistant Treasurer

the board of taxation
www.taxboard.gov.au

June 2012

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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its post-implementation review into certain aspects of the consolidation regime.

The Board has made a number of recommendations that seek to improve the operation of certain aspects of the consolidation regime with regard to the key objectives of the regime. These objectives are to promote business efficiency, improve the integrity of the Australian tax system and reduce ongoing income tax compliance costs for wholly-owned corporate groups that choose to consolidate.

The Board has also set out some reflections on the operation of the consolidation regime as a whole, as well as observations on issues which could be taken into account for the design and implementation of future tax regimes.

The Board will continue its investigation of the treatment of liabilities and other aspects of the consolidation regime, and expects to report to the Government on these issues by the end of 2012.

The Board established a Working Group chaired by Keith James to oversee the review. In the course of the review, the Board conducted consultations with stakeholders, issued a Discussion Paper and Position Paper and received 19 submissions. The Board would like to thank all those who so readily contributed information and time to assist the Board in conducting the review.

The Board would also like to express its appreciation for the assistance provided by Alexis Kokkinos, Andrew Mills and Geoffrey Lehmann, engaged as consultants to the Working Group, and to Matthew Hayes, Ken Spence and Tony Stolarek as members of the Expert Panel, in addition to the assistance received from officials from the Treasury and the Australian Taxation Office.

The *ex officio* members of the Board — the Secretary to the Treasury, Martin Parkinson PSM, the Commissioner of Taxation, Michael D'Ascenzo AO, and the First Parliamentary Counsel, Peter Quiggin PSM — have reserved their final views on the recommendations in this report for advice to Government.

Chris Jordan AO
Chairman, Board of Taxation

Keith James
Chairman of the Board's Working Group
Deputy Chairman, Board of Taxation

EXECUTIVE SUMMARY

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

2. 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) have elected to enter the consolidation regime, and 93 per cent of wholly-owned groups in the large business sector (groups with turnover of more than $250 million) are within the consolidation regime.[1]

3. On 3 June 2009 the Government announced that it had asked the Board of Taxation to undertake a post-implementation review of certain aspects of the consolidation regime.

4. As part of this post-implementation review, the Board released a Discussion Paper in December 2009, a Position Paper in October 2010, conducted targeted consultations and received 19 written submissions addressing the issues covered by the scope of the review.

5. In addition to making a number of recommendations to address specific issues arising in relation to the aspects of the consolidation regime within the scope of this post-implementation review, the Board considered it important to make a number of high-level reflections on the consolidation regime as a whole (Chapter 2). These reflections also draw upon the Board's experience in undertaking a related review on the consolidation rights to future income and residual tax cost setting rules which it completed in May 2011.

6. In summary, the Board considers that the consolidation regime has delivered substantial efficiency and integrity improvements to the Australian tax system when compared with the income tax grouping rules which wholly-owned groups previously had to apply. However, the Board also acknowledges there is substantial complexity in the operation of the consolidation regime and its implementation has been attended by some difficulties. The Board therefore considers that sufficient resources need to be allocated to the care and maintenance of the regime. It also considers that a further review could be undertaken of the consolidation regime within five years of the

1 Refer to Table A on page 70.

implementation of the recommendations contained in this report to determine whether structural changes are needed.

7. The Board also outlines its reflections on lessons which can be learnt for the design and implementation of future tax regimes.

8. A summary of the Board's key recommendations regarding those aspects of the consolidation regime within the scope of this review is set out as follows:

- Formal recognition should be given to the business acquisition approach in the consolidation core rules, along with the entry history rule, in relation to the treatment of assets transferred to a consolidated group from a joining entity. This should provide greater clarity in respect of the policy principles of the consolidation regime within the core rules of the regime (Chapter 3).
- An 'ending/creation model' should apply to ensure that the tax costs of intra-group assets (apart from membership interests) acquired, or disposed of, by consolidated groups, whether directly or indirectly, are appropriately recognised. However, some exceptions to the ending/creation model may be needed and should be considered on a case by case basis. This should provide a more consistent treatment of intra-group assets in the consolidation regime (Chapter 4).
- A number of recommendations are made to address issues concerning the interaction of the consolidation provisions with other provisions in the general income tax law (Chapter 5).
- Simplified rules should be introduced to assist small to medium sized business groups in overcoming the complexity and high compliance costs they face in entering the consolidation regime. These rules should also be made available to all wholly-owned corporate groups for a limited period of time (Chapter 6).

9. On 25 November 2011, the Government also requested that the Board investigate the treatment of liabilities under the consolidation regime and whether the consolidation tax cost setting amount for assets should be capped.

10. Given the time available and the substantial overlap between the treatment of liabilities and certain other issues being considered, the Board has decided to defer its advice on the following consolidation issues for inclusion in a separate report to the Government:

- the treatment of liabilities;[2]
- the treatment of deferred tax assets and deferred tax liabilities;
- investigating whether the tax cost of assets of entities joining a consolidated group should be capped;[3]
- issues arising in relation to the operation of CGT event J1; and
- issues arising in relation to the interaction between the CGT roll-over rules and the consolidation provisions.

11. The Board expects to report to the Government on these issues by the end of 2012.

2 Recommended by the Board at paragraphs 6.27 to 6.31 of its report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

3 Recommended by the Board at paragraphs 6.32 to 6.35 of its report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

CHAPTER 1: INTRODUCTION

BACKGROUND TO THE REVIEW

1.1 On 3 June 2009, the Government announced that the Board of Taxation would undertake a post-implementation review of certain aspects of the consolidation regime.

SCOPE OF THE REVIEW

Original scope

1.2 As it was not feasible to review the whole of the consolidation regime, the Board of Taxation was asked to focus on the following three key elements of the consolidation regime:

- the operation of the single entity rule;
- the interaction between the consolidation provisions and other parts of the income tax law; and
- the operation of the inherited history rules.

1.3 In light of empirical evidence which indicated a relatively poor take-up of the consolidation regime by eligible small business groups, the Board also considered the effectiveness of the consolidation regime for small business groups.

Announced measures subsumed into the Board's review

1.4 The Board notes that the implementation of a number of measures to amend the consolidation regime announced by the Government prior to June 2009 was deferred for consideration as part of the scope of the Board's post-implementation review.

1.5 A list of these announced (but unenacted measures) is in Appendix B.

Review of the consolidation rights to future income and residual tax cost setting rules

1.6 In the course of undertaking this post-implementation review, the Government requested that the Board review the consolidation rights to future income and residual tax cost setting rules.[4]

1.7 The Board completed its review of the consolidation rights to future income and residual tax cost setting rules and provided its report to the Assistant Treasurer on 31 May 2011.[5]

Review of consolidation liabilities and capping the tax cost setting amount

1.8 On 25 November 2011, the Government also requested that the Board investigate the treatment of liabilities under the consolidation regime[6] and whether the consolidation tax cost setting amount for assets should be capped[7], and asked that the Board include advice on these issues when it reports back on its consolidation post-implementation review.[8]

1.9 Given the time available and the substantial overlap between the treatment of liabilities and other issues being considered, the Board decided to defer its advice on the following consolidation issues for inclusion in a separate report to the Government:

- the treatment of liabilities;
- the treatment of deferred tax assets and deferred tax liabilities;
- investigating whether the tax cost of assets of entities joining a consolidated group should be capped;
- issues arising in the operation of CGT event J1; and
- issues arising in the interaction between the CGT roll-over rules and the consolidation provisions.

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4 Media Release No 045 of 30 March 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

5 Board of Taxation, *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules* (May 2011) – http://www.taxboard.gov.au/content/reviews_and_consultations/consolidation_rights_to_future_income/report/BOT_Consolidation_rights_report.pdf.

6 Recommended by the Board at paragraphs 6.27 to 6.31 of its report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

7 Recommended by the Board at paragraphs 6.32 to 6.35 of its report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

8 Media Release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

1.10 The Board expects to report to the Government on these issues by the end of 2012.

Additional consolidation issues outside of the Board's review

1.11 A number of aspects of the consolidation regime are outside the scope of the Board's review, notwithstanding that some of these may be longstanding areas of concern. Appendix C lists a number of these additional consolidation issues. As noted in Appendix C, the Board considers that it would be desirable for these issues to be resolved as soon as practicable.

REVIEW TEAM

1.12 The Board of Taxation is an independent, non-statutory body established to advise government on various aspects of the Australian taxation system.

1.13 The Board appointed a Working Group of its members to oversee the review. The members of the Working Group were Keith James (Chairman of the Working Group, and Deputy Chairman of the Board), Chris Jordan AO (Chairman of the Board) and Curt Rendall. Richard Warburton AO (former Chairman of the Board) was the Chairman of the Working Group until his retirement in February 2011.

1.14 Alexis Kokkinos, Andrew Mills and Geoffrey Lehmann were engaged as consultants to assist with the review. The Board also appointed an Expert Panel comprising Matthew Hayes, Ken Spence and Tony Stolarek to provide further specialist assistance to the Board in understanding the complex operation of the relevant taxation law and its practical application.

1.15 The Working Group was also assisted by officials from the Treasury and the ATO and members of the Board's Secretariat.

REVIEW PROCESS

1.16 Following the announcement of the review, the Board conducted targeted consultations with key stakeholders. Drawing on these consultations and other information, the Board developed a Discussion Paper which was released on 9 December 2009.

1.17 The Board received 11 submissions (two of which were confidential), in respect of the issues raised in the Discussion Paper. A list of submissions, other than confidential submissions, is provided in Appendix D.

1.18 In response to the submissions received and consultations undertaken, the Board prepared a Position Paper to provide a framework for further consideration of the key issues. The Position Paper set out the Board's proposed views on the following issues raised in the Discussion Paper:

- Chapter 2 considered the policy framework for the consolidation regime (including the operation of the inherited history rules);
- Chapter 3 considered issues relating to the operation of the single entity rule;
- Chapter 4 considered issues relating to interactions between the consolidation regime and other parts of the income tax law; and
- Chapter 5 considered the operation of the consolidation regime for small business corporate groups.

1.19 The Board received eight submissions (one of which was a confidential) in response to the proposals raised in the Position Paper.

1.20 The Board acknowledges the assistance provided by those who made submissions to the review. These submissions made a vital contribution to the review and, together with views expressed during consultations, were integral in helping to shape the recommendations contained in this report. Apart from those made in confidence, submissions have been published on the Board's website and a list of individuals and organisations that provided public submissions to the review is at Appendix D.

BOARD'S REPORT

1.21 In developing this report, the Board considered the views raised by stakeholders in their submissions and at the consultation meetings, and the views of the Board's consultants and members of the Expert Panel. However, the recommendations made by the Board in this report reflect the Board's independent judgment.

CHAPTER 2: OVERVIEW AND REFLECTIONS OF THE BOARD ON THE CONSOLIDATION REGIME

BACKGROUND

2.1 Prior to the introduction of the consolidation regime on 1 July 2002, members of Australian corporate groups were treated as separate entities for income tax purposes. Specific grouping rules for wholly-owned corporate groups allowed:

- losses to be transferred between group members;
- dividends to be paid tax free to another member of the group; and
- capital gains and losses to be rolled-over when assets were transferred between group members.

2.2 A number of specific rules were also introduced over time to address certain integrity issues which arose in the taxation of corporate groups.

2.3 The Review of Business Taxation in 1999 identified a large number of efficiency and integrity concerns that arose under this system. These were summarised in the Explanatory Memorandum which accompanied the introduction of the consolidation regime as follows:[9]

- tax impediments to business reorganisations — for example, possible tax costs of liquidating a redundant company in a wholly-owned group or buying back shares from a group entity;
- high compliance costs and complex tax laws to deal with groups — for example, the costs of dealing with the tax implications of group reorganisations, intra-group dividends and disposals of ordinary assets and revenue assets (including trading stock) within groups;
- double taxation — where gains realised in ordinary commercial transactions are taxed again on the disposal of equity;
- loss duplication — where losses realised in carrying on a business or on disposal of assets are realised again on the disposal of equity;

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9 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.3.

- loss cascading — where group companies (as well as companies that are less than 100 per cent owned) use a chain of companies to create multiple tax losses based on one initial economic loss;
- value shifting — where artificial losses are created (where there is no economic loss) through shifting value between group companies; and
- tax avoidance through intra-group dealings — for example, manipulating dealings between group companies to reduce or defer tax.

2.4 The consolidation regime was introduced as a structural solution to address these problems by:

- ceasing to recognise multiple layers of ownership within an Australian wholly-owned group; and
- treating Australian wholly-owned groups as a single entity for income tax purposes — that is, members of a consolidated group lose their separate tax identity when they join a consolidated group and acquire a tax identity when they leave the group.[10]

2.5 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.[11]

OVERVIEW OF THE CONSOLIDATION RULES

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

2.7 A consolidated group generally consists of an Australian resident 'head company' and all of its wholly-owned Australian resident subsidiaries. Specific rules also allow certain resident wholly-owned subsidiaries of a foreign holding company to consolidate (a multiple entry consolidated group (MEC group)).

2.8 The 'single entity rule', 'inherited history rules' and 'tax cost setting rules' are core rules in the consolidation regime.[12]

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10 ibid, paragraph 1.10.
11 ibid, paragraph 1.11.
12 Division 701 of the *Income Tax Assessment Act 1997* (ITAA 1997).

The single entity rule

2.9 Following a choice to consolidate, under the 'single entity rule' the members of a consolidated group are treated as parts of the head company of the group for income tax purposes (that is, the group is treated as a single entity). This means that:

- a single income tax return is lodged by the group and the group meets a single tax liability as well as pays a single set of pay as you go instalments;[13]
- losses, franking credits and foreign income tax offsets are pooled in the head company;
- the assets and liabilities (other than intra-group assets and liabilities) of the subsidiary members are treated as if they were assets and liabilities of the head company;
- the actions of the subsidiary members (for example, acquisition or disposal of assets) are treated as if they had been undertaken by the head company; and
- intra-group transactions (for example, the transfers of assets between group members) are treated as arrangements between divisions of a single company.[14]

2.10 The operation of the 'single entity rule' also means that where an entity joins a consolidated group, the entity will cease to be recognised as a separate entity, and its assets, liabilities and other tax attributes will be treated as though they are those of the head company of the group. Where an entity leaves a consolidated group, it will be recognised as a separate entity distinct from the consolidated group, and it will take its assets and liabilities out of the group.

2.11 Particular issues which arise in relation to the operation of the 'single entity rule' are discussed in Chapter 4 of this report.

The inherited history rules

2.12 The 'inherited history rules' support the 'single entity rule' by determining the tax history that the head company of a consolidated group inherits from an entity which joins the group (the 'entry history rule'), and determining the tax history that an entity inherits when it leaves the group (the 'exit history rule').

2.13 The history that is inherited has an impact on the tax implications which apply to the consolidated group after an entity joins the group and the tax implications which apply to an entity after it leaves. For example, under the 'entry history rule', a consolidated group may become entitled to certain deductions for expenditure

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13 Generally in the quarter commencing after the consolidated tax return has been lodged.
14 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.5 and 2.6.

incurred by a joining entity prior to it joining the group (such as being entitled to expenditure incurred by the joining entity which was allocated to a project pool). Similarly, the pre-CGT treatment of an asset in the hands of a joining entity is inherited by a consolidated group.

2.14 The operation of the 'inherited history rules' and a consideration of its relevance as part of the ongoing policy framework for the consolidation regime are set out in Chapter 3 of this report.

The tax cost setting rules

2.15 The 'single entity rule' is also supported by 'tax cost setting rules' which apply to the assets of an entity which joins a consolidated group that become assets of the group.

2.16 Where a subsidiary member joins a consolidated group and its assets are treated as belonging to the head company of the group, a question arises as to what tax cost should be given to these assets. If the consolidated group adopts the joining entity's tax cost for these assets, this may not reflect the cost which the group paid to acquire the joining entity which could result in the duplication of gains and losses.

2.17 To eliminate the duplication of gains and losses, the 'tax cost setting rules' often reset the tax cost of a joining entity's assets to reflect the consolidated group's cost of acquiring the joining entity. The group's cost also takes into account liabilities of the joining entity which become liabilities of the group.[15] The group's cost — which is allocated to the joining entity's assets — is also adjusted for certain retained earnings, distributions, losses and entitlements to future deductions which the group receives from the joining entity.[16]

2.18 The 'tax cost setting rules' also apply when an entity leaves a consolidated group.

2.19 When an entity leaves a consolidated group, a question arises as to what cost the group should recognise for selling its membership interests in the leaving entity. The 'tax cost setting rules' reconstruct the group's cost for these membership interests based on the group's tax cost of the net assets the leaving entity takes with it[17]. This ensures there is no duplication of gains and losses for the group, as the tax outcome for selling an entity out of the group aligns with the tax outcome that would arise from selling the net assets.

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15 ibid, paragraph 5.6.
16 ibid, paragraph 5.10.
17 ibid, paragraph 5.13.

REFLECTIONS OF THE BOARD

2.20 The Board notes that the scope of its post-implementation review is limited to the operation of certain elements of the consolidation regime. Although the Board received some brief comments on the assessment of the consolidation regime as a whole, for the most part stakeholders' comments concentrated on particular problems in relation to the operation of the consolidation rules.

2.21 This report largely focuses on specific problems which have arisen with respect to certain elements of the consolidation regime, and sets out the Board's recommendations as to how these specific problems can be addressed.

2.22 The Board also considered other specific elements of the consolidation regime in its review of the consolidation rights to future income and residual tax cost setting rules, which was completed in May 2011. That report also focused mainly on specific problems which had arisen with respect to the operation of particular rules in the consolidation regime.

2.23 Although the Board's two consolidation reviews have highlighted specific areas for the improvement of the consolidation regime, broader questions have been raised as to whether the benefits of the consolidation regime outweigh its problems. The Board therefore considered it appropriate to convey some high-level reflections on the consolidation regime as a whole.

2.24 In summary, the Board considers that the consolidation regime as a whole has delivered substantial efficiency and integrity improvements to the Australian tax system when compared with the income tax grouping rules which wholly-owned groups previously had to apply. In particular, existing consolidated groups now face significantly less complexity in relation to intra-group dealings and group reorganisations. In many respects, the consolidation provisions operate in a workable manner.

2.25 However, despite significant improvements relative to the previous tax grouping rules, the Board also acknowledges there is substantial complexity in the current operation of the consolidation regime, particularly when entities enter a consolidated group. In some cases, this can create difficulty for groups and their advisors when applying the consolidation provisions, and in some areas places significant resource requirements on the Government to maintain and administer the regime. The complexity of the rules and their interaction with the general tax law can also result in anomalous outcomes and make it difficult to predict the revenue consequences of changes to the consolidation rules.

2.26 The Board is of the view that the Government should allocate sufficient resources for the care and maintenance of the consolidation regime to ensure that issues can be addressed in a timely manner. The Government should also consider whether structural changes could be made to the consolidation regime to simplify its operation

whilst maintaining the efficiency and integrity benefits it has delivered to the Australian tax system. As discussed below, this may include undertaking a review to assess whether an 'entity based model' of consolidation would be more effective than the current 'asset based model' for the consolidation regime.

2.27 The Board provides more detailed comments below which address these matters.

2.28 In preparing these comments, the Board considered views raised by its consultants, members of its Expert Panel and officers of the Treasury and the ATO. The Board also met with members of the Corporate Tax Association to obtain their views. However, the Board's conclusions reflect its own independent judgment.

IMPROVEMENTS DELIVERED BY THE CONSOLIDATION REGIME

2.29 The Board is of the view that the consolidation regime has delivered substantial improvements to the Australian tax system in providing a set of rules for the taxation of wholly-owned corporate groups. Prior to the introduction of the regime in 2002, wholly-owned corporate groups were required to apply multiple provisions in the general income tax law which did not appropriately cater for the characteristics of corporate groups or the types of transactions they undertook.

2.30 The key improvements from the introduction of the consolidation regime are summarised below.

Better alignment with reporting for business and accounting purposes

2.31 The consolidation rules provide greater simplicity and transparency for wholly-owned corporate groups by more closely aligning the income tax position of the group with its position from a business and accounting perspective. Prior to consolidation, each member of the group was required to lodge an income tax return, and the tax position for the overall group was difficult to decipher from these multiple tax returns. Treating a group as a single entity for tax purposes facilitates better decision making by business managers, and also increases transparency and efficiencies for administration by the ATO.

Efficiency for business reorganisations

2.32 There has been a significant reduction in the tax analysis required where groups undertake corporate restructures and intra-group asset transfers under the consolidation regime. This has resulted in increased operational efficiency for wholly-owned corporate groups and has substantially reduced compliance costs. In the pre-consolidation environment, even the simplest corporate reorganisation required specific tax choices and elections to be made. Market valuations were often required to avoid the risk of triggering the value shifting provisions, and a range of difficult issues commonly had to be confronted relating to the transfer of revenue assets such as trading stock, consumables and trade debts which were not capable of relief under the

CGT roll-over rules. Tax issues were therefore often regarded as impediments to businesses wanting to restructure their operations for commercial reasons.

Pooling of tax attributes

2.33 The consolidation pooling of tax attributes such as tax losses, franking credits and foreign income tax offsets has been instrumental in generating sensible, simple and appropriate tax outcomes. In the pre-consolidation environment, many corporate groups faced significant complexity in ensuring that (via chains of dividend payments) sufficient franking credits were available to the holding company of the groups prior to their boards' declaration of a dividend.

2.34 Similarly, the intricacies and risks associated with the transfer of losses between group companies were substantial, particularly where there were pending tax disputes that could subsequently alter taxable income for specific group members. These complexities in relation to intra-group dividends and loss transfers were significant for both taxpayers to apply and for the ATO to administer. Consolidation allows corporate groups to manage their affairs as a single economic entity.

Internal gain and loss duplication

2.35 Prior to the consolidation regime, corporate groups transferred tax profits to prevent the duplication of taxable gains to the holding company prior to the sale of a subsidiary. The introduction of rules to counter intra-group loss duplication also led to increasingly complex legislative provisions and compliance costs for corporate groups. The consolidation regime provided a systemic framework which eliminates the occurrence of intra-group gain and loss duplication issues.

Concerns with the consolidation regime

2.36 Despite the above benefits, some stakeholders have raised concerns about the compliance costs associated with the consolidation regime. They have also raised concerns about the complexity and uncertainty of certain aspects of the regime. In addition, the ATO identified a number of ongoing structural concerns with the regime.

Compliance costs

2.37 The consolidation regime reduces compliance costs for intra-group transactions for consolidated groups once they have formed.

2.38 However, compliance costs can and do arise when an entity joins a consolidated group, or when a new consolidated group is formed. These costs include the costs for the accounting or tax function of a business familiarising themselves with the consolidation tax rules, the costs of paying advisers to provide advice on the law, costs of undertaking consolidation tax cost setting calculations and the costs of working out the treatment of losses held by an entity that joins the group. Corporate groups may also incur additional compliance costs to update reporting software and intra-group accounting systems.

Complexity

2.39 Some stakeholders and the ATO have raised concerns about the complexity of the rules which govern the tax outcomes that arise when an entity joins a consolidated group, or when a consolidated group forms. Most of these concerns relate to the complexity of the operation of the tax cost setting rules in certain cases.

2.40 The Board understands that, when looked at in isolation, the complexity of the tax cost setting rules is generally manageable. However, dealing with the rules is sometimes difficult when the complexity is compounded by the uncertainty associated with their detailed application, particularly when regard is had to interactions with other areas of the tax law.

Uncertainty

2.41 The primary concern with the operation of the consolidation regime is that it continues to give rise to uncertain outcomes. While this has been highlighted in a limited number of circumstances, they cover some important issues with potentially significant consequences.

2.42 Since the introduction of the consolidation regime, a number of anomalous and unintended outcomes have been identified when an entity joins a consolidated group, such as the inappropriate triggering of capital gains, incorrect amounts being recognised in the allocable cost amount, or the inability to recognise the tax cost amount allocated to an asset. Anomalous outcomes often arise as a result of specific facts interacting with very prescriptive tax rules. Many of these issues have been corrected via legislative amendments over the last decade; however, some remain outstanding. In some cases, amendments introduced have themselves resulted in anomalous and unintended outcomes requiring further amendment.

2.43 The interaction of the consolidation regime with the rest of the general tax law has also given rise to significant uncertainty. In this regard, that uncertainty often arises due to uncertainty about the operation of, and interaction with, other areas of the tax law, rather than the operation of the consolidation regime.

2.44 A number of interactions and uncertainties have been clarified via legislative amendment or via the provision of guidance material by the ATO. However, stakeholders have commented that many issues remain outstanding for a long period of time and that, of those which have been resolved, many took a significant amount of time for certainty to be provided.

2.45 The ATO also commented that many of the interaction uncertainties arise because different assumptions need to be made by consolidated groups, including the single entity rule and the inherited history rules. These assumptions require certain facts to be taken to exist and for other facts to be disregarded. This results in the general tax law applying to a consolidated group on the basis of a reconstituted set of facts, which often gives rise to uncertainty.

2.46 The Board addresses a number of specific consolidation interaction issues, including issues relating to the treatment of intra-group assets, in Chapters 4 and 5.

Unpredictability of revenue outcomes

2.47 The ATO commented that the complexity of the consolidation rules and their interaction with the rest of the general tax law makes it very difficult for the Government to predict the revenue consequences of introducing changes to the consolidation regime. This makes the consolidation regime difficult for the Government to change.

Concerns regarding valuations

2.48 The Board notes that the consolidation rules which apply when an entity joins a consolidated group rely heavily on the valuation of assets. Expert valuers can have vast differences in opinion on the value of an asset depending on the assumptions and methodologies they use. Also, it is difficult to dispute valuations due to the flexibility of valuation methodologies, the limited pool of expertise in Australia, and the expense involved.

2.49 The critical role valuation plays as part of the tax cost setting amount for assets, and the flexibility of different valuation methodologies that may be sought to be used, potentially pose a high risk to the revenue.

REFLECTIONS ON THE FUTURE OPERATION OF THE CONSOLIDATION REGIME

Policy principles

2.50 As an overarching principle, the Board considers that the operation of the income tax law for consolidated groups should be consistent with its operation for other taxpayers that do not, or cannot, form a consolidated group. For example, consolidated groups should not be entitled to deductions that are not available to other taxpayers.[18]

2.51 The Board considers that this overarching principle would have particular relevance in the context of the tax rules which apply when entities are acquired by a consolidated group. The Board elaborates further on this issue in Chapter 3 of this report.

2.52 However, the Board recognises that there are intended exceptions to this overarching principle. In particular, as a result of the core design principles of the

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18 At the same time, the core design principles (as reflected by the tax cost setting rules) may change the amount of a deduction and the timing of the deduction in some circumstances. Timing differences are expected to be reduced by the adoption of the business acquisition approach for the purposes of applying the residual tax cost setting rule (see Recommendation 2 of the Board's report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*, which has been agreed to by the Government).

consolidation regime, the tax outcomes for consolidated groups are different to those for other taxpayers that do not, or cannot, form a consolidated group in some circumstances. For example, under those core design principles the tax costs of assets brought into a consolidated group by a joining entity are reset, intra-group transactions are ignored, and tax attributes (such as tax losses, franking credits and foreign income tax offsets) are pooled.

2.53 The different outcomes that arise for consolidated groups because of the core design principles are intended to encourage wholly-owned corporate groups to enter the consolidation regime. However, if the Government decides to make future changes that cause the tax outcomes for consolidated groups to be different to those for other taxpayers that do not, or cannot, form a consolidated group, the changes should be properly evaluated before any announcement to ensure that the implications (including the budgetary implications) are fully understood. Also, the intention that there be different policy outcomes should be explicitly stated.

Care and maintenance and addressing unresolved issues

2.54 Although the Board considers the consolidation regime has been largely successful in providing a set of rules for the taxation of wholly-owned corporate groups in the Australian tax system, the Board is concerned about the complexity of the regime and the number of consolidation issues which remain unresolved.

2.55 The Board's current report seeks to address a number of these consolidation issues. However, a significant number of issues are outside the scope of the Board's review. A list of such issues is set out in Appendix C. The Board understands that some of these issues were originally raised with the ATO National Tax Liaison Group as priority issues as far back as May 2005.

2.56 For the consolidation regime to be adequately maintained over future years, the Board considers it critical for problems and issues with the operation of the consolidation regime to be identified, prioritised and resolved within a reasonable time frame.

2.57 The consolidation regime is a significant element of the business tax system, and it is likely that new issues will continue to arise as changes are made to the regime and to other provisions in the general tax law. Therefore, adequate resources should be given to the Treasury, the ATO and the Office of Parliamentary Counsel to ensure that appropriate care and maintenance can continue to be carried out, and to ensure that legislative amendments can be made where necessary on a timely basis.

2.58 If a proposal to change the law that is consistent with policy directions cannot be implemented in the short term due to budgetary considerations or because there are other parts of the system that warrant more urgent attention or are of greater priority, the Government could announce its broad support for the proposal, with an indication that it will be further considered once the budgetary conditions and priorities change.

2.59 The Board recommends that the Government implement a more systematic approach for addressing and resolving issues arising with the operation of the consolidation regime. This would include ensuring that an appropriate forum is available for these issues to be identified, prioritised and addressed, and that relevant people from the private sector, the Treasury and the ATO participate in the forum.

2.60 The Government could also review the existing consolidation provisions to assess whether the drafting of the provisions could be improved to reduce complexity and make the operation of the consolidation regime more certain. The Board appreciates this would be a significant exercise for the Government and for key stakeholders. An appropriate assessment should be done of the advantages of any re-drafting process against the resources and time required, and the likelihood of other uncertainties or unintended outcomes arising from the re-drafted rules.

Consideration of an alternative model for consolidation

2.61 The Board also notes that the Review of Business Taxation's discussion paper, *A Platform for Consultation*, considered two models for the implementation of Australia's consolidation regime.

2.62 The 'entity based model' for consolidation would retain the dual recognition of the cost base of the membership interests in an entity distinct from the cost base of that entity's assets. As such, the cost base of an entity's assets would not be reset upon entry into consolidation. Instead, where intra-group transactions or intra-group asset transfers are undertaken, these will result in changes to the cost base of the membership interests in the entities involved in those intra-group dealings. The 'entity based model' therefore involved very little cost for taxpayers to enter, but would require significant ongoing costs to adjust for intra-group transactions.[19]

2.63 The 'asset based model' for consolidation, which was adopted for the Australian consolidation regime on the recommendation of the Review of Business Taxation, requires the cost bases of an entity's assets (except for cash and other retained cost base assets) to be reset upon entry into consolidation. However, once reset, there is no need for recognition to be given for the cost bases of that entity's membership interests until the entity leaves the group. Under this model, a consolidated group is not required to make any adjustments where transactions occur intra-group. Thus, the 'asset based model' involves upfront costs for groups to reset the cost base of assets upon entry into consolidation, but thereafter has minimal costs for groups on an ongoing basis.

2.64 The Review of Business Taxation favoured the 'asset based model' because it did not require consolidated groups to track intra-group transfers of assets, which was seen as having less compliance and administrative costs than the 'entity based model'. It was also seen to have a broad degree of consistency with accounting consolidation.

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19 Review of Business Taxation, *A Platform for Consultation* (February, 1999), Chapter 27: Determining the cost base for disposal of equity.

The Review of Business Taxation also commented that any substantial complexity with resetting the tax cost of assets could be avoided via its recommendation for a transitional 'stick' option, under which a group could keep the existing tax costs of the assets of a subsidiary.[20]

2.65 The Board notes that most other countries with tax consolidation regimes have taken an approach based on accounting principles that is more consistent with an 'entity based model'. Therefore, by adopting an 'asset based model', Australia's consolidation regime appears to be unique.

2.66 An ongoing criticism of the 'asset based model' is that it can result in significant uncertainty, particularly due to the operation of the tax cost setting rules in certain situations. Reducing this uncertainty could, however, require a more prescriptive approach that may entail an increase in compliance costs and potentially lead to more arbitrary outcomes. However, if uncertainty continues to be a major concern following the implementation of the recommendations contained in this report, consideration could be given to making more substantive changes to the consolidation regime.

2.67 In this regard, there are a range of approaches that could be considered. One approach would be to retain the 'asset based model' but consider fundamental changes to the way that it has been implemented.

2.68 An alternative approach would be to explore whether an 'entity based model' would be a better model for Australia's consolidation regime moving forward. However, shifting from the current 'asset based model' to an 'entity based model' would itself be inherently complex and raise significant transitional issues.

2.69 It would be a significant exercise to convert Australia's consolidation regime from an 'asset based model' to an 'entity based model'. Therefore, a thorough assessment would need to be undertaken to ensure that the adoption of a different model would result in net benefits for the Australian tax system, and that these net benefits outweigh the costs of re-designing, re-drafting and implementing an alternative consolidation model. The assessment would need to include an analysis of the experiences of other tax jurisdictions which have adopted an 'entity based model'.

Conclusion

2.70 The Board considers that the consolidation regime has delivered significant efficiency and integrity improvements to the Australian tax system as compared with the previous income tax rules which wholly-owned groups needed to comply with. The Board agrees with the sentiments raised by its Expert Panel and members of the Corporate Tax Association that reverting to the old tax rules for corporate groups would be 'a return to the stone age'.

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20 Review of Business Taxation, *A Tax System Redesigned* (July, 1999), Section 15: Consolidated groups, pages 527-529.

2.71 In this regard, some aspects of the consolidation regime reduce the complexity of the business tax system. For example, the consolidation regime improves the efficiency of business reorganisations by ignoring intra-group transactions. It also reduces complexity by allowing tax attributes (such as tax losses, franking credits and foreign income tax offsets) to be pooled.

2.72 However, other aspects of the consolidation regime, such as the tax cost setting rules and the way that the consolidation regime interacts with other parts of the income tax law, in certain circumstances add to the complexity and uncertainty of the business tax system and require significant care and maintenance. As noted in paragraph 2.40, this complexity is generally manageable. At the same time, the complexity and uncertainty often makes it difficult to fully evaluate the consolidation impacts that arise when broader reforms are made to the income tax law.

2.73 The Board has recently conducted a review of tax design processes in its post-implementation review of the Tax Design Review Panel recommendations, and considers that its recommendations therein for improved tax design should be applied to the ongoing maintenance of the consolidation regime. Without a systematic maintenance program, the likelihood of the need for fundamental repair of, or change to, the system in the future will increase.

2.74 The Board expects that the adoption of the recommendations made in this report will improve the operation of the consolidation regime by clarifying the policy settings, reducing complexity and removing uncertainty. However, if significant issues continue to arise with the operation of the consolidation regime, it may be appropriate to explore whether more substantive changes should be made to the regime either by making fundamental changes to the 'asset based model' or by exploring an alternative approach to consolidation consistent with the 'entity based model'. Therefore, the Board recommends that the Government evaluate the state of the consolidation regime within five years of the implementation of the recommendations contained in this report, to assess the extent to which problems and issues continue to arise that may point to on-going structural problems with the regime.

Recommendation 2.1

The Board recommends that the Government:

- implement a more systematic approach for addressing and resolving issues arising in the operation of the consolidation regime; and
- evaluate the state of the consolidation regime within five years of the implementation of the recommendations in this report to assess the extent to which problems and issues continue to arise that may point to the need to address on-going structural problems with the regime.

GENERAL OBSERVATIONS ON THE DESIGN AND IMPLEMENTATION OF FUTURE TAX REGIMES

2.75 Despite the overall benefits delivered by the consolidation regime, the Board recognises that many specific problems have been raised in the course of the Board's two consolidation reviews.

2.76 After reflecting on these specific problems, the Board has made some observations about the design and implementation of future tax regimes into the Australian tax system.

Shared understanding of policy principles

2.77 There should be a shared understanding of the policy principles supporting the new regime during its design and implementation phases (including any particular mischief or concerns that are to be addressed by such a new regime). These policy principles should be clearly articulated in the design phase, be tested through consultation with the private sector, and be clearly incorporated into the drafting of the regime in the tax law.

2.78 This will ensure that collaboration with stakeholders will result in a coherent design of the tax law based on a common understanding of what the regime seeks to accomplish. It should also assist in the later interpretation of the enacted law by practitioners and the ATO.

Principle-based rules

2.79 Legislation to implement new regimes should be developed using coherent principles. The use of coherent principles generally results in law that is more sustainable and robust. Coherent principles can be supported by lower level details in the law and by interpretative products. However, a clear advantage is that law based on coherent principles generally requires less care and maintenance than 'black-letter' law.

2.80 In developing law to implement new regimes, the complexity of the rules should be assessed taking into account the intended users of the rules. In this regard, the Board is of the view that, whilst intended to provide certainty for consolidated groups, the complexity of the consolidation operative provisions makes the regime difficult for many business groups and their advisors to comply with. In particular, the provisions are overly complex for small to medium sized business groups even though they were intended users of the regime. The Board discusses this issue in more detail in Chapter 6.

Fully developed prior to introduction

2.81 The new regime should be fully developed before it is introduced, taking into account appropriate 'road-testing' via consultations. This may require the date of

introduction of the regime to be delayed. ATO guidance material should also be developed in conjunction with the legislative development process.

2.82 The Board notes that the consolidation regime was implemented via four tranches over 2002 and 2003, [21] with the last three tranches being enacted with retrospective effect back to the commencement of the regime on 1 July 2002. The first tranche contained the basic rules, and the others added to and built upon those basic rules.

2.83 The Board considers that the consolidation regime would have benefited if it had been introduced as a fully developed single package. The benefits may have included a more streamlined approach to introducing the regime, greater continuity and completeness in tax design consultations, greater efficiency in the use of Government resources and a more streamlined and coherent drafting of the consolidation rules.

2.84 In addition, the Board considers that the focus of tax design consultations should not be merely on issues expected to arise in the immediate years of the regime, but also issues expected to arise in later years. It appears that during the development of the consolidation regime, taxpayers and professional bodies primarily focused on issues that would be faced by groups when they first formed a consolidated group, with less emphasis on issues that would be later faced by these groups. The Board makes further comments on the implications of this in Chapter 3.

Interactions with the general tax law

2.85 Specific consideration should be given during the design and drafting stages as to how the new regime will interact with provisions in the general tax law. Although the policy principles supporting the new regime may be clearly understood by all stakeholders, substantial uncertainty can arise in determining interactions with other tax rules that have competing policy principles.

2.86 The sheer number of interactions can also give rise to substantial complexity in the design of interaction provisions in the new regime. Consideration should be given as to whether the drafting of the regime can be structured to facilitate interactions in a systematic way to provide greater simplicity and consistency in the tax law.

2.87 The Board addresses a number of specific consolidation interaction issues that have emerged since the introduction of the consolidation regime in Chapter 5.

Improving the relationship between government and non-government representatives

2.88 The Board notes that in recent years the Government has increased the amount of consultation it has conducted with stakeholders in developing and implementing

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21 Act No 68 of 2002; Act No 90 of 2002; Act No 117 of 2002; and Act No 16 of 2003.

changes to the taxation law. These consultation processes would be further improved by giving greater clarity to the roles of government and non-government representatives in the tax design process. This should promote greater openness in communication and the sharing of ideas and concerns during the design of the new regime.

2.89 The Board notes that issues concerning the relationship of government and non-government representatives in the tax design process were considered by the Board in its post-implementation review of the Tax Design Review Panel recommendations. The Board made a number of recommendations in this review for more effective input from private sector experts in the tax design process. These recommendations are set out in the Board's report on this review, delivered to the Government in December 2011.

Revenue costings

2.90 The Board notes the significance of revenue costings for the Government in considering the introduction of new regimes into the Australian tax system which may bring substantial change to existing tax policy. Minor policy changes that are designed to improve the operation of the existing law can also have significant revenue implications.

2.91 In this context, the Board is of the view that greater transparency in relation to revenue costings would improve consultation processes on the design of new tax regimes. Greater transparency, such as in allowing revenue costing assumptions to be tested, should result in more accurate costing outcomes and be of benefit to both the Government and the community.

Implementation and care and maintenance

2.92 When significant changes to the taxation law are made to introduce a new regime, it is important that the new regime is implemented effectively and that care and maintenance is undertaken after its introduction. Therefore, when the resource implications of developing the new regime are being considered, Treasury and the ATO should take into account the need for effective implementation and ongoing care and maintenance of the regime. As part of this care and maintenance, implications for the regime must be fully assessed when changes to other parts of the tax law are designed and implemented.

2.93 Problems and issues that arise in relation to the operation of the regime must be identified, prioritised and resolved within a reasonable time frame. In this regard, the Board understands that, in some cases, decisions on proposals to improve the law are deferred indefinitely due to budgetary considerations or because there are other parts of the system that warrant more urgent attention or are of greater priority. As a result, issues can remain unresolved for significant periods of time. If a proposal to improve the regime that is consistent with policy directions cannot be implemented in the short

term, the Government could announce its broad support for the proposal, with an indication that it will be further considered once budgetary conditions and priorities change.

Post-implementation reviews

2.94 The introduction of a new regime should be followed by a post-implementation review within a suitable timeframe. This would need to take into account the size and particular characteristics of the regime.

2.95 In the case of the consolidation regime, a post-implementation review after two years would have been premature, given amendments to clarify the operation of the regime were still being made. A post-implementation review after about five years may have been more appropriate.

CHAPTER 3: POLICY FRAMEWORK FOR THE CONSOLIDATION REGIME

3.1 The 'single entity rule' is the cornerstone principle of the consolidation regime. It operates to treat a wholly-owned corporate group as a single entity for income tax purposes.

3.2 The single entity rule is supported by 'tax cost setting rules' and 'inherited history rules'.

3.3 As outlined in Chapter 2, the 'tax cost setting rules' apply to reset the tax costs of the assets transferred from a joining entity to the consolidated group based on the group's cost of acquiring the entity.

3.4 When a consolidated group acquires an entity, the tax cost setting rules apply in three steps:

- Step A — Calculate the economic cost of acquiring the entity (known as the 'allocable cost amount').
- Step B — Allocate the allocable cost amount to the assets of the acquired entity. This step resets the tax cost of the acquired entity's assets to reflect the consolidated group's cost of acquiring the entity. The new tax cost allocated to each asset is known as a 'tax cost setting amount'.
- Step C — Determine how provisions in the general tax law apply to the tax cost setting amounts allocated to the assets in the hands of the consolidated group (for example, a consolidated group claiming deductions under the tax depreciation rules based on the tax cost setting amount allocated to a depreciating asset).

3.5 The tax cost setting rules also apply when an entity leaves a consolidated group. The rules reconstruct the consolidated group's cost base in the membership interests of the leaving entity based on the tax costs of the assets and the value of liabilities which the entity takes out of the group.

3.6 The 'inherited history rules' are also outlined in Chapter 2. These rules determine the history that a consolidated group inherits from an entity which joins the group (the 'entry history rule'), and the history that an entity inherits when it leaves the group (the 'exit history rule').

3.7 When the consolidation regime was being developed, a 'clean slate approach' was considered whereby an entity would not bring any income tax history with it

when it joins a consolidated group, and would not take any income tax history with when it leaves a consolidated group. This approach mimicked outcomes where an entity acquires assets from a third party or sells assets to a third party. In these cases, the history of the assets in the hands of the vendor is generally irrelevant to the purchasing entity.

3.8 The clean slate approach was abandoned in favour of the current inherited history framework. This was because the main focus was placed on the high incidence of formations of existing wholly-owned groups into new consolidated groups in the early years of the consolidation regime. Where an existing wholly-owned group elects to form a consolidated group, an inherited history approach was seen as appropriate to ensure that the history of the group remains unaffected through a choice to consolidate. The adoption of the inherited history approach was particularly important for the purposes of ensuring, for example:

- private binding rulings issued by the ATO before the formation of a consolidated group continued to apply after the formation of the group;
- the acquisition dates of pre-capital gains tax (CGT) assets was not refreshed; and
- the acquisition dates of pre-13 May 1997 assets were not refreshed (which could affect the CGT cost bases of certain assets).[22]

3.9 Although the inherited history approach is still relevant for formation cases, the fact that most large business groups have already entered the consolidation regime and the high incidence of mergers and acquisitions in the large business sector has meant that, in recent years, the number of entities joining existing consolidated groups has exceeded the number of new consolidated groups being formed.

3.10 In the 2010-11 income year, around 4,000 entities joined consolidated groups. The ATO estimates that at least 65 per cent of these were entities joining as a result of acquisitions (including the creation of new entities), rather than entities joining as a result of the formation of a new consolidated group. This pattern is broadly consistent over the past five income years providing evidence of a much greater prevalence of acquisition cases over formation cases in the consolidation regime. In the large business sector (turnover greater than $250 million) around 2,000 entities joined consolidated groups in the 2010-11 year and over 90 per cent of these were acquisitions (including the creation of new entities), rather than formation cases.

3.11 This evidence suggests that an inherited history framework may no longer be appropriate for the majority of cases where entities join a consolidated group. Instead, the Board's Position Paper proposed that an 'asset acquisition approach' should be adopted (Position 2.1).

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22 Section 110-40 of the ITAA 1997.

3.12 Under the asset acquisition approach, a consolidated group would be taken to acquire all the assets of a joining entity at the time the entity joins the group. The history which those assets had when they were held by the entity prior to joining the consolidated group will generally be disregarded. This is similar to the clean slate approach considered at the time the consolidated regime was being developed.

VIEWS IN SUBMISSIONS

3.13 The general consensus in submissions received by the Board was that the consolidation regime has led to increased business efficiency and integrity within the tax system for consolidated groups. Although the existing inherited history framework for the consolidation regime is, for the most part, working effectively, that framework has led to inappropriate outcomes arising in some cases.

> The Joint Bodies agree with the Board's conclusion that the current inherited history framework operates effectively in the majority of cases to achieve the primary objectives of the consolidation regime.
>
> However, there are some instances where unclear policy rationale has led to inappropriate outcomes and anomalies that need to be rectified.
>
> Institute of Chartered Accountants in Australia / The Tax Institute

3.14 Some submissions argued that the consolidation regime could be improved by adopting an asset acquisition approach given that the more common transaction today is the acquisition by, rather than formation of, a consolidated group.

> The CTA / MCA support the BoT's proposed asset acquisition approach as it would provide future clarity as to the objectives of tax outcomes in relation to the tax cost setting amounts allocated to assets of a joining entity, and in doing so would address a number of anomalous current issues. The asset acquisition approach would also substantially reduce tax differentials in respect of assets of a joining entity between transactions undertaken as an asset acquisition compared to an entity acquisition.
>
> Corporate Tax Association / Minerals Council of Australia
>
> We support the Board's view to adopt the asset acquisition model. An asset acquisition model would remove many of the uncertainties associated with the inherited history rule. It would also be expected to reduce compliance costs in the long-term.
>
> CPA Australia

BOARD'S CONSIDERATION

Consideration of the business acquisition approach in the Board's review of the rights to future income and the residual tax cost setting rules

3.15 The Board considered the asset acquisition approach in the context of its review of the consolidation rights to future income and residual tax cost setting rules. As part of that review, the Board recommended that the residual tax cost setting rules[23] should be modified to apply a 'business acquisition approach'.[24] The Government has accepted that recommendation.[25]

3.16 In undertaking that review, the Board determined that, when a consolidated group acquires an entity, it effectively acquires the assets of the entity in the context of acquiring a business, as distinct from separately acquiring each asset of the joining entity. Therefore, the Board concluded that the term 'business acquisition approach' describes this scenario more accurately than the term 'asset acquisition approach' that was used in the Board's Position Paper.

The current hybrid approach in the consolidation regime

3.17 In considering the appropriateness of introducing a business acquisition approach into the consolidation regime, it is important to acknowledge that both the inherited history approach and the acquisition approach already operate in the current consolidation rules.

3.18 The inherited history approach is embedded in the core rules of the consolidation regime in the form of the 'entry history rule' and the 'exit history rule'.[26]

3.19 Under the 'entry history rule', a joining entity's history will be inherited by the consolidated group. Therefore, under the current law, a consolidated group inherits:

- certain tax attributes held by a joining entity, such as tax losses and franking credits transferred to the head company of the group;
- entitlements to certain deductions for expenditure incurred by a joining entity prior to it joining the group (such as an entitlement to deductions for expenditure incurred by the joining entity which was allocated to a project pool);
- the value of liabilities (other than certain taxation of financial arrangements (ToFA) liabilities[27]) that a joining entity brings into the group; and

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23 Subsection 701-55(6) of the ITAA 97.

24 Recommendation 2 of the Board of Taxation's Report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*, May 2011.

25 See Media release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation and Tax Laws Amendment (2012 Measures No. 2) Bill 2012.

26 Sections 701-5 and 701-40 respectively of the ITAA 1997.

- the tax treatments covered by a private binding ruling issued by the ATO to the joining entity prior to it joining the group.

3.20 Although the entry history rule is embedded in the consolidation core rules, it is modified in the consolidation operative provisions when it comes to the treatment of assets under the 'tax cost setting rules'.

3.21 First, in allocating tax costs to the assets which a consolidated group will obtain from a joining entity[28], the tax cost setting rules apply both an entry history approach and an acquisition approach.

3.22 Under these rules, a consolidated group inherits the same tax costs that a joining entity had for assets that are 'retained cost base assets'[29] (reflecting an entry history approach). Retained cost base assets generally encompass Australian currency and rights to receive Australian currency. Some other types of assets are also treated as retained cost base assets in the case where a consolidated group is first formed, or in cases where majority-owned entities (that have been owned for a period of time) join a consolidated group.

3.23 For all other assets (referred to as 'reset cost base assets'[30]), the tax cost setting rules reset the tax cost of these assets based on the consolidated group's cost of acquiring the entity. This reflects an acquisition approach, since the tax costs allocated to these assets approximates the tax costs which the consolidated group would have obtained if it had purchased the net assets of the joining entity.

3.24 Second, the tax cost setting rules which determine how provisions in the general tax law apply to the tax cost setting amounts allocated to assets[31], also apply both an entry history approach and an acquisition approach. These rules are set out in a supporting provision of the consolidation regime.[32]

3.25 The supporting provision states that, for the purposes of applying certain provisions in the general tax law to an asset, the consolidated group will be taken to 'acquire' the asset for an amount equal to the asset's reset tax cost amount (reflecting an acquisition approach). This means that, in applying the provisions in the general tax law to the asset, the history which the asset had in the hands of the joining entity is generally disregarded.

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27 Attachment B to Media release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation and Tax Laws Amendment (2012 Measures No. 2) Bill 2012 – Schedule 2 proposes some changes to the operation of the ToFA rules for consolidated groups, including the treatment of liabilities held by a joining entity.

28 Referred to as Step B in paragraph 3.4.

29 Section 705-25 of the ITAA 1997.

30 Section 705-35 of the ITAA 1997.

31 Referred to as Step C in paragraph 3.4.

32 Section 701-55 of the ITAA 1997.

3.26 This acquisition approach applies for the following types of assets:

- depreciating assets (with some exceptions);
- qualifying securities;
- assets (and liabilities in some cases) subject to the ToFA regime; and
- assets that come within the scope of the residual tax cost setting rule (see Schedule 3 to Tax Laws Amendment (2012 Measures No. 2) Bill 2012).

3.27 The supporting provision also contains specific exceptions where, instead of an acquisition approach, the tax history of a joining entity's assets is inherited by the consolidated group (an entry history approach). This is the case for CGT assets (enabling consolidated groups to inherit pre-CGT treatment) and some types of depreciating assets.

3.28 Provisions outside of this supporting provision also operate as exceptions to the acquisition approach to make a consolidated group inherit the tax history of a joining entity's assets in certain cases (such as pre-July 2001 mining rights). Other provisions create further exceptions so that an entry history approach applies to certain types of assets (such as trading stock and internally generated assets) where a joining entity was majority-owned by the consolidated group.

3.29 Therefore, although the consolidation core rules only contain the entry history approach, the consolidation regime effectively applies a hybrid approach for the treatment of assets, incorporating both the entry history approach and the acquisition approach. This hybrid approach reflects certain policy decisions that have been made over time in respect of the treatment of the tax cost setting amount allocated to certain assets.

Giving formal recognition to the primacy of the business acquisition approach in the core rules of the consolidation regime

3.30 The Board is of the view that the operation of the consolidation regime would be improved if the guide material and the core rules were modified to formally recognise the existing hybrid approach for the treatment of assets (that is, to recognise the business acquisition approach along with the entry history approach in the core rules).

3.31 The Board considers that, for the purposes of determining the treatment of assets transferred to a consolidated group by a joining entity, the entry history rule should effectively operate as an exception to the business acquisition approach in the core rules. This would ensure that, going forward, the business acquisition approach would be the base on which policy options would be considered in relation to the treatment of these assets.

3.32 Having regard to the way the consolidation rules work when an entity leaves a consolidated group, the exit history rule would remain the base case and would not be supplemented by an additional core rule.

3.33 Even though the Board considers that the business acquisition approach should be adopted as the base case going forward for the treatment of the assets of a joining entity, the Board does not consider that it is necessary to alter the tax outcomes that arise under the existing exceptions to the business acquisition approach (discussed above at paragraphs 3.22, 3.27 and 3.28). The current tax outcomes for these exceptions have been determined as a matter of Government policy on a case by case basis as the consolidation rules have been amended, having regard to special policy considerations and revenue implications in particular cases.

3.34 However, the Board considers that the presentation of the law would be significantly improved if exceptions to the business acquisition approach that are located outside the core rules are rationalised and moved to a central location. This would make the law clearer for taxpayers and the ATO.

3.35 The Board therefore recommends that the business acquisition approach should be formally recognised in the core rules for the consolidation regime in relation to the treatment of assets transferred to a consolidated group from a joining entity. This should not result in any changes to:

- the current operation of the consolidation rules; or
- the current treatment of assets or liabilities under the consolidation regime.[33]

3.36 The Board also recommends that high-level principles be included in the core rules which specify the primacy of the business acquisition approach and the circumstances where the entry history approach should apply. This will provide a clearer policy framework for the application of these two approaches to guide future amendments to the consolidation provisions.

3.37 Under these principles, the business acquisition approach should generally apply to a consolidated group for the purposes of:

- resetting the tax cost setting amount of 'reset cost base assets' that a joining entity brings into the group (where the former tax cost of the joining entity's assets will generally not be taken into account);
- disregarding the tax history of assets in non-majority owned acquisition cases; and
- determining the value of ToFA liabilities that a joining entity brings into the group.

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33 The treatment of liabilities will be considered in a separate Board report to the Government, referred to in paragraph 1.9.

3.38 The entry history approach should generally apply for the purposes of:

- inheriting the tax history of assets in formation cases, or in cases where majority-owned entities (that have been owned for a period of time) join a consolidated group;
- inheriting certain tax attributes from a joining entity, such as the transfer of tax losses and franking credits to the head company of the group;
- inheriting certain deductions for expenditure incurred by a joining entity prior to it joining the group (such as deductions for expenditure incurred by the joining entity which was allocated to a project pool); and
- inheriting the tax treatments covered by a private binding ruling issued by the ATO to the joining entity prior to it joining the group.

3.39 In practice, the Government could always make exceptions to these principles, having regard to policy considerations and revenue implications in particular cases. Where exceptions are made, clear justification should be provided in the explanatory material of the amending legislation. Any new exceptions should be located, together with the existing exceptions, in a central location within the consolidation provisions.

Depreciating assets brought into a consolidated group by a joining entity

3.40 The Board notes that the Government has announced[34] that it will implement a proposal originally announced by the former Government affecting the rate of depreciation that applies to depreciating assets held by an entity that joins a consolidated group. In essence, if an entity acquires a depreciating asset, the rate of depreciation that the entity can apply is based on the effective life of the asset. If the entity chooses to apply the diminishing value method of depreciation, the rate of depreciation is based on the effective life increased by an uplift factor. For an asset that was acquired before 10 May 2006, the uplift factor is 150 per cent. For an asset that was acquired after 9 May 2006, the uplift factor is 200 per cent.

3.41 The Government's announcement is to prevent the 200 per cent uplift factor from applying where a consolidated group acquires an entity after 8 May 2007 that holds depreciating assets acquired before 10 May 2006.

3.42 The Board considers that the better policy outcome is for the 200 per cent uplift factor to apply in these circumstances, unless the joining entity is a majority-owned entity (in which case the 150 per cent uplift factor should apply). This policy outcome would be consistent with a business acquisition approach and with the original treatment of depreciating assets held by a joining entity. In this regard, the Board notes

34 Media release No. 053 of 13 May 2008 issued jointly by the Deputy Prime Minister and Treasurer and the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs.

that one of the objectives of applying the business acquisition approach to depreciating assets when the consolidation regime was implemented was to take away the benefits of accelerated depreciation that applied to depreciating assets held by a joining entity in some cases. Therefore, the Board considers that the Government should review its decision, but acknowledges that the Government may choose to implement its original decision having regard to revenue considerations.

Recommendation 3.1

The Board recommends that the core rules in the consolidation regime should be modified to:

- give formal recognition to the primacy of the business acquisition approach in relation to the treatment of assets transferred to a consolidated group from a joining entity;
- retain the entry history rule, but as an exception to the business acquisition approach; and
- include high-level principles which specify the general circumstances where the business acquisition approach or the entry history rule should apply.

The Board recommends that this modification to the consolidation core rules should not, by itself, result in any changes to:

- the current operation of the consolidation rules; or
- the current treatment of assets or liabilities under the consolidation regime.

The Board also recommends that the current exceptions to the business acquisition approach in the consolidation provisions should be rationalised and moved into a single location within the consolidation core rules.

CHAPTER 4: OPERATION OF THE SINGLE ENTITY RULE

4.1 The single entity rule operates to treat a consolidated group as a single taxpayer for income tax purposes by treating subsidiary members of the consolidated group as parts of the head company of the group.[35]

4.2 The objective of the single entity rule was expressed in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002:

> The single entity treatment, coupled with the inherited history rules and special rules for setting the cost for tax purposes of assets of entities joining and leaving consolidated groups, will:
>
> - simplify the tax system and reduce on-going compliance costs;
> - promote economic efficiency by providing a taxation framework that allows Australian businesses to adopt organisational structures based more on commercial rather than tax considerations; and
> - promote equity by improving the integrity of the tax system.[36]

4.3 Examples of the implications of the single entity rule are that a consolidated group can lodge a single income tax return, losses made by a subsidiary in the group are automatically pooled together with income of other members to form the taxable income of the group, franking credits are automatically pooled in the group and assets transferred between members of the group are ignored because they take place within a single taxpayer.

4.4 Although the single entity rule produces appropriate outcomes in most cases, issues have arisen with the practical operation of the single entity rule in certain circumstances. This has led to a degree of uncertainty for taxpayers in applying the single entity rule and has resulted in cases of inconsistency and unfairness in its operation, causing both favourable and unfavourable outcomes for taxpayers. The primary areas of uncertainty relate to:

- intra-group assets and intra-group liabilities, including in particular:
  - the acquisition of intra-group assets and implications for intra-group liabilities;

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35 The single entity rule only operates for 'head company core purposes' (section 701-1).

36 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.4.

  - the disposal of intra-group assets and implications for intra-group liabilities; and
  - value shifting caused by the acquisition and disposal of encumbered assets subject to intra-group rights; and
- dealings by third parties with a consolidated group.

4.5 The Board's recommendations in this chapter outline policy principles which provide a framework to guide the development of rules that govern the tax treatment of intra-group assets and liabilities and the application of the single entity rule for third parties.

4.6 The Board notes that the Government has announced changes[37] to ensure the tax cost setting rules apply only to assets that are recognised for taxation purposes. The announced changes also ensure that, for an asset that is a contractual entitlement to future income held by a joining entity, the contract will be treated as a retained cost base asset with a tax cost setting amount equal to, broadly, the CGT cost base for the asset. The Board understands these announced changes will apply to intra-group assets.

4.7 In addition, the Government has asked the Board to review the current treatment of liabilities under the consolidation regime.[38] It is likely that any changes to the treatment of liabilities arising from that review will affect equivalent intra-group liabilities.

Intra-group assets and liabilities

4.8 Intra-group assets arise primarily when contractual rights are created between members of the same consolidated group. These assets are disregarded by the head company of a consolidated group under the single entity rule. Examples of intra-group assets include rights relating to intra-group debt interests and intangible rights relating to intra-group assets (for example, options, rights or licences).

4.9 Intra-group assets can:

- be created within a consolidated group;
- be brought into a consolidated group through the direct acquisition of the asset by a member of the consolidated group;

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37 Attachment B to Media release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation and Tax Laws Amendment (2012 Measures No. 2) Bill 2012.

38 The treatment of liabilities will be considered in a separate Board report to the Government, referred to in paragraph 1.9.

- be brought into a consolidated group through the acquisition of the membership interests in an entity holding the asset (that is, an indirect acquisition);
- lapse or cease to exist within a consolidated group;
- be sold by a consolidated group through the direct disposal of the asset by a member of the consolidated group; or
- be sold by a consolidated group through the disposal of the membership interests in the member of the consolidated group which holds the asset (that is, an indirect disposal).

4.10 An intra-group asset held by a member of a consolidated group will generally be offset by an intra-group liability or obligation held by another member of that group.

4.11 The intra-group liability may be a liability that is recognised for accounting purposes, such as an intra-group loan payable which offsets an intra-group loan receivable.

4.12 Alternatively, the intra-group liability may be a legal or business liability or similar type of obligation that is not recognised for accounting purposes. For example, where a member of a consolidated group owns an asset and has an obligation to provide use of the asset under a licence agreement to another member of the consolidated group, the obligation to provide use of the asset would not generally constitute a liability that is recognised for accounting purposes.

ACQUISITION AND DISPOSAL OF INTRA-GROUP ASSETS

4.13 The Board's Position Paper summarised problems and uncertainties which arise in the current tax treatments that apply to the acquisition[39] and disposal of intra-group assets (apart from membership interests).

4.14 In relation to the acquisition of intra-group assets, the Board's Position Paper proposed that (Position 3.1):

- the tax cost of an intra-group asset[40] that does not have a corresponding accounting liability which is recognised elsewhere in the consolidated group should be recognised for income tax purposes;

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39 An intra-group asset is acquired when it becomes intra-group by virtue of an entity joining the group, regardless of whether the asset was owned by the group or by the joining entity.

40 The tax cost of the intra-group asset will be equal to the actual cost of acquisition if acquired directly by the consolidated group, or will be equal to the tax cost setting amount of the intra-group asset if acquired indirectly by the consolidated group.

- this tax cost should be recognised when the consolidated group subsequently disposes of the asset or when the asset lapses intra-group; and
- the income tax history the intra-group asset had prior to coming into the consolidated group should be treated as irrelevant when the consolidated group subsequently disposes of the intra-group asset or the asset lapses.

4.15 In relation to the disposal of intra-group assets (apart from membership interests), the Board's Position Paper proposed changes to the operation of the 'intra-group liability adjustment'[41] in the consolidation tax cost setting rules that applies when an entity leaves a consolidated group.

4.16 The Board also proposed that the intra-group liability adjustment should be modified so that (Position 3.2):

- the adjustment is triggered when an intra-group asset that does not have a corresponding liability owed to it by a member of the old group leaves a consolidated group with a leaving entity; and
- the adjustment applies to liabilities and other similar types of obligations.

Views in submissions

4.17 Stakeholders supported the proposal that the tax cost of an intra-group asset acquired by a consolidated group should be recognised for income tax purposes.

4.18 However, submissions disagreed that the tax cost should only be recognised when the consolidated group subsequently disposes of the asset or when the asset ceases to be recognised on becoming an intra-group asset. This was on account of the additional compliance costs that would be imposed due to the need to track intra-group assets within the consolidated group.

4.19 To address the Board's concern that granting an immediate tax deduction or capital loss on acquisition of an intra-group asset could have revenue consequences that are unsustainable for the Government, some submissions proposed that the tax cost of intra-group assets be amortised over a period of time.

4.20 Although stakeholders generally agreed with the Board's position in relation to the disposal of intra-group assets, submissions raised a number of specific issues requiring clarification.

4.21 In particular, the Corporate Tax Association and the Minerals Council of Australia expressed concerns in their joint submission regarding the requirement that

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41 Section 711-40 of the ITAA 1997.

an intra-group asset not have a 'corresponding liability' owed to it by a member of the old group.

4.22 Submissions also sought clarification as to when an intra-group asset would 'not have a corresponding accounting liability which is recognised elsewhere in the consolidated group', and some questioned the need for this condition.

The Board's consideration

4.23 The Board considers that the tax cost of an intra-group asset acquired by a consolidated group should be recognised for income tax purposes, whether the asset is acquired directly or indirectly by the consolidated group. This will ensure that real economic outlays of a consolidated group will be recognised for income tax purposes.

4.24 In determining when the tax cost of an acquired intra-group asset should be recognised, the Board explored three options:

- the ending/creation model — under this model the tax cost of an intra-group asset would be recognised at the time when the intra-group asset is brought into the consolidated group;
- the disposal model — under this model the tax cost of an intra-group asset would be recognised at the time when the intra-group asset is sold to a third party or lapses within the consolidated group; and
- the amortisation model — under this model the tax cost of an intra-group asset would be recognised over an amortisation period starting at the time when the intra-group asset is brought into the consolidated group.

4.25 The Board does not support the disposal model as it does not reflect the in-substance commerciality of the transactions undertaken by a consolidated group with a third party and requires intra-group assets to be tracked even though they are taken to cease to exist within the consolidated group. The disposal model may also give rise to integrity risks as consolidated groups may be able to manipulate tax outcomes by cancelling intra-group rights within the group to bring forward the time that the tax costs are recognised.

4.26 The amortisation model is not supported as it also requires intra-group assets to be tracked even though they are taken to cease to exist within the consolidated group and would add complexity to the law. As a result, the amortisation model may also give rise to integrity risks.

4.27 The Board has concluded that the ending/creation model provides a more robust policy for recognising the tax costs of intra-group assets. This model is consistent with the single entity rule principle and is simpler than the alternative models as it alleviates the need for consolidated groups to track intra-group assets within the group.

Acquisition of intra-group assets

4.28 Under the ending/creation model, an intra-group asset acquired by a consolidated group, whether directly or indirectly, will be taken to come to an end at the time the intra-group asset is brought within the consolidated group.

4.29 Consequently, the tax cost incurred by the consolidated group to acquire the intra-group asset, whether directly or indirectly, should be recognised in the same way that it would be recognised under the income tax law if a single entity paid the same amount to bring to an end obligations it owed to a third party.

4.30 Thus, for example, the acquisition of an intra-group licence from a third party should be treated in the same way that a single entity would be treated if it paid an amount to cancel its licence obligations to the third party. This would typically give rise to a deduction or capital loss for the entity depending on the character of the outlay.

4.31 In developing rules to implement the ending/creation model, some exceptions to the principle may be needed. For example, where the intra-group asset is a debt interest, application of the ending/creation model to the acquisition of the asset may cause unintended consequences to arise that may give consolidated groups better tax outcomes than taxpayers who have not consolidated. Therefore, the application of the ending/creation model to intra-group assets that are debt interests should be further considered during the development of rules to implement the model. Other exceptions should be considered on a case by case basis.

Disposal of intra-group assets

4.32 Under the ending/creation model, when an intra-group asset is sold by a consolidated group, whether directly or indirectly, the asset will be taken to be created at that time (that is, at the time the intra-group asset emerges from the consolidated group).

4.33 Where intra-group rights are directly sold to a third party, the ending/creation model will result in the transaction being treated as the grant of new rights to a third party for the purposes of determining the tax outcomes which apply under the CGT rules. Different CGT provisions would apply depending on the types of rights which are granted by the consolidated group.[42]

4.34 For example, if lease rights are created over land within a consolidated group, the lease rights will be an intra-group asset and should be ignored under the single entity rule. If a third party then pays an amount to acquire these lease rights, the consolidated

42 For example, CGT event D1 (in relation to creating contractual or other rights), CGT event D2 (in relation to the granting of an option), CGT event D3 (in relation to the granting of a right to income from mining) and CGT event F1 (in relation to the granting of a lease).

group should be treated as granting new lease rights to the third party and should make a capital gain.[43]

4.35 This will align the treatment of consolidated groups (treated as a single taxpayer under the single entity rule) with the treatment of taxpayers under the general tax law.

4.36 The Board considers that the income tax history which an intra-group asset has prior to coming into a consolidated group is irrelevant when the consolidated group subsequently disposes of the intra-group asset or the asset lapses. The adoption of the ending/creation model will ensure that the income tax history of an intra-group asset ceases to be relevant once the intra-group asset is acquired by a consolidated group and comes to an end.

The intra-group liability adjustment

4.37 Where an entity leaves a consolidated group holding intra-group rights (so that the intra-group rights are indirectly sold by the consolidated group to a third party), the intra-group liability adjustment applies to determine the relevant tax outcomes. This adjustment operates only where a member of the old group owes a 'liability' to the leaving entity[44].

4.38 The Board considers that the intra-group liability adjustment should not be restricted in its operation to cases where the intra-group liability is recognised as an accounting liability (as proposed in the Government's announcement on 13 May 2008[45]). This would place too restrictive a scope on the meaning of 'liability' in the intra-group liability adjustment.

4.39 Instead, as proposed in its Position Paper, the Board recommends that the intra-group liability adjustment should apply to liabilities and other similar types of obligations owed by a member of the old group to the leaving entity.

4.40 In its Position Paper, the Board proposed that the intra-group liability adjustment should operate only when a leaving entity takes an intra-group asset which 'does not [emphasis added] have a corresponding liability owed to it by a member of the old group'. Submissions commented that this proposal was ambiguous and difficult to justify.

4.41 The Board has reviewed this position and agrees that the intra-group liability adjustment should also apply where an intra-group asset does have a corresponding liability owed by a member of the old group. For example, where a consolidated group indirectly disposes of an intra-group loan receivable, there will be a corresponding

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43 Under CGT event F1.

44 Subsection 711-40(1) of the ITAA 1997.

45 Media release No. 053 of 13 May 2008 issued jointly by the Deputy Prime Minister and Treasurer and the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs.

liability owed by a member of the old group. In this case, the intra-group liability adjustment should apply to ensure that the market value of the intra-group asset is included in a leaving entity's allocable cost amount. Otherwise, the consolidated group could make a capital gain when, in substance, it enters into a transaction to make a new loan to a third party.

4.42 Submissions sought further clarification on the Board's position as to whether the intra-group liability adjustment applies correctly when a consolidated group sells an entity which holds rights in the form of an encumbrance over an underlying asset belonging to the consolidated group.

4.43 The intra-group liability adjustment has special rules which apply when a leaving entity holds the following types of encumbrances over an underlying asset belonging to the consolidated group: lease rights, licence rights, option rights and rights to income from mining.

4.44 The CGT rules apply a special tax treatment in respect of the creation of these types of encumbrances. When a taxpayer grants these rights to a third party over an underlying asset, any consideration it receives from the third party is generally treated as a capital gain for the taxpayer.[46] The capital gain is only offset by costs the taxpayer may incur on granting or creating the rights for the third party.

4.45 The imposition of a capital gain is appropriate in these circumstances because the cost base of the taxpayer's underlying asset is not reduced as a result of the grant of these rights.

4.46 Applying the ending/creation model, where a consolidated group receives a payment for disposing of an existing intra-group asset in the form of an encumbrance over an underlying asset, the consolidated group will be taken to have granted or 'created' new rights over an underlying asset to a third party for payment.

4.47 Given the general law will impose a capital gain on the creation of these intangible rights, the Board considers that the correct policy outcome is for a consolidated group to also make a capital gain when it 'creates' the same rights via disposing of intra-group rights to a third party.

4.48 The Board notes that the existing intra-group liability adjustment achieves these outcomes.

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46 See CGT event D1 (in relation to creating contractual or other rights), CGT event D2 (in relation to the granting of an option), CGT event D3 (in relation to the granting of a right to income from mining) and CGT event F1 (in relation to the granting of a lease).

Interaction with other provisions in the income tax law

4.49 The Board considers that, as part of developing rules to implement the ending/creation model, consideration should be given as to how those rules will interact with other provisions in the income tax law to ensure appropriate tax outcomes arise.

4.50 An example is the interaction between the ending/creation model for intra-group assets and the tax rules governing foreign currency gains and losses.[47] Rules may need to be designed to ensure that, for example, when a consolidated group has a foreign currency denominated liability owing to a third party, and that liability becomes intra-group and is taken to 'end' where the consolidated group acquires the corresponding foreign currency receivable, the ending of the foreign currency denominated liability should trigger a foreign currency exchange event. The amount paid by the consolidated group to acquire the foreign currency receivable should be taken to be the amount paid by the group to extinguish its third party foreign currency liability.

Recommendation 4.1:

The Board recommends that the ending/creation model be applied to ensure that the tax costs of intra-group assets (apart from membership interests) acquired or disposed of by consolidated groups, whether directly or indirectly, are appropriately recognised. Some exceptions to the ending/creation model may be needed and should be considered on a case by case basis.

The Board also recommends that the intra-group liability adjustment should apply to liabilities and other similar types of obligations owed by a member of the old group to the leaving entity, regardless of whether or not the liability is recognised for accounting purposes.

VALUE SHIFTING RULES FOR INTRA-GROUP TRANSACTIONS

4.51 The Board's Position Paper identified that, where the single entity rule applies to ignore the taxation consequences of intra-group dealings within a consolidated group, value shifts may not be appropriately recognised in the tax system.

4.52 The Board therefore proposed (at Position 3.3) that additional integrity provisions be designed to address inappropriate outcomes that arise from consolidated groups using intra-group transactions to create value shifts.

47 Division 775 of the ITAA 1997.

Views in submissions

4.53 Although stakeholders generally agreed that integrity provisions would be required to address the cases raised in the Board's Position Paper, submissions were unanimous in expressing that caution be applied in designing any integrity provisions as these could impose significant complexity and compliance costs on consolidated groups, especially where they are required to track intra-group transactions.

4.54 A number of submissions, including the joint submission from the Institute of Chartered Accountants in Australia and The Tax Institute and the submission from Ernst & Young, also commented that integrity issues only appeared to arise in a limited range of circumstances, and that integrity rules should target these circumstances.

4.55 Pitcher Partners raised concerns that any additional integrity provisions which had too broad an application could significantly impact on consolidated groups in the middle market sector.

> … we would be gravely concerned if these provisions were drafted in such a broad manner that they imposed compliance burdens on taxpayers in the middle market in relation to 'vanilla' transactions that do no more than 'tidy up' an entity prior to it leaving a consolidated group.
>
> Pitcher Partners

The Board's consideration

4.56 The Board agrees that any integrity rules should be appropriately targeted to address the specific integrity risks which arise and should not result in unintended consequences where ordinary commercial transactions are entered into by these groups.

4.57 The Board also agrees that any integrity rules should not require consolidated groups to track intra-group transactions which would impose substantial compliance costs.

Disposal of encumbered assets subject to intra-group rights

4.58 From its investigations and based on stakeholder comments, the Board has concluded that integrity issues only arise when an encumbered asset whose market value has been reduced, due to the intra-group creation of rights over the encumbered asset, are sold by a consolidated group. This could arise if the encumbered asset is sold directly or indirectly. The Board therefore considers that any integrity rules should be specifically targeted to this case and should not affect other transactions which may result in value shifts within a consolidated group.

4.59 Where a consolidated group sells an encumbered asset that is subject to rights belonging to another member of the group, the group would make a reduced taxable

gain on sale of the encumbered asset. The reduction would typically be equivalent to the market value of the rights which the group retains.

4.60 If the consolidated group sells the encumbered asset directly to another entity, it could receive a market value cost base in the rights it retains.[48] If the consolidated group sells an entity which holds the encumbered asset, the consolidation rules will give the group a market value cost base in the rights it retains.[49]

4.61 The Board considers it inappropriate for a consolidated group to benefit from making a reduced taxable gain on sale of the encumbered asset and at the same time be entitled to recognise a market value cost base in the rights it retains. The consolidated group effectively receives a double benefit in this circumstance.

4.62 The Board therefore recommends that integrity rules should be designed to address any double benefit which arises when an encumbered asset whose market value has been reduced, due to the intra-group creation of rights over the encumbered asset, are sold by a consolidated group, whether directly or indirectly.

4.63 The Board also suggests that consideration be given to whether an objective 'purpose test' should be incorporated into the design of the integrity rules. This may be appropriate if the integrity rules result in unintended consequences or substantial compliance costs for consolidated groups.

Acquisition of encumbered assets where rights become intra-group

4.64 The Board also investigated the tax outcomes that arise when a third party encumbered asset which is subject to rights held by a consolidated group is subsequently acquired by the consolidated group. This results in the rights held by the consolidated group becoming intra-group rights, and the consolidated group effectively acquiring full ownership over the unencumbered asset.

4.65 Under the current law, a consolidated group which buys an encumbered asset will never be able to recognise the tax cost it previously paid to acquire the rights which become intra-group.

4.66 The ending/creation model will allow the tax cost of such intra-group rights to be recognised at the time the rights are brought into the consolidated group and are taken to come to end. This will also ensure that the consolidated group does not need to track the existence of the rights within the group.

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48 This depends on the operation of the deemed cost base rules in the CGT provisions (under Division 112 of the ITAA 1997).

49 Sections 701-20 and 701-60 of the ITAA 1997.

Recommendation 4.2

The Board recommends that integrity rules should be designed to address any double benefit which arises when an encumbered asset, whose market value has been reduced due to the intra-group creation of rights over the encumbered asset, is sold by a consolidated group, whether directly or indirectly.

EXTENSION OF THE SINGLE ENTITY RULE TO THIRD PARTIES

4.67 With some limited exceptions, the single entity rule does not apply to an entity outside a consolidated group (a third party) which deals or transacts with a member of the consolidated group.

4.68 Consequently, although a transaction between members of a consolidated group does not give rise to any income tax consequences for the group, the transaction may affect the income tax position of a third party who deals with the group. This can occur when a provision of the income tax law requires a taxpayer to have regard to the transactions, assets or liabilities of another party. If the other party is a consolidated group, the taxpayer may need to recognise transactions, assets or liabilities that are ignored by the group.

4.69 The Board's Position Paper concluded that the single entity rule should be extended to third parties in a broader range of circumstances, and that it would be preferable for this to be done on a principled basis rather than purely on a case by case basis.

4.70 The Board therefore proposed (at Position 3.4) that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who are:

- shareholders of the head company of a consolidated group; or
- liquidators appointed to the head company of a consolidated group.

4.71 The Board also proposed that consideration be given to extending the single entity rule (together with other parts of the consolidation provisions) so that it applies to the dealings of a related third party with a consolidated group.

Views in submissions

4.72 Stakeholders generally agreed with the Board's proposal as a broad principle. However, the majority of stakeholders stated that the single entity rule should not be extended to these types of third parties in all cases, but instead on a case by case basis.

> In our view a general rule to extend the single entity rule either to all third parties or to the three categories noted above [shareholders, liquidators and related parties] is probably not warranted. Any extension of the SER should be implemented by specific rules relevant to the particular provisions concerned, in some central location in the Act for any modifications. This could be in Division 701.
>
> Ernst & Young

4.73 Submissions also noted that the use of an 'associate' test to determine whether a third party is related to a consolidated group would be difficult to apply for taxpayers, and could result in substantial uncertainty.

4.74 Submissions identified a number of specific provisions in the tax law to which they considered the single entity rule should apply, or should not apply. Submissions agreed with the Government's announcement on 13 May 2008 that the single entity rule should extend to the operation of CGT event K6 (regarding pre-CGT shares and trust interests) and the operation of the CGT discount rules.

4.75 The Corporate Tax Association and the Minerals Council of Australia stated that the single entity rule should not extend to the operation of the non-resident CGT rules[50], as it would alter the current operation of the rules for existing groups owned by foreign entities.

4.76 Deloitte noted that taxpayers could manipulate tax results if the single entity rule applied to direct shareholders but not to indirect shareholders. This would be particularly relevant for the operation of the CGT discount and the operation of the non-resident CGT rules.

4.77 CPA Australia commented that extending the single entity rule for the purposes of the operation of Division 7A (regarding distributions to entities connected with a private company) should alleviate anomalies arising with the interaction of that division and the consolidation rules.

4.78 A few submissions commented that extending the single entity rule for the purposes of the small business CGT concessions would also be appropriate. Pitcher Partners noted that it would be appropriate for the single entity rule to apply to both direct and indirect shareholders in this case.

4.79 The Institute of Chartered Accountants in Australia and The Tax Institute noted that extending the single entity rule to shareholders of a MEC group will raise specific issues which would need to be addressed, particularly in the operation of the non-resident CGT rules and Australia's double tax agreements.

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50 Division 855 of the ITAA 1997.

The Board's consideration

4.80 The Board agrees that, although the general principles it proposed in its Position Paper would be appropriate to guide the extension of the single entity rule to third parties, any extensions should be considered on a case by case basis with regard to specific provisions in the tax law.

4.81 The Board also notes the suggestions raised by stakeholders for the single entity rule to be extended to third parties under a number of specific tax provisions. The Board considers that these suggested extensions be considered in further public consultation before they are adopted, to ensure unintended consequences do not arise.

4.82 The Board therefore recommends that, as a guiding principle, the single entity rule should apply when a provision in the income tax law applies to a transaction between a consolidated group and a third party that is either a shareholder of the head company of the group, a liquidator appointed to a member of the group or a third party that is an associate of the group. That is, the relevant third party should be taken to deal with the consolidated group as a single entity for the purpose of applying the relevant income tax provision.

4.83 However, the application of this principle in specific cases should be assessed on a case by case basis having regard to the following factors:

- the appropriateness of the tax outcomes that arise;
- whether the third party would reasonably have knowledge that the entity it is dealing with is part of a consolidated group and the character that the transaction has for that group;
- whether the rule is difficult to apply in practice;
- the effect on the revenue; and
- any other relevant matters.

4.84 The Board considers that, to support clarity and simplicity in the law, cases where the effect of the single entity rule is taken to extend to third parties should be incorporated into a single location within the consolidation provisions.

4.85 The Board also considers that shareholders should be consulted to prioritise the determination of the circumstances in which the single entity rule should be extended. Prioritisation could be undertaken based on how commonly each circumstance arises in commercial practice, or based on the financial magnitude of the transactions concerned.

Recommendation 4.3

The Board recommends that, as a guiding principle, the effect of the single entity rule should be extended when a provision in the income tax law applies to a transaction between a consolidated group and a third party that is either a shareholder of the head company of the group, a liquidator appointed to a member of the group or a third party that is an associate of the group. However, the application of this principle in specific cases should be assessed on a case by case basis.

CHAPTER 5: INTERACTION BETWEEN THE CONSOLIDATION REGIME AND OTHER PARTS OF THE INCOME TAX LAW

5.1 The Board identified in its Position Paper a number of issues and uncertainties that arise as a result of the interaction between the consolidation regime and other parts of the income tax law.

5.2 These issues fall into five broad but overlapping categories:

- taxation of trusts;
- consolidation membership rules;
- international tax issues;
- CGT issues; and
- deferred tax assets and liabilities.

TAXATION OF TRUSTS

5.3 The Board's Position Paper identified two issues that arise as a result of the interactions between the trust provisions and the consolidation provisions:

- determining the amount of a trust's net income that is assessed to each beneficiary and/or trustee when the trust is a member of a consolidated group for part of an income year; and
- the calculation of the allocable cost amount when a trust joins a consolidated group part way through an income year.

Determining the net income of a trust that is a member of a consolidated group for part of an income year

5.4 To overcome the issues that currently arise when determining the net income of a trust that is a member of a consolidated group for part of an income year, the Board's Position Paper proposed (at Position 4.1) that the amount be determined:

- by reference to the income and expenses that are reasonably attributable to the period and a reasonable proportion of such amounts that are not attributable to any particular period; and

- to the extent income and expenses are apportioned in calculating the trust's net income for the non-membership period, similar adjustments are appropriate when calculating the trust law income.

5.5 The Board also proposed that a beneficiary's and the trustee's share of the trust's net income should be determined by taking into account events that happen after a trust joins or leaves a consolidated group (Position 4.2).

5.6 Following the release of the Board's Position Paper, the Government announced that the trust provisions will be rewritten to overcome uncertainties that have arisen following the recent High Court decision in *Bamford*.[51] As first steps towards updating and rewriting the trust income tax provisions, the Government released a discussion paper on 4 March 2011[52] and a consultation paper on 21 November 2011.[53]

5.7 As the issues relating to the determination of a trust's net income mainly arise because of the operation of the trust provisions, the Board recommends that these issues be considered as part of the rewrite of the trust rules.

5.8 In relation to the determination of these amounts prior to the finalisation of the new trust rules, the ATO has advised the Board that taxpayers have generally been using methods which achieve an appropriate outcome in determining the net income of a trust that is a member of a consolidated group for part of an income year.

Recommendation 5.1

The Board recommends that the issues relating to the determination of the amount of a trust's net income that is assessed to each beneficiary and/or trustee when the trust is a member of a consolidated group for part of an income year be considered as part of the rewrite of the trust income tax provisions.

Calculating the allocable cost amount of a trust that joins a consolidated group part way through an income year

5.9 When a consolidated group acquires a trust part way through an income year, it may adjust the price it pays to reflect any tax that the group expects to pay on its share of net income for the trust's non-membership period.

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51 Media release No 025 of 16 December 2010 issued by the then Assistant Treasurer, in response to the decision in *Bamford v Commissioner of Taxation* [2009] FCAFC 66.

52 Discussion Paper - Improving the taxation of trust income, March 2011 - http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2011/trust-income-tax.

53 Consultation Paper - Modernising the taxation of trust income - options for reform, November 2011 http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2011/modernising-trust-income-tax.

5.10 Currently, the tax cost setting rules do not recognise the tax for which a consolidated group may be liable on the net income of the trust's non-membership period as a cost to the group of acquiring the trust. Only the trust's liabilities are taken into account in calculating its allocable cost amount at the joining time. This can result in anomalous outcomes.

5.11 In the Position Paper, the Board proposed that a consolidated group's tax liability in relation to the net income of a trust's non-membership period should be included as a liability in working out the allocable cost amount of a trust that joins a consolidated group (Position 4.3).

5.12 Stakeholders generally agreed with the Board's proposal in principle, but raised some technical issues about how the proposal could be implemented. For example, the Corporate Tax Association and Minerals Council of Australia suggested that:

- the definition of liability in this context should be the relevant share of net income multiplied by the corporate tax rate; and
- the liability should not be reduced by any tax attributes such as losses of the acquiring group that may apply to reduce this liability following the joining time.

5.13 In addition, the Institute of Chartered Accountants in Australia and The Tax Institute suggested that the deferred tax liabilities inherited by the head company should also be included in the calculation of the allocable cost amount.

5.14 The Board considers that these technical issues should be considered in the development of legislation to implement the recommendation, having regard to the outcomes of the Board's investigation of the treatment of liabilities under the consolidation regime.

5.15 The Board notes that, in implementing this recommendation, the outcomes of the rewrite of the trust provisions in the income tax law will also need to be taken into account.

Recommendation 5.2

The Board recommends that, subject to the outcomes of the Board's review of the treatment of liabilities under the consolidation regime, a consolidated group's tax liability in relation to the net income of a trust's non-membership period should be included in the calculation of the allocable cost amount of a trust that joins a consolidated group part way through an income year.

CONSOLIDATION MEMBERSHIP RULES

5.16 The Board considered the application of the consolidation membership rules as they relate to:

- trusts; and
- non-resident entities that satisfy the foreign hybrid rules.

Applying the consolidation membership rules to trusts

Membership of a consolidated group — the trustee

5.17 To overcome difficulties that arise when a trustee remains outside the consolidated group or is a member of a different consolidated group, the Board proposed in its Position Paper that the consolidation membership rules be amended to treat a trustee, in its capacity of trustee of a trust that is a member of a consolidated group, as a member of the same consolidated group as the trust (Position 4.4).

5.18 Although some stakeholders expressed the view that the current law can be interpreted to achieve appropriate outcomes, others were of the view that the Board's position would overcome difficulties that arise when a trustee is a member of more than one consolidated group. They also submitted that the Board's proposal would provide certainty.

5.19 One submission also suggested that any amendments should specify that a change in trustee will not result in a trust joining or leaving a consolidated group.

5.20 One of the Board's criteria when conducting reviews is to ensure legislation is expressed in a clear, simple, comprehensible and workable manner. As there is some uncertainty about the operation of the current law, the Board recommends that the legislation be amended to clarify that, for the purposes of applying the consolidation provisions:

- a trustee, in its capacity of trustee of a trust that is a member of a consolidated group, will be treated as a member of the same consolidated group as the trust; and
- a change in trustee will not result in a trust joining or leaving a consolidated group.

Recommendation 5.3

The Board recommends that the tax law be clarified so that, for the purposes of applying the consolidation provisions:

- a trustee, in its capacity of trustee of a trust that is a member of a consolidated group, will be treated as a member of the same consolidated group as the trust; and
- a change in trustee will not result in a trust joining or leaving a consolidated group.

Membership of a consolidated group — beneficiaries

5.21 To overcome difficulties that arise when a trust is a member of a consolidated group, but the beneficiary of the trust remains outside the consolidated group, the Board proposed in its Position Paper that the consolidation membership rules be amended to ensure that a trust will only qualify as a member of a consolidated group if all the beneficiaries, including debt beneficiaries, unit holders or objects of a trust, are subsidiary members of the consolidated group (Position 4.5).

5.22 The majority of submissions generally agreed with the Board's proposal.

5.23 The Corporate Tax Association and Minerals Council of Australia do not support the Board's proposal on the basis that it is inconsistent with the treatment of companies and may be contrary to the outcomes of the review of managed investment trusts.

5.24 The Institute of Chartered Accountants in Australia and The Tax Institute generally agreed with the Board's proposal. However, they questioned whether debt beneficiaries should be excluded from the scope of the trust provisions. They also highlighted some technical issues that would need to be resolved. For example, if a debt beneficiary can become a member of a consolidated group, a key issue that will need to be addressed is the extent to which the debt beneficiary should be jointly and severally liable for a group liability under a tax sharing agreement. Pitcher Partners also expressed similar views.

5.25 The Board notes that the trust provisions are currently in the process of being rewritten. The Board therefore recommends that the treatment of debt beneficiaries should be reviewed in the context of the outcomes arising from the rewrite of the trust provisions.

Recommendation 5.4

The Board recommends that:

- a trust should qualify as a member of a consolidated group only if all members including beneficiaries, unit holders or objects of the trust, are also members of the consolidated group; and
- the treatment of debt beneficiaries of the trust should be reviewed in the context of the rewrite of the trust provisions.

Application of the membership rules to non-resident entities that satisfy the foreign hybrid rules

5.26 In its Position Paper, the Board proposed that non-resident entities that satisfy the foreign hybrid rules should be eligible to become members of a consolidated group (Position 4.6).

5.27 All stakeholders supported this proposal. Although stakeholders claimed to be unaware of any integrity risks, the Board recommends that this position be reviewed in the event that the ATO identifies any integrity risks.

Recommendation 5.5

The Board recommends that there should be no change to the foreign hybrid rules. However, the Government should continue to monitor whether any integrity risks may arise.

INTERNATIONAL TAX ISSUES

Operation of the non-resident CGT rules

5.28 The Board's Position Paper outlined proposals to overcome the following concerns that arise as a result of the interaction between the consolidation regime and the non-resident CGT rules:[54]

- moving Australian assets within a MEC group and then disposing of them without recognising a capital gain; and
- uplifting the cost base of Australian assets where there is no change in the underlying beneficial ownership of assets without recognising a capital gain.

54 Division 855 of the ITAA 1997.

5.29 Some submissions expressed the view that the general anti-avoidance rules[55] were sufficient to cater for these situations where necessary. However, as the Board previously quoted in its Position Paper, Justice Richard Edmonds noted the following in his article in Lawyer's Weekly:

> It is not in the interests of the ATO to have to fall back, as a matter of last resort, on Part IVA and taxpayers certainly don't embrace such resort. Part IVA cases are never easy and the outcome is, in many cases, tinged with uncertainty.[56]

5.30 In addition, the Board is of the view that, as far as possible, similar entities should be taxed consistently. The extent to which the taxation treatment favours particular types of entities has an impact on horizontal equity. This allows certain entities to receive benefits at a cost to the taxation revenue and can create inappropriate investment distortions.

Moving Australian assets within a MEC group and then disposing of them without recognising a capital gain

5.31 The current interaction between the consolidation regime and the non-resident CGT rules enable a MEC group to use its structure and the consolidation rules to move assets within the MEC group and then dispose of them without recognising a capital gain or loss.

5.32 This has an impact on horizontal equity as it allows MEC groups to receive benefits at a cost to the taxation revenue which may create investment distortions. In addition, foreign owned entities that form a MEC group have an advantage over other Australian and foreign owned entities.

5.33 To overcome these concerns, the Board proposed to extend the principal asset test in the non-resident CGT rules so that it includes all the assets of a MEC group (Position 4.7).

5.34 In relation to the Board's proposal, some stakeholders expressed the view that:

- the current integrity provisions in the non-resident CGT rules (in Division 855) and the general tax anti-avoidance rules would apply to overcome the integrity issues raised;
- the proposal would significantly increase costs and add complexity as all of the assets of the MEC group would need to be valued; and
- the proposal would contradict the policy behind the non-resident CGT rules.

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55 Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).

56 Justice Richard Edmonds, *Lawyer's Weekly - Law's taxing sham*, 12 March 2010, pages 14 and 15.

5.35 Ernst & Young expressed concerns that the proposal may create distortions and anomalous outcomes. They did not support a *'one-way' integrity rule that would only expand the reach of Division 855'* [italics added] on the basis that such a proposal would have significant implications for existing wholly-owned group structures.

5.36 Stakeholders also submitted that if the Board forms the view that the existing integrity provisions are insufficient, then:

- the Board's proposal should only be implemented if existing MEC groups are given the option of making, revoking or altering MEC group elections to excise nominated eligible tier 1 companies from their group; and
- consideration should be given to other possible solutions, including the modification of subsection 855-30(3) so that it takes into account asset transfers that occurred within the MEC group prior to the CGT event.

5.37 The Board has been advised that the non-resident CGT rules were introduced partly to address issues around the Alienation of Property Article in Australia's previous model tax treaty that departed from the OECD Model to include a general sweep up provision that preserved Australia's right to tax gains of a capital nature not specifically dealt with in the Article.

5.38 Australia's insistence on the inclusion of this sweep up provision caused some difficulties in treaty negotiations and created pressure for Australia to provide offsetting benefits, such as agreeing to reduce rates of withholding tax in respect of dividends, interest and royalties. Moving away from this position has reduced this pressure. Further, aligning with the OECD Model facilitated the introduction of integrity measures that protected Australia's taxing rights where non-resident interposed entities are used to avoid Australian CGT selling the interposed entity, rather than the Australian assets.

5.39 Whilst Australia's source country taxing rights might be able to be expanded on a treaty by treaty basis, the offsetting tax concessions might exceed any revenue gain. It would also take many years to negotiate such changes, particularly as other countries would not have an imperative to give up their resident country taxing rights.

5.40 In light of these considerations, the Board considers that the Government should undertake further work to review the interaction of the policy principles underlying the non-resident CGT rules and the MEC group rules, taking into account integrity issues concerning the appropriate taxation of Australian corporate groups.

Uplifting the cost base of Australian assets without recognising a capital gain

5.41 Another concern that arises as a result of the interaction between the consolidation regime and the non-resident CGT rules is that consolidated groups that are wholly-owned by a non-resident entity and MEC groups can uplift the cost base of

Australian assets where there has been no change in their underlying beneficial ownership without recognising a capital gain.

5.42 Where an entity joins another consolidated group or MEC group, the cost base of the joining entity's assets can be uplifted even though the vendor is not taxable on the capital gain made on the disposal of the membership interests.

5.43 To overcome these concerns, the Board proposed to retain the tax costs of a foreign owned entity's assets where a foreign resident disregards a capital gain or capital loss under the non-resident CGT rules if there is no change in the underlying beneficial ownership of the assets (Position 4.8).

5.44 In relation to the Board's position, some submissions expressed the view that:

- the current integrity provisions in Part IVA should apply to overcome the integrity issues raised;
- the proposal has the potential to distort investment decisions which may impede business or asset restructures; and
- any additional integrity provisions would complicate commercially driven restructures and increase compliance costs.

5.45 Although submissions expressed these views, they also expressed the view that if the Board proceeds with the proposal, then:

- any limitation of the setting of the tax cost of the assets of the transferred entity on joining the new group should also apply in cases where a capital loss is disregarded under Division 855;
- the Board's proposal should apply only where relevant assets have been majority owned for more than 2 years;
- the tax cost of the membership interests of the acquired entity should be quarantined and recognised in the event that the entity leaves the group;
- the proposal should apply prospectively; and
- suitable transitional rules should apply to existing structures.

5.46 The joint submission received from the Corporate Tax Association and Minerals Council of Australia included the following suggestions:

> … the non-resident vendor of the transferred entity may have acquired the transferred entity for a significant amount, and therefore if using this original cost as the ACA step 1 amount would result in the tax value of asset being stepped up above their existing tax values, then this stepped up reset tax cost base amount should instead apply.

> Secondly, what is not acknowledged in this BoT proposal is that the tax-free status of the group's shareholding in the non-TARP transferred entity is being terminated by this transfer. Given that this tax-free status is likely to be an extremely valuable tax characteristic, it would be inappropriate and inequitable if some ongoing recognition was not obtained in regard to the termination of this attribute. To balance these equity concerns underlying Position 4.7, the CTA/MCA propose that some limited recognition continue to be provided in relation to the market value of shares in the transferred Australian subsidiary as at the transfer date, as follows.
>
> (i) If assets of the transferred subsidiary are subsequently directly disposed of, then, as per BoT Position 4.8, gains and losses should be calculated by reference to their pre-existing tax value (or their limited stepped up amount as per the previous proposal above).
>
> (ii) However, if an entity holding such assets is subsequently disposed of by the group, then the Division 711 exit cost base of shares in that subsidiary should be calculated by reference to what otherwise would have been the tax value of the relevant assets.
>
> A similar 'outside basis' consolidation approach currently applies to certain formerly privatised assets and therefore it should be relatively straightforward to implement (refer section 705-47 and section 711-25).

5.47 The joint submission received from the Institute of Chartered Accountants in Australia and The Tax Institute suggested that the Board's proposal apply only where relevant assets have been majority owned for more than 2 years because:

> … as part of a global acquisition it is not uncommon for a multinational group multinational group to acquire entities at the non-resident level and subsequently rationalise its ownership structures in relevant jurisdictions. The effect of Position 4.8 is that these groups would be disadvantaged as compared to the possible outcome that would have emerged had the Australian consolidated group made the acquisition from the third party (a position that is not always commercially possible).

5.48 In reviewing the comments received in submissions and deciding on an appropriate measure to address the concerns identified, the Board affirms its view stated in its Position Paper that the general anti-avoidance rules in Part IVA should not be relied upon as a primary measure to address these concerns. Instead, the Board considers that specific integrity provisions should be designed to address these concerns.

5.49 The Board does not support the suggestion that the tax costs of the transferred entity's assets be retained only where the relevant assets have been majority owned for more than 2 years, as it considers this would limit the intended scope of this measure. Instead, the Board considers a 12 month period would be more appropriate. This would enable the tax costs of the assets of a target entity that has been recently

acquired by a foreign entity to continue to be reset where the entity is transferred into a consolidated group owned by the same foreign entity.

5.50 The Board considers that this proposal would be simpler to implement and understand compared to other measures that would seek to quarantine the tax cost of the transferred entity and to only recognise the tax cost where the entity leaves the consolidated group. Such a measure may result in some consolidated groups never recognising the tax cost if the entity never leaves the group. It may also be open to artificial arrangements where the assets of the entity can be moved elsewhere in the group enabling the entity to be sold for nominal consideration, thereby triggering a capital loss.

5.51 Whilst the Board acknowledges the suggestion that the purchase price paid by the foreign parent for the transferred entity could be applied as the Step 1 amount when the membership interests in the entity are transferred into the consolidated group, the Board considers that designing rules to achieve this would also give rise to significant complexity.

5.52 The Board therefore recommends that where the membership interests in an entity that are transferred to a consolidated group are not regarded as taxable Australian property under the non-resident CGT rules, the consolidation tax cost setting rules should only apply to the transferred membership interests if:

- there has been a change in the underlying majority beneficial ownership of the membership interests in the entity; or
- there has not been a change in the underlying majority beneficial ownership of the membership interests in the entity, but those membership interests were recently acquired by the foreign entity (or the foreign group);
  - membership interests in an entity will be recently acquired if they have been majority owned by the foreign entity (or the foreign group) for less than 12 months.

Recommendation 5.6

The Board recommends that where the membership interests in an entity that are transferred to a consolidated group are not regarded as taxable Australian property under the non-resident CGT rules, the consolidation tax cost setting rules should only apply to the transferred membership interests if:

- there has been change in the underlying majority beneficial ownership of the membership interests in the entity; or
- there has not been a change in the underlying majority beneficial ownership of the membership interests in the entity, but the membership interests in the entity were recently acquired by the foreign entity (or the foreign group);
  - membership interests in an entity will be recently acquired if they have been majority owned by the foreign entity (or the foreign group) for less than 12 months.

Application of double tax agreements to consolidated groups

5.53 The Board's Position Paper suggested that it is unclear how Australia's double tax agreements apply to consolidated groups. In particular, there is some uncertainty about whether:

- Australia's double tax agreements apply to a consolidated group, its head company, subsidiary members or a combination of these (a treaty interpretation issue); and
- for double tax agreement purposes, the single entity rule applies to attribute the actions of subsidiary members of a consolidated group to the head company of the group (a single entity rule interpretation issue).

5.54 In view of these uncertainties, the Board proposed that the Government should undertake a review to clarify how Australia's double tax agreements apply to a consolidated group (Position 4.12).

5.55 After further consideration, the Board noted that no substantive areas of concern were identified in the course of its review in relation to the operation of Australia's double tax agreements for consolidated groups. The Board therefore considers that it is unnecessary for a review to be undertaken at this stage.

5.56 The Board recommends that the Government should continue to monitor the interaction between Australia's double tax agreements and the tax consolidation rules.

Recommendation 5.7

The Board recommends that the Government should continue to monitor the interaction between Australia's double tax agreements and the tax consolidation rules.

CGT ISSUES

Operation of CGT event J1

5.57 The Board's Position Paper identified concerns about the appropriateness of the outcomes that arise under CGT event J1[57] in certain circumstances where CGT assets which have been rolled over between members of a wholly-owned group are subsequently transferred out of the wholly-owned group.

5.58 The particular circumstances which are problematic are where the CGT assets that had been subject to a roll over (the rolled over assets) are held by:

- a subsidiary member that leaves a MEC group;
- an eligible tier-1 company (that is, a non-resident company's first tier of investment in Australia) that leaves a MEC group; or
- the head company of a consolidated group that leaves the group.

5.59 The Board's Position Paper raised a number of questions and proposed tax treatments to address the problems that arise in these cases (Positions 4.9 to 4.12).

5.60 The Board received a number of submissions from stakeholders responding to the Board's questions and proposals regarding changes to the operation of CGT event J1.

5.61 Although submissions raise a number of alternative options as to how CGT event J1 could be amended, the Board has not been able to draw a conclusion on recommendations that would be suitable. The Board will undertake further analysis of these issues and expects to report to the Government on its recommendations regarding CGT event J1 by the end of 2012.

Interaction between the CGT roll-over rules and the consolidation regime

5.62 The Pitcher Partners submission identified problems that arise in the interaction between the CGT roll-over rules and the consolidation rules. Pitcher Partners raised these concerns in the context of small businesses and privately owned groups wanting

57 Section 104-175 of the ITAA 97.

to restructure as wholly-owned groups using CGT roll-overs in order to facilitate entry into the consolidation regime.

5.63 The Board acknowledges that these interaction problems can be an impediment for groups of all sizes that seek to use a CGT roll-over to form a consolidated group or to bring an entity into an existing consolidated group.

5.64 In investigating ways to address these interaction problems, the Board has identified a number of complexities. This is due to the availability of several different CGT roll-overs, different policy principles supporting the operation of these roll-overs in the general law, and the presence of some special rules that facilitate appropriate tax outcomes where the consolidation rules interact with certain CGT roll-overs in particular circumstances.

5.65 The Board will undertake further work to ascertain whether a principled approach can be developed to address the problems arising in the interaction of the CGT roll-over rules and the consolidation provisions. The Board expects to report to the Government on its findings by the end of 2012.

Deferred tax assets and liabilities

5.66 The Board's Position Paper noted that there are multiple issues, complexities and inequities that arise as a result of the current treatment of deferred tax assets and liabilities in the consolidation allocable cost amount and the tax cost setting process.

5.67 The Board sought stakeholders' views on options to address these issues.

5.68 On 25 November 2011, the Government requested that the Board investigate the treatment of liabilities under the consolidation regime as part of its post-implementation review.[58]

5.69 Given the substantial overlap between the treatment of liabilities and deferred tax assets and liabilities in the consolidation allocable cost amount and the tax cost setting process, the Board has decided to consider the tax treatment of deferred tax assets and liabilities as part of its review of the treatment of liabilities in the consolidation regime. The Board expects to report to the Government on its findings for this review by the end of 2012.

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58 Media Release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

CHAPTER 6: OPERATION OF THE CONSOLIDATION REGIME FOR SMALL BUSINESS CORPORATE GROUPS

6.1 The Board identified in its Discussion Paper and Position Paper that a number of difficulties exist for wholly-owned small to medium size corporate groups which enter the consolidation regime. The predominant issues for these corporate groups are the upfront cost and complexity associated with the formation of a consolidated group.

6.2 As a result of these difficulties, only a relatively small percentage of small and medium size corporate groups have entered the consolidation regime. This is notwithstanding that the consolidation regime was originally intended to be available to corporate groups of all sizes.

6.3 Drawing on the feedback received in submissions, the Board has considered further the issues faced by small to medium size businesses structured as wholly-owned corporate groups which are eligible to enter the consolidation regime, and has made recommendations for ongoing simplified formation rules for these groups to assist them with entering the consolidation regime.

6.4 The Board has also investigated additional issues faced by other small to medium size businesses which are not structured as wholly-owned corporate groups. In particular, the Board has considered the issues faced by micro-enterprise groups, with aggregated turnover of less than $2 million.

6.5 In its Position Paper, the Board made proposals for the small business simplified formation rules to be made available to all wholly-owned corporate groups for a limited time. The Board has further considered these proposals in light of the views expressed in submissions.

STATISTICS ON SMALL BUSINESS AND CONSOLIDATION

6.6 The tax consolidation regime is generally available only to groups of entities which are wholly-owned by a single Australian corporate taxpayer (wholly-owned corporate groups).[59]

6.7 Statistics show that although a significant number of small businesses are structured as wholly-owned groups, only a relatively small proportion of these have elected to enter the consolidation regime (see Table A below).

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59 The main exception to this is rules which enable Australian entities which are commonly owned by an ultimate foreign entity to elect to form a MEC group.

Table A: Consolidation statistics for wholly-owned groups

Category by turnover levels[60]	Consolidated groups	Wholly-owned groups[61]	Comment
Micro enterprise < $2m	3,304	16,330	
SME $2m to $10m	1,819	5,402	9,044 wholly-owned groups with turnover of $2 to $50 million
SME $10m to $50m	1,956	3,642	
SME $50m to $100m	714	1,013	3,106 wholly-owned groups with turnover of more than $50 million
SME $100m to $250m	769	918	
Large $250m to $500m	382	431	
Large $500 to $1,000m	256	282	
Large > $1,000m	452	462	
Total	9,652	28,480	

Source: ATO

6.8 The statistics in Table A show a clear trend that the smaller the size of a wholly-owned group, the less the likelihood that the group has chosen to enter the consolidation regime:

- of the 16,330 micro-enterprise groups (those groups with less than $2 million turnover), only 20 per cent have elected to form consolidated groups;
- of the 9,044 small to medium size enterprise groups with turnover of $2 million to $50 million, 42 per cent have elected to form consolidated groups; and
- of the 3,106 medium to large enterprise groups with turnover of more than $50 million, 83 per cent have elected to form consolidated groups.

6.9 Submissions received in response to the Board's Position Paper commented that the consolidation regime should also cater for some small business groups that operate through structures that are not wholly-owned corporate group structures. These include, for example, entities which are not wholly-owned by a single company but are instead commonly owned by a group of individuals. Submissions suggested that rules could be designed to facilitate the reorganisation of these small business structures into wholly-owned corporate groups so as to enable them to form a consolidated group.

6.10 The Board had difficulty obtaining accurate data on the number of small business structures operating in Australia. However, as a proxy, a comparison can be made between the number of small business wholly-owned groups and the number of small business 'economic groups' (which comprise groups that are owned by an Australian holding entity with at least a 50 per cent interest) (see Table B below).

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60 'Turnover levels' - this is ATO segmentation according to the sum of total business income taken from each group member's latest tax return lodged for the income years between 2009 and 2011. This is different to 'aggregated turnover' under the small business entity concessions, a term which includes the turnover of connected and affiliate entities.

61 'Wholly-owned groups' – ATO data comprises all groups which are wholly-owned by an Australian holding entity.

Table B: Proportion of economic groups in the form of a wholly-owned group

Category by turnover levels[62]	Wholly-owned groups[63]	Economic groups[64]	Comment
Micro enterprise < $2m	16,330	56,352	
SME $2m to $10m	5,402	13,023	18,883 wholly-owned groups with turnover of $2 to $50 million
SME $10m to $50m	3,642	5,860	
SME $50m to $100m	1,013	1,332	3,694 wholly-owned groups with turnover of more than $50 million
SME $100m to $250m	918	1,109	
Large $250m to $500m	431	479	
Large $500 to $1,000m	282	301	
Large > $1,000m	462	473	
Total	28,480	78,929	

Source: ATO

6.11 These statistics reveal that only 29 per cent of micro-enterprise economic groups are structured as a wholly-owned group. This contrasts with 84 per cent of medium to large economic groups (with turnover of more than $50 million) which are structured as wholly-owned groups.

6.12 This supports comments raised by stakeholders that small business groups commonly operate through structures that are not wholly-owned corporate group structures.

SIMPLIFIED FORMATION RULES FOR SMALL TO MEDIUM SIZED CORPORATE GROUPS

6.13 In its Position Paper, the Board proposed that ongoing simplified formation rules be made available for wholly-owned small business and medium sized corporate groups to assist them with entering the consolidation regime. These proposals were designed to address the low take up of consolidation among these groups caused by the upfront compliance costs and complexity of entering the consolidation regime.

6.14 The simplified formation rules the Board proposed were similar to the transitional concessions that were originally made available when the consolidation rules were introduced. The Board proposed (under Position 5.1) that:

- ongoing simplified formation rules be made available via an election to wholly-owned corporate groups with an aggregated turnover of less than $100 million and assets of less than $300 million in the prior income year;

62 Refer footnote 60.
63 Refer footnote 61.
64 'Economic group' – ATO data comprises all groups which are owned by an Australian holding entity with at least a 50 per cent interest.

- if a group elects to apply the simplified rules:
  - the existing tax costs of assets for all subsidiary members should be retained (a stick approach);
  - losses held by subsidiary members that are transferred to the consolidated group should be able to be utilised over three years; and
  - the election should apply to all subsidiary members of the group; and
- the simplified formation rules should not be available for MEC groups.

6.15 The Board sought stakeholder comments on these proposed simplified formation rules.

Views in submissions

6.16 Submissions were broadly supportive of the Board's proposed simplified formation rules, but highlighted a number of issues.

6.17 The majority of submissions identified that a $300 million asset threshold test would impose a significant compliance burden on small businesses.

> [T]he assets threshold turnover of $300 million may require annual independent valuations since many SMEs do not prepare accounts in accordance with accounting standards. Currently, under the TOFA rules, assets are valued in accordance with commercially accepted valuation principles if accounts are not prepared in accordance with accounting standards. We do not consider that an asset threshold test is, therefore, consistent with Position 5.1 and it should not be introduced.
>
> CPA Australia

6.18 Some submissions also suggested that flexibility should be offered to consolidated groups in choosing which simplified rules to apply to particular subsidiaries.

> For those companies that elect the concession in relation to the tax value of assets, it may be more appropriate to then make the 'three year drip' treatment of losses elective rather than mandatory, because in some circumstances the available fraction treatment of losses may not be complex to calculate or disadvantageous.
>
> Corporate Tax Association / Minerals Council of Australia

6.19 The Pitcher Partners submission also commented that a separate choice should be provided for subsidiaries that had been recently acquired to adopt a 'spread' treatment for their assets. This would ensure that an amount recently paid by the group to

acquire the subsidiary could be reflected in the tax cost of the subsidiary's assets through the normal tax cost setting process.

> [A] choice to 'stick' or 'spread' on an entity by entity basis must, at the very least, be available for non-majority owned subsidiary entities that have been acquired within five years of the formation of the consolidation group.
>
> Pitcher Partners

Board's consideration

6.20 The Board considers that the cost and complexity associated with acquiring the requisite knowledge to confidently apply the consolidation formation rules is too high for small business and medium sized corporate groups and their usual accounting and tax advisers. The Board therefore recommends that ongoing simplified formation rules should be made available for small to medium size corporate groups to assist them with entering the consolidation regime.

6.21 These simplified formation rules should enable small to medium size corporate groups to enter consolidation without the complexity of tax cost setting calculations (to set the tax cost of assets brought into the group) or the complexity of available fraction calculations (to set the rate at which losses can be utilised which are brought into the group). The simplified rules should also eliminate the need for these groups to incur substantial costs in obtaining market valuations or preparing audited financial accounts as a prerequisite to entering the consolidation regime.

Eligibility criteria

6.22 The Board considers that the $100 million aggregated turnover threshold which it originally proposed is too high and does not adequately target those small to medium size corporate groups which should benefit from the simplified formation rules.

6.23 The Board is of the view that the vast majority of groups with aggregated turnover of between $50 and $100 million should be able to justify the cost of engaging tax advisers to assist in preparing consolidation entry calculations against the benefits of being in the regime.

6.24 The statistics also show an increased take up of consolidation for groups with turnover of $50 to $100 million (of 70 per cent) compared to the take up of consolidation for groups with less than $50 million turnover (of 28 per cent). This suggests that groups with aggregated turnover of over $50 million are already able to enter consolidation without the need for simplified formation rules.

6.25 The Board therefore recommends that the simplified formation rules should be made available to small to medium sized corporate groups with aggregated turnover of less than $50 million in the prior income year. The Board notes that the targeting of the simplified formation rules to groups with less than $50 million aggregated turnover

should also reduce the revenue cost associated with the introduction of the simplified rules.

6.26 The definition of aggregated turnover should be consistent with that under the small business entity concessions,[65] which includes the turnover of connected and affiliate entities. Although some submissions suggested that the test should apply to the turnover of the wholly-owned corporate group, the Board considered that this could be vulnerable to manipulation and that the aggregated turnover test would provide a degree of integrity for these simplified formation rules. The Board also considers that the aggregated turnover test under the small business entity concessions should already be familiar and understood by small to medium size businesses.

6.27 The Board agreed with comments raised by stakeholders that an asset threshold test would require independent valuations or the preparation of audited financial accounts, and would thus impose a significant compliance burden on small businesses. It therefore considers that an asset threshold test should not be incorporated into the eligibility criteria for the simplified formation rules unless, on further examination by the Government, this would allow very large businesses to obtain unintended benefits from these simplified rules.

6.28 The Board also notes that there may be some small to medium sized corporate groups whose aggregated turnover is just over the recommended $50 million threshold. These groups will still be able to take advantage of the transitional consolidation simplified formation rules which the Board recommends should be available to all wholly-owned corporate groups for a limited period of time (under Recommendation 6.3 below).

Election to apply the simplified formation rules

6.29 The Board considers that, as a base case, small business and medium sized corporate groups which form a consolidated group should be able to make a single election to apply the simplified formation rules.

6.30 If a simplified formation rules election is made, the consolidated group should retain the existing tax costs of assets held by subsidiary members (the stick concession) and be entitled to apply the simplified loss utilisation rule.

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65 Section 328-115 of the ITAA 1997.

6.31 In considering the operation of the simplified loss utilisation rule, the Board was of the view that this simplified rule should be made available only for losses which can be transferred into the new consolidated group on the basis of satisfying the continuity of ownership test (that is, 'COT transfer losses'). This is consistent with the original transitional loss rules which applied when the consolidation regime was first introduced.

6.32 On a consideration of preliminary revenue costs, the Board considered that its proposed three year utilisation period for COT transfer losses was not sustainable as part of an ongoing simplified formation rule. The Board therefore recommends that a five year utilisation period apply for COT transfer losses under the simplified loss utilisation rule. However, the Board acknowledges that, having regard to revenue considerations, the Government could adopt a different loss utilisation period.

6.33 Although stakeholders commented that the simplified formation rule should be made available on an entity by entity basis, the Board was of the view that this would add complexity to the operation of the simplified rules, and would defeat the intended purpose of the simplified rules as compliance saving measures.

6.34 The Board therefore recommends that where an eligible group forms a consolidated group and makes a simplified formation rules election, the stick concession should apply to *all* subsidiary members in the consolidated group which is formed and the simplified loss utilisation rule should apply to COT transfer losses from *all* entities in the group. This base case treatment may be modified where a consolidated group also makes an available fraction election or a recently acquired entity election, which are discussed below.

Flexibility for groups to elect to apply an available fraction method for losses

6.35 The Board considers that the majority of small to medium sized corporate groups wanting to take advantage of the simplified formation rules would only need to make a single simplified formation rules election to enable them to apply both the stick concession and the simplified loss utilisation rule.

6.36 However, some small to medium sized corporate groups may wish to depart from the base case election to apply an available fraction method for the utilisation of their COT transfer losses. This would require consolidated groups to undertake further calculations and will involve increased complexity, but would be beneficial in providing flexibility in the rules for the few groups that may be disadvantaged in applying the simplified loss utilisation rule. Stakeholders also identified that there may be cases where the available fraction may be easy to calculate.

6.37 The Board therefore considers that, where an eligible group has made a simplified formation rules election, it should be given a choice to make an 'available fraction election' under which the rate of utilisation of COT transfer losses from *all*

entities in the consolidated group should be calculated based on the ordinary available fraction rules.

Exception for recently acquired entities

6.38 The Board is of the view that an exception to the simplified formation rules election would be appropriate for entities which have been recently acquired by a group. In these cases, as was raised by submissions, sticking with the existing tax costs of assets held by a recently acquired entity may not reflect the amount recently paid by the group to acquire the entity.

6.39 Whether or not an entity has been recently acquired should be assessed based on whether the entity has been majority owned by the group for the previous three years. Where an entity has not been majority owned for the previous three years, it should be taken to be a recently acquired entity.

6.40 The Board considers that where an eligible group has made a simplified formation rules election, it should be given a choice to make a recently acquired entity election under which the tax cost of the assets of *all* recently acquired entities should be ascertained based on the ordinary consolidation tax cost setting process and the rate of utilisation of any losses transferred to the consolidated group from a recently acquired entity should be calculated based on the ordinary available fraction rules.

Subsequent joining of long-term majority-owned entities

6.41 The Board recognises that a number of small to medium sized corporate groups may have some entities which are controlled but are not wholly-owned by those groups. For such a group to be able to form a consolidated group relying on the 'stick approach' for all subsidiaries in the group, the group would need to wait until it acquires 100 per cent of the membership interests in all of its subsidiary members before electing to form a consolidated group.

6.42 The Board considers it would be beneficial for these types of groups to be able to elect to form a consolidated group up front relying on the formation concessions, but still be able to apply a 'stick approach' to a long-term majority owned subsidiary when it subsequently becomes wholly-owned at a later date and is brought into the consolidated group. This could be allowed where the subsidiary is majority owned by the group at the time it forms a consolidated group and has also been majority owned for over five years.

6.43 Therefore, the Board recommends that the Government should investigate whether rules should be introduced which enable small to medium size corporate groups to apply a 'stick approach' to long-term majority owned subsidiaries when they become wholly-owned by a consolidated group after the formation time.

Other considerations

6.44 The Board considers that where an eligible group makes any of the elections above (the simplified formation rules election, available fraction election and/or a recently acquired entity election), the elections should be made by the date the tax return is due for lodgement for the income year in which the consolidated group is formed. This timing is consistent with the choice to consolidate.[66]

6.45 The Board considers that the simplified formation rules should not be available to foreign owned corporate groups that elect to form MEC groups. The Board considers that the upfront cost for these groups to engage tax advisers to assist with formation of a MEC group should generally be justified when compared with the benefits they receive inside the consolidation regime.

6.46 The Board considers that where a consolidated group makes a simplified formation rules election and the stick concession applies to an entity within the group, the Government should investigate whether the unrealised loss rules[67] apply appropriately to prevent any loss integrity issues from arising.

6.47 The Board also considers that, in combination with the Board's recommendation for the business acquisition approach to be formally recognised together with the inherited history rule in the consolidation core rules (Recommendation 3.1), the business acquisition approach should not apply to entities that retain the tax costs of their assets. Consequently, the history of these assets would be retained so that the tax status and outcomes in respect of these assets would remain unchanged.

6.48 Lastly, to assist small to medium sized corporate groups with applying the simplified formation rules, the Board considers that there would be benefit if changes to the tax law to implement the simplified formation rules could be located in one single area of the consolidation provisions.

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66 Section 703-50 of the ITAA 1997.

67 Subdivisions 165-CC and 165-CD, and Subdivisions 715-A and 715-B of the ITAA 1997.

Recommendation 6.1

The Board recommends that:

- ongoing simplified formation rules should be available for wholly-owned corporate groups that have an aggregated turnover of less than $50 million in the prior income year;
- a simplified formation rules election should be available for eligible groups forming a consolidated group, under which:
  - the existing tax costs of assets should be retained for *all* subsidiary members of the consolidated group which is formed;
  - the simplified loss utilisation rule should apply to COT transfer losses from *all* entities in the consolidated group which is formed;
    - a five year utilisation should period apply for COT transfer losses under the simplified loss utilisation rule; and
  - the business acquisition approach should not apply to any assets which have their tax cost retained under this election;
- the Government should investigate whether rules should be introduced to enable small to medium sized corporate groups to apply a 'stick approach' to long-term majority owned subsidiaries when they become wholly-owned by a consolidated group after the formation time.

CONSOLIDATION AND MICRO-ENTERPRISE GROUPS

6.49 At the time of its introduction in 2002, the consolidation regime was intended to cater for all wholly-owned corporate groups. On this basis, former grouping concessions were repealed for all groups (such as provisions enabling the transfer of losses and the transfer of assets within a group) on the expectation that groups would instead enter the consolidation regime where tax losses are automatically grouped and intra-group transactions are ignored for income tax purposes.

6.50 However, the statistics above show a low entry by micro enterprise groups (with aggregated revenue of less than $2 million) into the consolidation regime.

6.51 Evidence also indicates that the majority of micro enterprise businesses are not structured as wholly-owned groups which is necessary to enter consolidation, and would need to undertake group reorganisations if they wanted to form a consolidated

group. These group reorganisations would typically be undertaken using CGT roll-overs.

Views in submissions

6.52 In its submission, Pitcher Partners commented on problems faced by small businesses and privately owned groups not structured as wholly-owned groups. The submission noted that similar issues were covered by recommendations made in the Review of Business Taxation report in 1999.

> As outlined in the RBT report … privately owned groups will rarely consist of wholly-owned corporate groups. We believe that the solution to this problem is to either allow a more flexible set of arrangements (for example, a MEC type group for SMEs), or alternatively, to allow privately owned groups an opportunity to appropriately restructure their corporate entities to take advantage of the tax consolidation provisions. Both of these two suggestions were made by the RBT in 1999 [known as Recommendations 15.6(a) and 15.6(b)].
>
> In our view, the second recommendation is the easiest to implement. Privately owned groups generally already have access to rollover provisions, such as Subdivision 122-A and 124-M. However, these provisions do not interact with the tax consolidation provisions for privately owned groups.
>
> Pitcher Partners

6.53 The submission then elaborated on a number of problems in the interaction of the CGT roll-over provisions and the tax consolidation provisions that made it problematic for small businesses to restructure into a wholly-owned corporate group before forming a consolidated group.

Board's consideration

Appropriateness of the consolidation regime for micro-enterprise structures

6.54 From its investigations and based on discussions with the Expert Panel, the Board found that a large majority of micro-enterprises would not choose to enter consolidation even if problems with the interaction of the CGT roll-over rules were addressed and even if simplified formation rules were made available. This was for the following reasons.

- A large number of micro-enterprise groups operate through multiple discretionary trusts. In these structures, multiple silos of entities are each owned by a separate discretionary trust where family members are common objects of these trusts. This would not be available if these entities reorganised into a wholly-owned corporate group.

- A large proportion of micro-enterprise groups are structured to enable the flow-through of capital gains and dividends through trusts. These groups are not in a form eligible to enter the consolidation regime.
- The use of trusts and family trust elections already allow micro-enterprise groups to effectively pool tax losses on a group basis.
- Many micro-enterprise groups have no need to undertake intra-group asset transfers or intra-group transactions, and do not need to pool franking credits or foreign tax credits. Thus the benefits of the consolidation regime do not appeal to these groups.
- Many micro-enterprise groups do not to prepare audited financial accounts. The restructuring of such a group into a wholly-owned corporate group necessary for consolidation may result in the group having to prepare audited financial accounts.
- Notwithstanding the Board's recommendations for simplified formation rules for small businesses to assist with entry into consolidation, a number of micro-enterprise groups are still deterred from entering the consolidation regime due to the complexity and compliance costs associated with complying with the consolidation rules on an ongoing basis.

6.55 Some of these points are also expressed in CPA Australia's submission:

> We note that many small to medium enterprises (SMEs) that were eligible to consolidate chose not to do so because of the complexity and uncertainty surrounding the consolidation rules. Further, since many SMEs have very small corporate groups with limited intra-group transactions, the compliance cost savings that would have been achieved through consolidation do not outweigh the additional compliance costs incurred in applying the rules.
>
> CPA Australia

6.56 The Board therefore reached a view that the consolidation regime, although originally intended to cater for taxpayer groups of all sizes, would not generally be suitable for taxpayer groups in the micro-enterprise sector (with aggregated turnover of less than $2 million).

Other considerations for micro-enterprise

6.57 Although the Board considers that the consolidation regime would not generally be suitable for taxpayer groups in the micro-enterprise sector, the Board is of the view that other tax rules may be necessary to cater for taxpayer groups in the micro-enterprise sector.

6.58 The Board notes that since the former grouping provisions were repealed in 2003, micro-enterprise groups have been prejudiced by not being provided with suitable tax

rules which adequately compensate them. This is particularly so given the repeal of grouping rules that enabled the transfer of losses.

6.59 The Board notes that making recommendations for the design of alternative tax rules suitable for micro-enterprise groups is outside the scope of the Board's current post-implementation review. The Board therefore recommends that the Government should investigate whether alternative tax rules should be introduced for micro-enterprise groups.

6.60 In considering the factors that should be taken into account by the Government in any investigation of this issue, the Board notes that the Review of Business Taxation report in 1999 previously identified a need for tax rules to be designed which cater for groups in the micro-enterprise sector. Specifically, Recommendation 15.6(a) stated:

> That an alternative, more flexible, set of arrangements be made available for groups of trusts and companies, 'owned' by members of the one family, to be taxed as a single consolidated entity.

6.61 The Board also considers it may be an option for special rules to be designed to provide rules for micro-enterprise taxpayer groups which enable them to group losses without requiring them to enter the tax consolidation regime.

6.62 A few submissions to the Board's review also raise this as an option.

> It is our recommendation that to develop a simplified consolidation regime for small business may itself be problematic. Rather, it may be more appropriate to allow grouping relief for small business entities (as defined within the ITAA 1997) which would enable assets and losses to be transferred or dividends paid within wholly-owned groups of such entities without tax impediments.
>
> PricewaterhouseCoopers

> In relation to this group of taxpayers, the Board could consider a number of alternatives, being either a simplified consolidation regime, an alternative regime being an entity flow-through taxation regime, or an alternative limited grouping regime (similar to that which operated before the tax consolidation provisions).
>
> Deloitte

6.63 The Board therefore recommends that, given the unsuitability of the consolidation regime for micro-enterprise groups (with less than $2 million aggregated turnover), the Government should investigate whether alternative tax grouping rules should be introduced for these micro-enterprise groups. As part of this process, the Government should consider whether existing micro-enterprise groups which have formed a consolidated group should be given a choice to opt out of the consolidation regime and into the new micro-enterprise tax grouping rules.

The Board acknowledges, however, that there will be a small percentage of micro-enterprise groups which will still seek to enter consolidation, notwithstanding the reasons outlined above (at paragraph 6.55). This is reflected in the fact that there are currently 3,304 consolidated groups in the micro-enterprise sector. The Board therefore considers that its recommended small business simplified formation rules (Recommendation 6.1) still be made available for any micro-enterprise groups that choose to enter consolidation.

Recommendation 6.2

The Board recommends that, given the unsuitability of the consolidation regime for micro-enterprise groups (with less than $2 million aggregated turnover), the Government should investigate whether alternative tax grouping rules should be introduced for these micro-enterprise groups.

EXTENSION OF THE SIMPLIFIED FORMATION RULES TO ALL WHOLLY-OWNED GROUPS FOR A LIMITED PERIOD OF TIME

6.64 In its Position Paper, the Board proposed that the simplified formation rules which were proposed for small to medium sized corporate groups be extended as transitional rules to all wholly-owned corporate groups. Transitional rules were proposed for corporate groups eligible to form a consolidated group at the date of the announcement of the measure for a 12 month period. The Board also proposed that the transitional rules not be available to foreign owned corporate groups that elect to form a MEC group.

6.65 The transitional simplified formation rules were proposed in response to a number of larger wholly-owned corporate groups not having elected to enter the consolidation regime due to significant uncertainty with its operation and concerns about inequitable outcomes that can arise under the tax cost setting rules in certain circumstances.

6.66 Many of the uncertainties and problems present during the initial years of the consolidation regime were subsequently clarified in the *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, enacted in June 2010. However, by the time these clarifications were enacted, large corporate groups which had deferred entering the consolidation regime were out of time to use the original consolidation transitional rules which only operated during from 1 July 2002 to 30 June 2004.

6.67 The Board sought stakeholder comments on its proposed transitional simplified formation rules.

Views in submission

6.68 Submissions generally supported the Board's proposal for transitional simplified formation rules to be made available to all corporate groups for a limited time.

6.69 Although most submissions were in favour of a 12 month period for the operation of the transitional rules, a number of submissions suggested this would be too short and instead proposed a 24 month period of operation. Some stakeholders commented that the longer time period would be necessary given taxpayers would need to assess the tax consequences of a choice to enter consolidation relying on the transitional simplified formation rules.

6.70 One submission also questioned the need for MEC groups to be carved out of the transitional simplified formation rules.

Board's Consideration

6.71 The Board considers that it would be appropriate to enable all wholly-owned corporate groups to apply the simplified formation rules set out in Recommendation 6.1 for a limited period of time. That is, during a set transitional period, all wholly-owned corporate groups should be able to form a consolidated group and make a 'stick election', a 'COT transfer loss election' and/or a 'recently acquired entity election'.

6.72 The Board acknowledges that a 12 month transitional period starting from the date of announcement may not give taxpayers sufficient time to assess the impact of applying the transitional simplified formation rules. The Board therefore recommends that the 12 month transitional period should commence immediately after the income year in which the measures are enacted. This should give taxpayers and advisers sufficient time to determine whether to apply the transitional simplified formation rules.

6.73 In addition, as an integrity measure, the transitional simplified formation rules should be available only to those wholly-owned groups which are eligible to form a consolidated group at the date of any announcement of this proposal. However, as privately owned groups are not often structured as wholly-owned groups, the Board considers that it would be appropriate to allow the transitional simplified formation rules to be extended to either (a) entities in which these groups have a greater than 80 per cent interest at the date of announcement, or (b) entities within a family group[68] that are majority owned by any 'member' of the family group at the date of the announcement.[69]

68 As defined in section 272-90 in Schedule 2F of the ITAA 36.

69 The simplified loss utilisation rules will not apply to entities outside the wholly-owned group.

6.74 The Board is of the view that costs associated with the formation of a MEC group are not a significant impediment for foreign owned corporate groups, and these generally have a degree of flexibility in how to form a MEC group. The Board therefore considers it unnecessary to extend the transitional simplified formation rules to MEC groups.

Recommendation 6.3

The Board recommends that:

- the small business simplified formation rules set out in Recommendation 6.1 should be made available as transitional simplified formation rules for all wholly-owned corporate groups which elect to form a consolidated group within a set time period;
- the transitional simplified formation rules should be available for consolidated groups which form in the income year immediately following the income year in which the measures are enacted, but should only be available to those groups which are eligible to form a consolidated group at the date of any announcement of this proposal;
- the formation concession should also be extended either to entities in which these groups have a greater than 80 per cent interest at the date of announcement, or to entities within a family group that are majority owned by any member of the family group at the date of the announcement; and
- the transitional simplified formation rules should not apply to foreign owned corporate groups that elect to form MEC groups.

APPENDIX A: LIST OF BOARD'S RECOMMENDATIONS

Recommendation 2.1

The Board recommends that the Government:

- implement a more systematic approach for addressing and resolving issues arising in the operation of the consolidation regime; and
- evaluate the state of the consolidation regime within five years of the implementation of the recommendations in this report to assess the extent to which problems and issues continue to arise that may point to the need to address on-going structural problems with the regime.

Recommendation 3.1

The Board recommends that the core rules in the consolidation regime should be modified to:

- give formal recognition to the primacy of the business acquisition approach in relation to the treatment of assets transferred to a consolidated group from a joining entity;
- retain the entry history rule, but as an exception to the business acquisition approach; and
- include high-level principles which specify the general circumstances where the business acquisition approach or the entry history rule should apply.

The Board recommends that this modification to the consolidation core rules should not, by itself, result in any changes to:

- the current operation of the consolidation rules; or
- the current treatment of assets or liabilities under the consolidation regime.

The Board also recommends that the current exceptions to the business acquisition approach in the consolidation provisions should be rationalised and moved into a single location within the consolidation core rules.

Recommendation 4.1

The Board recommends that the ending/creation model be applied to ensure that the tax costs of intra-group assets (apart from membership interests) acquired or disposed of by consolidated groups, whether directly or indirectly, are appropriately recognised.

Some exceptions to the ending/creation model may be needed and should be considered on a case by case basis.

The Board also recommends that the intra-group liability adjustment should apply to liabilities and other similar types of obligations owed by a member of the old group to the leaving entity, regardless of whether or not the liability is recognised for accounting purposes.

Recommendation 4.2

The Board recommends that integrity rules should be designed to address any double benefit which arises when an encumbered asset, whose market value has been reduced due to the intra-group creation of rights over the encumbered asset, is sold by a consolidated group, whether directly or indirectly.

Recommendation 4.3

The Board recommends that, as a guiding principle, the effect of the single entity rule should be extended when a provision in the income tax law applies to a transaction between a consolidated group and a third party that is either a shareholder of the head company of the group, a liquidator appointed to a member of the group or a third party that is an associate of the group. However, the application of this principle in specific cases should be assessed on a case by case basis.

Recommendation 5.1

The Board recommends that the issues relating to the determination of the amount of a trust's net income that is assessed to each beneficiary and/or trustee when the trust is a member of a consolidated group for part of an income year be considered as part of the rewrite of the trust income tax provisions.

Recommendation 5.2

The Board recommends that, subject to the outcomes of the Board's review of the treatment of liabilities under the consolidation regime, a consolidated group's tax liability in relation to the net income of a trust's non-membership period should be included in the calculation of the allocable cost amount of a trust that joins a consolidated group part way through an income year.

Recommendation 5.3

The Board recommends that the tax law be clarified so that, for the purposes of applying the consolidation provisions:

- a trustee, in its capacity of trustee of a trust that is a member of a consolidated group, will be treated as a member of the same consolidated group as the trust; and
- a change in trustee will not result in a trust joining or leaving a consolidated group.

Recommendation 5.4

The Board recommends that:

- a trust should qualify as a member of a consolidated group only if all members including beneficiaries, unit holders or objects of the trust, are also members of the consolidated group; and

- the treatment of debt beneficiaries of the trust should be reviewed in the context of the rewrite of the trust provisions.

Recommendation 5.5

The Board recommends that there should be no change to the foreign hybrid rules. However, the Government should continue to monitor whether any integrity risks may arise.

Recommendation 5.6

The Board recommends that where the membership interests in an entity that are transferred to a consolidated group are not regarded as taxable Australian property under the non-resident CGT rules, the consolidation tax cost setting rules should only apply to the transferred membership interests if:

- there has been change in the underlying majority beneficial ownership of the membership interests in the entity; or

- there has not been a change in the underlying majority beneficial ownership of the membership interests in the entity, but the membership interests in the entity were recently acquired by the foreign entity (or the foreign group); and

  - membership interests in an entity will be recently acquired if they have been majority owned by the foreign entity (or the foreign group) for less than 12 months.

Recommendation 5.7

The Board recommends that the Government should continue to monitor the interaction between Australia's double tax agreements and the tax consolidation rules.

Recommendation 6.1

The Board recommends that:

- ongoing simplified formation rules should be available for wholly-owned corporate groups that have an aggregated turnover of less than $50 million in the prior income year;

- a simplified formation rules election should be available for eligible groups forming a consolidated group, under which:

  - the existing tax costs of assets should be retained for *all* subsidiary members of the consolidated group which is formed;

  - the simplified loss utilisation rule should apply to COT transfer losses from *all* entities in the consolidated group which is formed;

    : a five year utilisation should period apply for COT transfer losses under the simplified loss utilisation rule;

  - the business acquisition approach should not apply to any assets which have their tax cost retained under this election; and

- the Government should investigate whether rules should be introduced to enable small to medium sized corporate groups to apply a 'stick approach' to long-term majority owned subsidiaries when they become wholly-owned by a consolidated group after the formation time.

Recommendation 6.2

The Board recommends that, given the unsuitability of the consolidation regime for micro-enterprise groups (with less than $2 million aggregated turnover), the Government should investigate whether alternative tax grouping rules should be introduced for these micro enterprise groups.

Recommendation 6.3

The Board recommends that:

- the small business simplified formation rules set out in Recommendation 6.1 should be made available as transitional simplified formation rules for all wholly-owned corporate groups which elect to form a consolidated group within a set time period;

- the transitional simplified formation rules should be available for consolidated groups which form in the income year immediately following the income year in which the measures are enacted, but should only be available to those groups which are eligible to form a consolidated group at the date of any announcement of this proposal;

- the formation concession should also be extended either to entities in which these groups have a greater than 80 per cent interest at the date of announcement, or to entities within a family group that are majority owned by any member of the family group at the date of the announcement; and
- the transitional simplified formation rules should not apply to foreign owned corporate groups that elect to form MEC groups.

APPENDIX B: ANNOUNCED MEASURES THAT WERE SUBSUMED INTO THE BOARD'S REVIEW

The following table provides a list of unenacted measures that were announced by the Government prior to June 2009 which were subsumed into the Board's post-implementation review.

Announced measure	Date of announcement	Proposed start date	Board's report
Entry history rule and applying the 200% diminishing value rate	13 May 2008	8 May 2007	Covered in Chapter 3: Policy framework for the consolidation regime
Extending the single entity rule to discount capital gains and CGT event K6	13 May 2008	8 May 2007	Covered by principles in Chapter 4: Operation of the single entity rule
Beneficiaries of a trust and the sharing of net income	13 May 2008	Start of the 2007/08 income year	Covered in Chapter 5: Interaction between the consolidation regime and other parts of the income tax law

APPENDIX C: CONSOLIDATION ISSUES RAISED IN SUBMISSIONS OUTSIDE OF THE BOARD'S REVIEW

The following consolidation issues raised in submissions are outside the scope of the Board's review:

- various issues relating to MEC groups including:
  - the treatment of transfers up and transfers down of eligible tier-1 companies;
  - MEC pooling rules relating to functional currency;
  - interaction between MEC groups and loss rules including issues relating to the available fraction;
  - deemed failure of the continuity of ownership test for MEC groups where there is no actual change in majority beneficial ownership; and
  - interaction with the thin capitalisation rules;
- access to the Subdivision 126-B CGT roll-over by a foreign resident with more than one wholly-owned entry point company in Australia that has not formed a MEC group;
- application of CGT event L5 to subsidiary members that are deregistered;
- allowing the modified tax cost setting rules in Subdivision 705-C to apply in additional cases where a consolidated group is acquired;
- clarification of whether the foreign hybrid tax cost setting rules contained in Division 830 apply before or after the cost setting rules in Division 705;
- extending the principle in the tax law that allows inconsistent elections to be cancelled or ignored when an entity joins a consolidated group;
- clarification of how the consolidation rules apply to intangible economic assets (that is, non-CGT assets such as customer relationships, know-how and similar assets);
- disclosure of Division 7A amounts on income tax returns;
- interactions with the new managed investment trust regime;

- practical issues that arise when a public trading trust or a corporate unit trust becomes the head company of a consolidated group;
- clarification of the treatment of amounts paid under earnout arrangements in the entry allocable cost amount calculation;
- interactions with FOREX and ToFA provisions; and
- treatment of intra-group transactions that straddle the time an entity joins or leaves a consolidated group.

The Board considers that Treasury and the ATO should take necessary action to consider and, where appropriate, resolve these issues as soon as practicable.

Appendix D: List of Submissions

Submissions in response to the Board's Discussion Paper

BDO (Australia) Limited

Blake Dawson

Corporate Tax Association and the Minerals Council of Australia

CPA Australia

Deloitte Touche Tohmatsu

Group of 100

Institute of Chartered Accountants in Australia and The Tax Institute

MGI Melbourne

PricewaterhouseCoopers

Submissions in response to the Board's Position Paper

Corporate Tax Association and the Minerals Council of Australia

CPA Australia

Deloitte

Ernst & Young

Institute of Chartered Accountants in Australia and The Tax Institute

Pitcher Partners

Raytheon Australia

FOI 2473
Document 10

12 November 2013

Senator the Hon Arthur Sinodinos AO
Assistant Treasurer
Parliament House
Canberra ACT 2600

Senator

s 22

Yours Sincerely

s 47F

James Sorahan
Director – Taxation

Cc: Roger Paul, Board of Taxation Secretariat

Announced but unlegislated tax measures under consideration
Comments to the Board of Taxation, 12 November

MEASURES WHICH SHOULD PROCEED		
Item	**Measure**	**Announced**
s 22		
78	**Improvements to the company loss recoupment rules.** Modifies company loss recoupment rules to correct technical issues.	2011-12 Budget
s 22		

THE TAX INSTITUTE

THE MARK OF EXPERTISE

FOI 2473
Document 11

12 November 2013

Senator the Hon Arthur Sinodinos AO
Assistant Treasurer
PO Box 6100
Senate
CANBERRA ACT 2600

By email: senator.sinodinos@aph.gov.au

Dear Minister,

Restoring Integrity in the Australian Tax System

The Tax Institute takes this opportunity to make a submission in relation to the 64 previously announced measures which are subject to further consultation to determine whether the Government should proceed with these measures.

The review of these 64 measures is focused on determining "whether there are any unintended consequences from not proceeding with the measures or whether there are compelling reasons why the measure should proceed". That is, whether there is good reason for keeping a measure other than to provide certainty and efficiency and prevent taxpayers from having to unwind transactions.

Further, we understand legislative protection will be afforded to a taxpayer who has self-assessed factoring in an announced measure that will not proceed. There is also a promise of an entitlement to a refund where a taxpayer has complied with a previously announced measure and paid tax accordingly and the announced measure does not proceed following this consultation process.

In light of the expeditious consultation process being undertaken and on reliance on the parameters of the consultation process set out above, The Tax Institute seeks to bring to the attention of the Minister only priority measures which we strongly recommend be progressed through Parliament by 1 July 2014 with solid reasons in support of their progression. In doing so, we have considered what harm may be suffered by taxpayers should certain measures not be proceeded with and whether there is an appropriate

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administrative solution to the issue the measure is intended to address. We refer to the items as numbered in the table attached to the media release[1] as relevant.

Measures to proceed by 1 July 2014

1. ***Capital Gains Tax – look-through treatment for earn out arrangements (#46)***

Earn out arrangements are increasingly being used, particularly by the small and medium enterprise market. The Australian Taxation Office's (**ATO**) method of taxing earn out arrangements as contained in TR 2007/D10 gives rise to several adverse consequences for the buyer and seller which are inconsistent with the economics of the transaction and virtually impossible to apply in practice.

The proposed look-through method solves this issue and reduces complexity and compliance costs as it is more appropriate and practical in its effect and much less likely to give rise to as many adverse consequences as the ATO's interpretation of the current rules. The absence of look-through treatment negatively impacts on the CGT treatment of the transaction; there are significant timing issues, particularly in the case where the consequences of the earn out is taxed upfront, earn out payments are not made due to conditions of the earn out not being met (eg lack of business performance) which results in a capital loss for the taxpayer (seller) and no corresponding economic gain has been recognised. Legislating this amendment will reduce 'red tape' and compliance costs associated with earn out arrangements (eg it will no longer be necessary to obtain a valuation).

The ATO made it clear during consultation that they did not believe look-through treatment is possible for buyers and sellers. It is unlikely their views will change in the absence of an appropriate legislative amendment. Therefore, there is no appropriate administrative solution available.

2. ***Consolidation – operation of the rules following a demerger (#84)***

The demerger provisions were introduced to ensure that tax considerations were not an impediment to the restructuring of a business, and in recognition that there should be no taxing event for a restructuring that leaves members in the same economic position as they were just before the restructuring.

The proposed amendments were designed to ensure that two current consolidation outcomes that are inconsistent with the above principle are overcome:

[1] Joint media release between the Treasurer and Assistant Treasurer entitled "Restoring Integrity in the Australian Tax System" issued 6 November 2013

- **Treatment of liabilities**: Currently, where the liabilities of a demerged entity exceed the tax cost of its assets, a capital gain may arise (CGT event L5) as a result of the demerged entity having low historical tax cost in its assets, or because the tax cost has been fully depreciated.

  Further, these liabilities are not taken into to account in resetting the tax cost of the assets of the new demerged group that forms a tax consolidated group.

  The proposed amendments would overcome both of these inappropriate outcomes.

- **Resetting of tax costs**: Where a demerger group forms a tax consolidated group, it is currently required to reset the tax cost of its assets. This will often result in existing cost base in depreciable assets (such as property, plant and equipment) being reallocated to non-depreciable assets (such as goodwill). As a fundamental principle of a demerger is that there is no change in the underlying economic ownership of an asset, this is also an inappropriate outcome that would be rectified under the proposed amendment.

  The resetting of tax costs also requires the demerger group to undertake complicated resetting calculations and incur valuation costs – both of these are an unnecessary compliance cost to business.

These outcomes arise under current law and there is no appropriate administrative solution. The provisions require amendment to ensure the appropriate treatment arises.

3. Debt/equity tax rules – limiting scope of integrity rule (#74)

The current integrity provision, section 974-80[2], is being applied much more widely by the ATO than is intended by the law, resulting in the re-characterisation of certain related-party debt as being equity. This is inconsistent with the policy intent behind section 974-80.

The ATO should narrow the scope of application of the provision to bring it back into line with the original intention of the law. This would require a redraft of the ATO's 2007 Draft Discussion Paper and Taxation Ruling TR 2012/D5. However, a legislative amendment would ensure the scope of the application of the provision was narrowed appropriately and would provide the necessary certainty around the application of this provision.

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[2] *Income Tax Assessment Act 1997*(Cth)

4. *GST – cross-border transactions – 'connected with Australia' rules (#48)*

The current rules discourage foreign residents from transacting with Australian residents and they impose significant compliance costs on foreign residents in order to comply with Australian GST rules. The proposed legislative amendment would ease the compliance burden on foreign residents who become subject to the Australian GST regime and would assist to improve Australia's international competiveness.

There is no suitable administrative response to the current compliance burden. Two rounds of consultation on this issue have already occurred and as a result, draft legislation making the amendment should be fairly close to finalisation.

5. *Administration of the GST system*

a) *GST – Government response to Board of Taxation report: GST Administration – review multi-party transactions (#42)*

There is a significant amount of litigation around multi-party transactions caught in the system that would be alleviated following a proper examination. There is asymmetry for parties to transactions where a liability arises but no corresponding credit is necessarily available. This affects many business-to-business transactions.

The ATO has been trying to produce administrative guidance in this area; however, the guidance is not producing the desired symmetrical treatment. The ATO guidance is exacerbating the problem as taxpayers have challenged (and continue to challenge) the ATO guidance on issue, further contributing to the increasing litigation in this area. Accordingly, this is a significant area where it would be beneficial for the recommended review to occur.

b) *GST – Government response to Board of Taxation report: GST Administration – simplify grouping rules (#79)*

The current grouping rules are complex and difficult to apply. Most holding companies register for GST – though this is consistent with the policy intent, it is inconsistent with the legislation; hence there is broad non-compliance with the current provisions. Should the measure not proceed, this would require the ATO to actively enforce the law which is inconsistent with the policy intent. Non-compliance with the law (by holding companies choosing to register for GST which has associated compliance costs to taxpayers) would also persist.

Proceeding with this measure would fix a flaw in the legislation that administrative treatment could not circumvent. This would ensure the legislation accords with the policy intent and that taxpayers are not put in a position where they do not comply with the law.

Care and Maintenance of the Australian Tax System

There are several measures in the list of 64 that have been announced for the purpose of providing improvements and necessary corrective action / care and maintenance to the taxation system which should still be addressed at a later stage when time permits so this opportunity is not forgone.

- **Loss recoupment rules** – A general review of the company and trust loss recoupment rules should be conducted through which the multiple share class amendments (#59) and other minor technical issues (#78) could be made.

- **Simplified imputation system (#75)** – It is recommended the re-write of the imputation system rules be completed at some stage.

- **CGT provisions** – Many of the proposed CGT amendments are to overcome technical glitches that cannot be overcome by an administrative solution. The proposed amendments (such as the measures affecting insurance policies, revenue assets and trading stock and deceased estates) should proceed as they will ensure consistency and equity within the CGT provisions. These measures are not complicated and involve simple drafting. Little or no further consultation is required.

- **Consolidation measures** – many of the proposed consolidation measures could be dealt with as part of the Government's consideration of recommendations made by the Board of Tax in its review of consolidation that have not been included on the list of 64 measures.

- **GST measures** – many of the proposed GST measures are drawn from recommendations made by the Board of Taxation and focus on removing anomalies and streamlining the GST provisions. Not proceeding with the measures is contributing the 'red tape' currently imposed on taxpayers in complying with the Australian GST regime.

- **Taxation of not-for-profits** - Reform in respect of taxation of not-for profits should be fully co-ordinated to avoid unnecessary duplication or inconsistency. Further reform should not occur until the Government has considered the report commissioned from the Not-For-Profit Sector Tax Concession Working Group (which is not yet publicly available) and settled its overall reform agenda in this area. However, the "Not-for-profit sector reforms - better targeting of not-for-profit tax concessions" measure (#33) should not proceed.

- **Taxation of superannuation** – consistent with the Government's pre-election policy, restoration of stability and certainty in this area is welcome.

Other

In determining its tax agenda, there are other consultations on foot not listed which we strongly urge the Government to continue with, in particular the modernisation of the taxation of trust income.

The Tax Institute is keen to discuss the above measures in further detail with relevant Government stakeholders and to assist as much as possible in the consultation process.

Please contact either me or Senior Tax Counsel, Robert Jeremenko, on 02 8223 0011 to discuss further.

Yours sincerely

Steve Westaway
President

CC The Hon Joe Hockey MP, Treasurer
Mr Rob Heferen, Executive Director, Revenue Group, The Treasury
Ms Christine Barron, Corporate & International Tax Division, The Treasury
Mr Gerry Antioch, Tax System Division, The Treasury
Ms Brenda Berkeley, Indirect, Philanthropy & Resource Tax Division, The Treasury
Ms Teresa Dyson, Chair, Board of Taxation

FOI 2473
Document 12

CORPORATE TAX
ASSOCIATION
of Australia Incorporated

12 November 2013

The Hon Mr Joe Hockey
Treasurer
Parliament House
CANBERRA ACT 2600

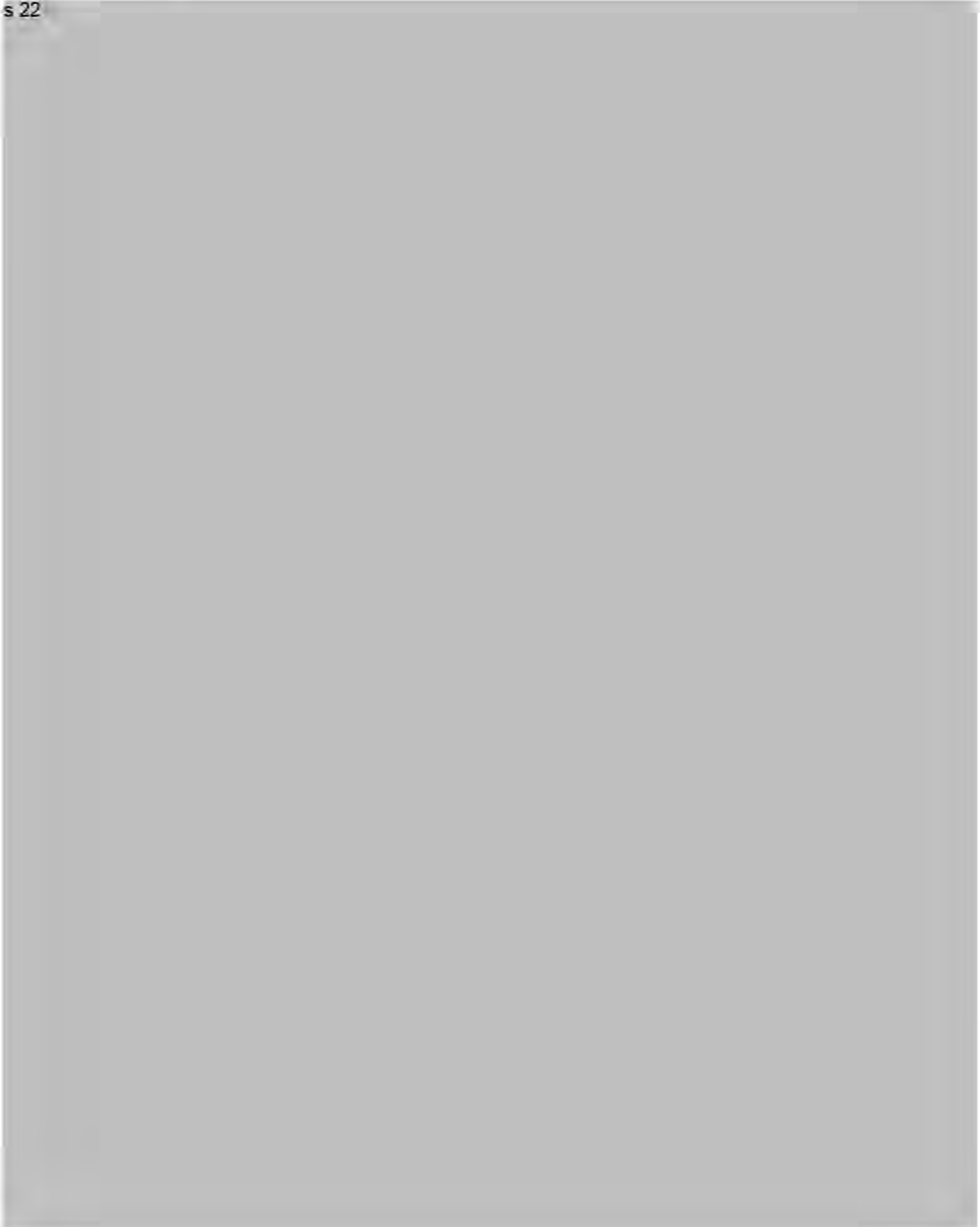
Dear Mr Hockey,

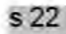
Restoring Integrity in the Australian Tax System
Joint Ministerial Announcement 6 November 2013

s 22

Level 11, 455 Bourke St,
Melbourne Victoria 3000
Telephone: (03) 9600 4411
Facsimile: (03) 9600 4055
Email Address: admin@corptax.com.au

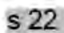
s 22





- Item 59 **Loss recoupment rules where there are multiple classes of shares**

  This announcement applies back to the start of the consolidation regime on 1 July 2002 and addresses a technical problem with the loss recoupment rules where there are non-standard classes of shares. This issue will remain important after 1 July 2014. *This measure should proceed by 1 July 2014 unless the ATO can adopt an administrative*



s 22

- Item 78 **Improving the company loss recoupment rules**

  This was a May 2011 announcement, with a date of effect from 1 July 2011. The measure proposed to modify the continuity of ownership test so that ownership does not need to be traced through certain superannuation entities. It also proposed to correct a number of technical deficiencies in the modified rules for widely held entities. These are matters that the Commissioner should be able to deal with by way of a statutory discretion. *However, this measure should proceed by 1 July 2014 unless the ATO can adopt an administrative solution.*

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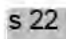
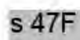


Best regards,



(Frank Drenth)
Executive Director

cc

The Hon Mr Arthur Sinodinos, Assistant Treasurer

Mr Chris Jordan, Commissioner of Taxation

Ms Teresa Dyson, Board of Taxation

Mr Rob Heferen, Treasury

FOI 2473
Document 13

Institute of Chartered Accountants Australia

15 November 2013

Senator the Hon Arthur Sinodinos AO
Assistant Treasurer
The Senate
CANBERRA ACT 2600

By email: senator.sinodinos@aph.gov.au

Dear Senator Sinodinos

Restoring integrity in the Australian tax system – Announced but unlegislated tax and superannuation measures

Customer Service Centre

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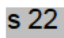
Issues which should proceed

For the reasons set out in Appendix A (income tax measures) and Appendix B (GST measures), the following measures should proceed in the same manner as the 21 tax measures identified in the Government's media release:

Income tax measures

- Item 36 – Taxation of financial arrangements – amendments to the tax hedging rules
- Item 46 – Look-through treatment for earn-out arrangements
- Items 59 & 78 – Loss recoupment rules – multiple share classes and technical amendments

- Item 74 - Debt/equity tax rules – limiting the scope of integrity rule
- Item 84 – Consolidation – operation of the rules following a demerger



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Yours sincerely

Bill Palmer

Bill Palmer
General Manager, Leadership & Quality

cc The Hon Joe Hockey MP, Treasurer
Mr Phil Lindsay, Assistant Treasurer's Office

Ms Teresa Dyson, Chair, The Board of Taxation
Mr Chris Jordan, Commissioner of Taxation
Mr Rob Heferen, Executive Director, Revenue Group, The Treasury
Ms Christine Barron, General Manager, Corporate and International Tax Division, Revenue Group, The Treasury

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Item 59 and 78: Loss recoupment rules - multiple classes of shares and technical amendments

Under the current law, the ability of a company to utilise revenue losses, capital losses and bad debts is subject to meeting either the continuity of ownership test (COT) or the same business test (SBT). It is fair to say that, on a technical reading of the provisions, various aspects of the operation of the COT could be problematic for companies with multiple classes of shares on issue or shares with discretionary entitlements (i.e. unequal share structures).

The announcement to address this issue was originally made in the 2008-09 Budget. Exposure draft legislation (ED) was released for public consultation on 4 September 2009 and a revised ED subsequently released on a limited basis on 8 July 2011. The revised ED differed significantly from the original ED.

Based on the announcement/ED the proposed new rules were to apply as follows:

- Proposed changes to the dividend and capital distribution tests – losses incurred in a year commencing on or after 1 July 2002 and to pre-1 July 2002 losses if such losses could have been utilised in the first income year after 30 June 2002 on the basis of the COT rules as at 30 June 2002
- Proposed changes to the voting test – losses incurred in a year commencing on or after 1 July 2007 and pre-1 July 2007 losses if such losses could have been utilised in the first income year after 30 June 2007 on the basis of the COT rules as at 30 June 2007
- Turning off the entry history rule when an entity is joining a consolidated or MEC group – 1 July 2002.

There is very little in the way of judicial or public ATO guidance on how to apply the loss rules where a company has an unequal share structure. Anecdotal evidence would suggest that companies may have been applying the loss rules based on unpublished 'tax lore' or, in more recent times, on the basis that the law will be amended to apply as it should (even if that does not accord with the strict wording of the media release or publicly released ED).

Pending the amendments becoming law, the ATO has held off commencing audit activity in relation to companies with multiple share classes. Failure to proceed with this measure will therefore almost invariably lead to specific ATO audit activity.

This measure affects numerous companies, both large and small. It is extremely common for private companies to have different classes of shares or shares which have discretionary entitlements to dividends and returns of capital.

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Institute of Chartered Accountants Australia

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FOI 2473
Document 14

Response to the *Improvements to the Company Loss Recoupment Rules Consultation paper* (July 2011)

Submission to the Treasury

From:

KPMG on behalf of **Cable & Wireless Global Business Services Pty Limited**

KPMG

Basis of Submission

This submission is in response to the *Improvements to the Company Loss Recoupment Rules Consultation Paper* ("the Consultation Paper") released by the Assistant Treasurer, Bill Shorten on 14 July 2011.

KPMG welcomes the opportunity to put forward our client's concerns on the proposed reforms and operation of the legislation as it currently stands. In this regard, Cable & Wireless Global Business Services Pty Limited ("C&W GBS") has requested a submission be made as a result of a restructure causing a failure of the continuity of ownership test ("COT") under *s 166-230 Income Tax Assessment Act 1997* ("ITAA97") and that further, the proposed amendments discussed in the Consultation Paper will not remedy the COT failure under the demerger.

As detailed below, C&W GBS submits that the proposed changes outlined in the Consultation Paper and current functioning of s 166-230(3) ITAA97 may lead to a situation where COT is failed despite no ultimate change in beneficial ownership occurring.

Background

- C&W GBS has generated tax losses in the year ended 31 March 2003 ("the 2003 year") and the year ended 31 March 2005 ("the 2005 year").
- C&W PLC, C&W GBS' ultimate parent company, was listed on the London Stock Exchange ("LSE") from December 1983 to 22 March 2010, when a demerger commenced.
- The demerger was put in place in order to separate the Communications and the Worldwide businesses of the former Cable & Wireless group. The Communications business provided full service telecommunications to customers, including mobile, broadband and fixed line services. The Worldwide business focused on providing infrastructure and services to large users of telecommunications. The demerger took place on a worldwide basis and was not driven in any way by Australian tax considerations.
- We understand that the demerger involved the following steps:-
  - A new company, Cable & Wireless Communications ("C&W Communications"), became the new parent company of the Cable & Wireless group. Under a scheme of arrangement approved by shareholders and the court, the former shareholders in C&W PLC received the same number of Ordinary shares and B shares in C&W Communications as they formerly held in C&W PLC. The shareholders in C&W PLC held only ordinary shares. To facilitate the demerger, the B shares issued by C&W PLC shareholders were redeemable shares, which were held for only a short period of time (see below). Their shares in C&W PLC held by the former public shareholders were cancelled ("Transaction Step 1");
  - C&W Communications then reduced its capital by redeeming its B shares and transferred assets of the Cable & Wireless Worldwide business to another new company, Cable & Wireless Worldwide ("C&W Worldwide"). The assets transferred included shares in an overseas company through which C&W GBS was 100% owned.
  - In consideration for the transfer of assets, C&W Worldwide issued new ordinary shares to the former C&W PLC shareholders ("Transaction Step 2"). Following the demerger

and redemption of the B shares, former shareholders in C&W PLC therefore held the same number of ordinary shares in both C&W Communications and C&W as they had previously held in C&W PLC.

- At the same time, or soon after the transfer of the group business to C&W Communications, C&W Communications became listed on the London Stock Exchange. We understand that C&W Worldwide became listed on the London Stock Exchange at the same time as it acquired the assets of the Worldwide business.
- The demerger steps were completed by 26 March 2010.

- As a result of the acquisition of the Worldwide business by C&W Worldwide, C&W GBS became an (indirect) 100% subsidiary of C&W Worldwide and there was no change in ultimate beneficial ownership at this time.

COT Failure at Transaction Step 1 – s 166-230(3)(c) ITAA97

In C&W GBS' situation, no relief will be available for Transaction Step 1 to avoid a COT failure under s166-230 ITAA97 as the transaction involved the issue of redeemable shares (specifically excluded under s 166-230(3)(c) ITAA97). The issue of redeemable shares is also unlikely to satisfy the requirement in s 166-230(3)(b) ITAA97 as the new interposed entity does not have the same classes of shares or other interests as the old interposed entity.

The redeemable shares were issued proportionately to all former holders of original shares in C&W PLC. They were only in place for a matter of days until they were redeemed by way of capital reduction. It seems anomalous that the issue of redeemable shares should cause a failure of COT when there has been no change in ultimate ownership of C&W GBS following the restructure.

Legislative history of s 166-230(3)(c) ITAA97

S 166-230(3)(c) was inserted by the *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005* along with the other concessional COT rules under *Division 166 ITAA97.* Little guidance is available in the explanatory materials to this Act on the reasons for inserting the specific exclusion for arrangements involving redeemable preference shares. However, s 166-230(3)(c) ITAA97 does appear to parallel the former s 165-195(1) ITAA97 in relation to the substantive COT, which stated:

> ***'s 165-195 Disregard redeemable shares***
>
> *165-195(1) For the purposes of a test, a person who beneficially owns redeemable shares at a particular time, is taken not to own the shares beneficially at that time'*

s 165-195 ITAA97's equivalent provision in the *Income Tax Assessment Act 1936* ("ITAA36") was s 50K ITAA36 (inserted by the *Income Tax Assessment Amendment Bill (No. 2) 1978*). The Explanatory Memorandum ("EM") to this Bill notes that s 50K ITAA36 was inserted as a safeguard, where:

> *'notwithstanding that there may have been a technical compliance by the company with the continuity of ownership test in accordance with the requirements of 50D, the notional loss will not be taken into account as an eligible notional loss where there were*

arrangements in existence under which persons who were not shareholders in the company, during the loss period, will benefit from activities in relation to the company's affairs at the expense of persons who are shareholders'

The EM goes on to say that COT will be failed as a result of certain 'disqualifying events', which bear no relationship to whether COT is disturbed, but have a tax avoidance connotation. The issue of redeemable shares is one such 'disqualifying event':

's 50K(3) – 'redeemable shares' beneficially owned by a person at any time shall be treated as not having been owned by the person at that time'

As can been seen above, s 50K(3) ITAA36 appears to be an anti-avoidance measure to avoid redeemable shareholders benefiting from the losses where they were not shareholders during the loss period, at the expense of the actual beneficial shareholders. S 50K(3) has subsequently been replicated under substantive COT as s 165-195 ITAA97. The concept is picked up under s 166-230(3)(c) ITAA97 through the disqualification of redeemable shares.

From the Consultation Paper, it appears that this disqualification will be continued into the proposed amendments to COT to provide relief where a s 125 ITAA97 demerger occurs. Specifically, the Consultation Paper notes that the demerger relief will not be available where redeemable shares are issued as part of that demerger. It is submitted that the disqualification of redeemable preference shares is inconsistent with the stated intention of the amendments, being to allow the COT to be met where there has been no change in beneficial ownership.

Repeal of s165-195 ITAA97

Relevantly, the disregarding of redeemable preference shares under *s 165-195* was repealed by the *Tax Laws amendment (Loss recoupment and other measures) Bill 2005*. The EM to this Bill noted:

3.49 Section 165-195 was introduced as a specific anti-avoidance measure. However, it is no longer necessary given the Commissioner's discretion in relation to arrangements affecting the beneficial ownership of shares (s 165-180) and the same share test (s 165-165).

s 165-180 is a specific anti-avoidance measure that offers the Commissioner the discretion to treat a person as not having beneficially owned shares where:

*165-180(2) An *arrangement must have been entered into at some time that in any way (directly or indirectly) related to, affected, or depended for its operation on:*

*(a) the beneficial interest in the *shares, or the value of that beneficial interest; or*

(b) a right carried by, or relating to, the shares; or

(c) the exercise of such a right.

*165-180(3) The *arrangement must also have been entered into for the purpose, or for purposes including the purpose, of eliminating or reducing a liability of an entity to pay income tax for a *financial year.*

Importantly, the specific example of a situation that would be covered by s 165-180 ITAA97 states:

> *Example: The Commissioner may treat a person as not having beneficially owned redeemable shares at a particular time if the conditions in subsections (2) and (3) are met in respect of those shares.*

As such, s 165-180 ITAA97 provides a discretionary power under which the Commissioner may effectively cause a taxpayer to fail COT where the issue of redeemable preference shares confers a tax avoidance connotation.

Further, *ATO Interpretative Decision 2005/9* ("ATOID 2005/9) confirms that s165-180 may apply to a listed public company for the purposes of the concessional ownership testing in s 166 ITAA97.

COT failure arising from Transaction Step 2 under the Consultation Paper

The Consultation paper proposes to amend s 166-230 ITAA97 so that COT will continue to be satisfied where the top interposed entity demerges, subject to certain conditions. The Consultation Paper proposes to amend section 166-230 where:

- *the top interposed entity is a company or a trust;*
- *a demerger (as defined in subsection 995-1(1)) happens to a demerger group, of which the top interposed entity is the head entity (as defined in subsection 995-1(1));*
- *as a consequence of the demerger, one or more entities that previously held an indirect stake in the tested company continues to hold an indirect stake, or begins to hold a direct stake, in the tested company;*
- *the demerged entities have the same classes of shares or other interests as the top interposed entity;*
- *if the top interposed entity demerges shares in the tested company or another company interposed between itself and the tested company,* ***the shares are not redeemable shares;*** *and*
- *each stakeholder holds the same proportion of total voting stakes, dividend stakes or capital stakes in the demerged entities immediately after the demerger as the stakeholder held in the top interposed entity immediately before the demerger.* ***[emphasis added]***

Accordingly, a Company that otherwise satisfies the demerger provisions and where the ultimate beneficial ownership remains unchanged, would fail COT under this provision as a result of any redeemable shares issued as a part of the demerger. For C&W GBS, this would precipitate a failure of COT at Transaction Step 2. For Companies which issue redeemable shares as part of a demerger, this would result in a failure to satisfy COT, even in circumstances where there is no change in ownership.

Submissions

- s 166-230(3)(c) ITAA97 and the redeemable preference share exclusions discussed in the Consultation Paper are a legacy of a historical anti-avoidance measure reflected in s 50K

ITAA36 and s 165-195 ITAA97, both of which are no longer operational. These provisions were repealed on the basis that s 165-180 ITAA97 offered the Commissioner sufficient discretion to exclude redeemable preference shares where an arrangement exists with an anti-avoidance connotation.

- As it has been shown in ATOID 2005/9 that s 165-180 ITAA97 will also apply to Division 166 companies, it is submitted that to s 165-230(3)(c) and the redeemable preference share exclusion in the Consultation Paper are unnecessary, and ineffective in that the exclusion may precipitate a COT failure where:
  - There has been no change in the beneficial ownership of a Company as a result of the acquisition of another widely held company (s166-230(3) ITAA97) or as a result of a demerger (as discussion in the Consultation Paper); and
  - There is no tax avoidance arrangement or motive.
- Accordingly it is submitted s 165-180 ITAA97 offers the Commissioner sufficient discretion to exclude arrangements involving redeemable preference shares where there exists a tax avoidance connotation or motive. On this basis:
  - s 166-230(3) ITAA97 should be amended to remove the redeemable preference share exclusion currently under s166-230(3)(c) ;
  - s 166-230(3) ITAA97 should be amended to ensure that the provision will not be failed under s 166-230(3)(b) where redeemable preference shares are issued and redeemable to the original shareholders; and
  - no exclusion for redeemable preference shares be included in the proposed amendments contained in the Consultation Paper relating to the COT demerger provisions.

FOI 2473
Document 22

Australian Government
The Treasury

7 February 2011

Mr Ben Kelly
Senior Tax Counsel
Law Design Team
Australian Taxation Office

Dear ~~Mr Kelly~~ BEN

s 22

Your second proposal is to amend the modified continuity of ownership test that applies to widely held companies to clarify the operation of the provision which specifies the time that a corporate change ends (section 166-175 of the ITAA 1997). We agree with that approach.

Given the current processes for obtaining the Government's agreement to amend the income tax law, we have included these proposals in a new policy proposal for consideration in the 2011-12 Budget.

We look forward to working with you to implement these proposals in due course.

Langton Crescent, PARKES ACT 2600, Australia
P 02 6263 3820 F 02 6263 4466
www.treasury.gov.au

Please contact Tony Regan, Manager, Company Tax Unit (Ph 02 6263 3334) if you wish to discuss these issues.

Yours sincerely

Paul McCullough
General Manager
Business Tax Division

FOI 2473
Document 23

s22

From: s22 @finance.gov.au>
Sent: Wednesday, 30 March 2011 2:57 PM
To: s22
Cc: Regan, Anthony; s22
Subject: RE: Income Tax: refining the company loss recoupment rules [SEC=IN-CONFIDENCE]

OBPR ID: 12480

Office of Best Practice Regulation
Ground Floor, Minter-Ellison Building
National Circuit, Barton ACT 2603
AUSTRALIA

s22
The Treasury
Langton Cres PARKES ACT

Dear s22

Re: Proposed changes – Income tax: refining the company loss recoupment rules.

Thank you for the information provided on 24 March 2011 in relation to the above-mentioned proposal.

The OBPR agrees that the proposed changes are minor and machinery of government in nature and no further analysis (in the form of a Regulation Impact Statement) is required. Please note our reference for this proposal is ID 12480 and retain this e-mail as record of the OBPR's advice.

Should your proposal change significantly from the details provided, please contact us again to ensure our advice remains current.

If you have any further queries please call me on s22

Regards

s22
Special Adviser
Regulation Impact Analysis Team 3
Office of Best Practice Regulation
Department of Finance and Deregulation
Ph s22

From s22 @TREASURY.GOV.AU]
Sent: Thursday, 24 March 2011 4:15 PM
To: s22 Help Desk - OBPR
Cc: Regan, Anthony s22
Subject: Income Tax: refining the company loss recoupment rules [SEC=IN-CONFIDENCE]

Hi s22

Our RIS Overview Form, and attachment, for this measure is attached. The attachment summarises the seven sub-measures that are included in the Budget measure.

The loss recoupment rules provide for concessional tracing rules for widely held companies, as the compliance burden of tracing through to an ultimate owner would otherwise be very onerous. The rules generally seek to group classes of shareholders for testing purposes and to apply the test to major shareholders who would ordinarily control the company.

The proposed amendments have been raised by industry, seeking clarification and confirmation of their existing practices. They largely identify situations where there are uncertainties in the law in respect of events that don't substantially change ultimate ownership (for example, the interposing of entities in certain parts of a chain of wholly owned entities), although the chain leading to the ultimate owner may have altered. They also seek to apply the superannuation entity exception, where a superannuation entity is regarded as the ultimate owner, consistently across the loss measures.

It is expected that the same outcomes in respect of the loss recoupment rules (either the test is passed or not) would be achieved under the current law and the proposed amendments. However, the amendments will simplify the application of the tests in some of these cases, resulting in a minor reduction of compliance costs. Essentially, we are legislating to confirm existing practice.

At this time, we have not sought an Departmental Impact Assessment from the ATO as these measures are not expected to have an impact on other Departments or have a cost, given their minor nature and the fact that they are intended to codify existing practice.

Please contact me if you'd like to discuss any aspect of the measure.

Regards,

s22

Senior Adviser

Company Tax Unit, Business Tax Division
The Treasury, Langton Crescent, Parkes ACT 2600
phone: s22
mobile
fax: (02) 6263 4466
email: s22 treasury.gov.au

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FOI 2473
Document 24

Summary of the Regulatory and Compliance impacts of the Company loss recoupment rules proposal

	Amendment	Description of proposed amendment	Sought by		Impact	
			Business and professional groups	Australian Taxation Office	Regulatory	Compliance
s22						
c)	Modified COT: Interposed entity	Ensure the concessional tracing rules apply where an entity interposed between a relevant stakeholder and the loss company demerges	✓	✓	Nil	Insignificant positive
s22						

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Best Practice Regulation – Is a RIS required?

The Office of Best Practice Regulation (OBPR) assesses all regulatory proposals to determine whether a regulation impact statement (RIS) is required. This form will help you identify the key features of your regulatory proposal, which, in turn, will allow us to quickly assess whether an RIS is required.

Overview

Name of department/agency | The Treasury

Name of proposal | Income Tax: Refining the company loss recoupment rules

s22

First, under the modified COT, concessional tracing rules apply so that companies can stop tracing ownership where, broadly, a relevant direct or indirect stakeholder has a less than 10 percent stake in the loss company in a range of circumstances. It is proposed to extend the circumstances in which the concessional tracing rules apply, to give taxpayers more certainty, so that the rules apply where:

- an entity is interposed between relevant direct stakeholders and the loss company (consistent with rules that apply to relevant indirect stakeholders);
- an entity that is interposed between relevant stakeholders and the loss company demerges; or

- a foreign entity that is interposed between a stakeholder and the loss company issues bearer depository receipts (consistent with the bearer share rules).

s22

Likely impact on the business and not-for-profit sectors

Is your proposal likely to have any regulatory impacts? If so, please specify.

This proposal only affects corporate taxpayers in very limited circumstances. The proposed amendments are machinery in nature and are not expected to have any regulatory impact.

Is your proposal likely to affect compliance costs? If so, how?

This proposal has been sought by business and professional groups to overcome technical difficulties that currently arise under the company loss recoupment rules. The amendments are of a minor technical nature and companies will not be required to collect or report any additional information, retrain staff or engage new staff in order to comply with the proposal.

The amendments relating to the modified COT extend the application of the existing concessional tracing rules. As these rules are designed to reduce the compliance burden for widely held companies applying the COT, it is expected that this part of the proposal may marginally reduce compliance costs. However, as the amendments are of a minor technical nature and will apply in very limited circumstances, this effect is not expected to be significant.

The amendments relating to the general COT and to the loss integrity rules confirm existing practice and are not expected to have any impact on compliance costs.

Timing

Key dates and timeline:

These measures are expected to be announced in the 2011-12 Budget and will apply from the 2011-12 income year.

Contact Information

Please enter your contact information below.

Name: s22

Email: s22 @treasury.gov.au

Phone: s22

Date: 24/3/2011

Please forward the completed form to the OBPR (helpdesk@obpr.gov.au) or call 6215 1955 to discuss your proposal with an OBPR officer.

FOI 2473
Document 26

Improvements to the company loss recoupment rules

Consultation Paper
July 2011

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ISBN

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Consultation Process

Request for feedback and comments

The Government seeks your feedback and comments on the issues outlined in this consultation paper. The information obtained through this process will inform the Government's approach on the way forward.

While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 26 August 2011

Email:	companylosses@treasury.gov.au
Mail:	The General Manager Business Tax Division The Treasury Langton Crescent PARKES ACT 2600
Enquiries:	Enquiries can be initially directed to Teresa Bostle (Ph 02 6263 3005) or Tony Regan (Ph 02 6263 3334)

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1. BACKGROUND

1. As part of the 2011-12 Budget, the Government announced that it will improve the operation of the company loss recoupment rules by simplifying the continuity of ownership test in certain circumstances and removing some minor technical defects.

2. This consultation paper forms the basis for consultation on these proposals and sets out, in broad terms, the way they may be implemented. The purpose of this consultation paper is to provide interested parties with an opportunity to comment on the policy design of the proposals.

3. It is expected that there will be a further opportunity to comment on exposure draft legislation.

4. All legislative references in this paper are to the *Income Tax Assessment Act 1997*.

2. OUTLINE OF THE CURRENT LAW

5. Under the company loss recoupment rules, a company is able to deduct prior year losses, or apply net capital losses, only if it satisfies the continuity of ownership test or the same business test (section 165-10).

2.1 CONTINUITY OF OWNERSHIP TEST

6. The continuity of ownership test is satisfied if the same persons have more than 50 per cent of the voting power, rights to dividends and rights to capital distributions at all times during the ownership test period (section 165-12). The ownership test period is generally the period between the start of the income year in which the loss was incurred (the loss year) and the end of the year in which the loss is sought to be recouped (the claim year).

7. Generally, a company must trace ownership through to the ultimate beneficial owners of the shares in the company to determine whether the continuity of ownership test is satisfied.

8. To reduce compliance costs, these rules are modified for widely held companies and certain other types of companies (Division 166). Under the modified continuity of ownership test, broadly:

   - ownership is tested at certain points in time (rather than throughout the whole of the ownership test period); and

   - concessional tracing rules apply so that it is not necessary to trace ownership through to the ultimate beneficial owners of the shares in the test company in some circumstances.

2.2 SAME BUSINESS TEST

9. The same business test is satisfied if the company is carrying on the same business in the claim year as it carried on immediately before the test time (section 165-13). For these purposes, the test time is generally the time that the company failed the continuity of ownership test.

2.3 LOSS INTEGRITY RULES

10. If a change occurs in the ownership or control of a company that has an unrealised net loss, the loss integrity rules apply to prevent the company, to the extent of the unrealised net loss, having capital losses taken into account, or deducting tax losses, in respect of CGT events that happen to CGT assets that it owned at the time of the change, unless it satisfies the same business test (Subdivision 165-CC). For the purpose of applying Subdivision 165-CC, a company may choose to disregard CGT assets acquired for less than $10,000 (subsection 165-115A(1B)).

11. Similarly, when an alteration takes place in the ownership or control of a company, and significant equity and debt interests that non-individual entities have in the company are realised, multiple recognition of the companies losses are prevented by the rules in Subdivision 165-CD. To apply Subdivision 165-CD, the company must work out its adjusted unrealised loss (section 165-115U). This requires the company to work out its notional losses in respect of CGT assets that it owned at the relevant time (section 165-115V). For the purpose of working out its notional losses, CGT assets acquired by the company for less than $10,000 are disregarded (subsections 165-115GC(6) and 165-115V(2)).

3. OUTLINE OF IMPROVEMENTS TO THE COMPANY LOSS RECOUPMENT RULES

12. The operation of the company loss recoupment rules will be improved by:

- modifying the ordinary continuity of ownership test so that, where shares are held by a complying superannuation fund, a complying approved deposit fund, a first home savers account trust, a special company or a managed investment scheme, the company is not required to trace ownership through that entity;

- extending the concessional tracing rules under the modified continuity of ownership test where direct and indirect stakeholders have a less than 10 per cent stake in the loss company so that they apply where:

  – an entity is interposed between relevant direct stakeholders and the loss company;

  – an entity that is interposed between relevant stakeholders and the loss company demerges shares in the loss company or interests in another entity interposed between itself and the loss company; or

– a foreign listed company that is interposed between a stakeholder and the loss company issues bearer depository receipts;

- extending the concessional tracing rules under the modified continuity of ownership test so that they apply where an entity is interposed between the loss company and a relevant stakeholder that is a complying superannuation fund, a foreign superannuation fund regulated under a foreign law, a complying approved deposit fund, a first home savers account trusts, a special company or a managed investment scheme; and
- clarifying that, for the purpose of applying the modified continuity of ownership test when a corporate change happens because new shares have been issued in a company, the corporate change ends when all of the new shares are issued.

13. Finally, the loss integrity rules will be modified so that, for the purpose of applying the low value asset exclusions, all membership interests in an entity, which are owned by the test company at the relevant times, will be treated as a single asset.

4. MODIFICATIONS TO THE CONTINUITY OF OWNERSHIP TEST

14. For the purpose of applying the continuity of ownership test, the tests for finding out whether a company has maintained the same owners are contained in Subdivision 165-D.

15. A company satisfies the continuity of ownership test if it satisfies the primary test or the alternative test in respect of voting power, rights to dividends and rights to capital distributions during the ownership test period (sections 165-150, 165-155 and 165-160).

16. The primary test is satisfied if there are persons who, at a particular time, beneficially own between them shares that carry the right to:

- exercise more than 50 per cent of the voting power in the company;
- receive more than 50 per cent of any dividends that the company may pay; and
- receive more than 50 per cent of any distribution of capital of the company.

17. The alternative test is satisfied if, broadly, it is the case, or it is reasonable to assume, that there are persons (none of whom are companies or, in the case of voting power, companies or trustees) who at a particular time directly or indirectly:

- control, or are able to control, more than 50 per cent of the voting power in the company;
- have the right to receive for their own benefit more than 50 per cent of any dividends that the company may pay; and
- have the right to receive for their own benefit more than 50 per cent of any distribution of capital of the company.

18. For the purpose of applying these tests, shares held by, broadly, government entities, non-profit companies and charitable bodies are taken to be beneficially owned by a person who is not a company, and in the case of charitable bodies that are a trust, is neither a company nor a trustee (section 165-202). As a result, it is not necessary to trace through shares held by these entities to determine ultimate beneficial ownership.

Proposed changes

19. It is proposed to amend section 165-202, or insert an additional subsection that has the same effect, so that it covers shares held by an entity that is:

- a complying superannuation fund;
- a foreign superannuation fund regulated under a foreign law;
- a complying approved deposit fund;
- a first home savers account trust;
- a special company (as defined in subsection 995-1)(1);
- a managed investment scheme registered under the *Corporations Act 2001*, or recognised under an equivalent foreign law as an entity with similar status; or
- an entity prescribed by the *Income Tax Assessment Regulations 1997*.

20. However, the concessional tracing rules will not apply to entities with less than 10 members, mirroring the integrity rules in section 166-245.

21. As a result, it will generally not be necessary to trace through the shares held by these entities to determine ultimate beneficial ownership.

22. The scope of this exception is consistent with the scope of a similar exception that applies under the modified continuity of ownership test (see subsections 166-245(2) and (3)).

5. Extension of the concessional tracing rules under the modified continuity of ownership test

23. To reduce compliance costs, the operation of the continuity of ownership test will be modified for widely held companies and eligible Division 166 companies (together known as 'tested companies') seeking to deduct tax losses or apply net capital losses.

24. A primary benefit of the modified continuity of ownership test is that concessional tracing rules apply so that it is not necessary to trace ownership through to the ultimate beneficial owners of the shares in the tested company where, broadly:

- direct stakes of less than 10 per cent are held in the tested company (section 166-225);

- indirect stakes of less than 10 per cent are held in the tested company (section 166-230);
- stakes between 10 per cent and 50 per cent in the tested company are held directly or indirectly by a widely held company (section 166-240);
- stakes in the tested company are held directly or indirectly by a superannuation fund or certain other types of entities (section 166-245);
- bearer shares are held in foreign listed companies that hold stakes, directly or indirectly, in the tested company (section 166-255); or
- depository entities hold stakes in foreign listed companies that hold stakes, directly or indirectly, in the tested company (section 166-260).

25. The proposed improvements to the modified continuity of ownership test will extend the circumstances in which these concessional tracing rules apply.

5.1 HOLDING COMPANY INTERPOSED BETWEEN A DIRECT STAKEHOLDER AND THE TESTED COMPANY

26. Where a stakeholder has a direct stake in the tested company that carries rights to less than 10 per cent of the voting power, dividends and capital distributions, it is not necessary to trace through to the ultimate beneficial owners (section 166-225). This is achieved by treating all direct stakes of less than 10 per cent as being held by a single notional entity that is a person.

27. A similar concession applies where a stakeholder has an indirect stake in the tested company that carries rights to less than 10 per cent of the voting power, dividends and capital distributions (section 166-230). In these circumstances, the ownership tracing rules are applied as though the top interposed entity is a single person.

28. A problem arises if, during the test period, a holding company is interposed between the tested company and a less than 10 per cent direct stakeholder. In these circumstances, the stake will be attributed to the interposed company under section 166-230 from that time onwards, rather than the single notional entity to whom the stake was initially attributed to under section 166-225. Consequently, the tested company may fail the continuity of ownership test, even though the interposition of the holding company does not change the ultimate beneficial ownership of the tested company.

Proposed changes

29. It is proposed to amend section 166-225 where:

- a new entity (the interposed entity) acquires all the shares or other interests in the tested company;
- an entity that was, before the interposition, a less than 10 per cent direct stakeholder acquires, directly or indirectly, all the shares or other interests in the interposed entity;

- the new interposed entity has the same classes of shares or other interests as the tested company;

- if the new interposed entity is a company — the shares are not redeemable shares; and

- in any case — each stakeholder holds the same proportion of total voting stakes, dividend stakes or capital stakes in the new interposed entity immediately after the acquisition as the stakeholder held in the tested company immediately before the acquisition.

30. In these circumstances, section 166-225 will apply as if, during the test period, the new interposed entity is a person (other than a company) who is the same single notional entity under subsection 166-225(2), or the new interposed entity is taken to have held the stake of the single notional entity at all relevant times.

31. As a result, the same single notional entity will be taken to hold the stakes in the tested company before and after the entity is interposed between the direct stakeholder and the tested company. Therefore, the interposition of a holding company between the tested company and a less than 10 per cent direct stakeholder will not, of itself, cause a failure of the continuity of ownership test.

5.2 DEMERGER BY A TOP INTERPOSED ENTITY

32. Where a stakeholder has an indirect stake of less than 10 per cent in the test company, it is not necessary to trace through to the ultimate beneficial owners of the stake in the test company. Instead, the indirect stake of less than 10 per cent is attributed to the top interposed entity (section 166-230).

33. If the top interposed entity demerges shares in the tested company, or interests in another entity interposed between itself and the tested company, the legal owner of the 10 per cent indirect stake changes. As a result, the concessional tracing rules cease to apply as the indirect stake is either attributed to a different top interposed entity, or is a stake that is held directly, from that time onwards (even though no change in the ultimate beneficial ownership of the stake arises as a consequence of the demerger).

34. If the tested company applies the ordinary continuity of ownership test, it will need to trace ownership through to the ultimate beneficial owners and, all other things being equal, will continue to pass the continuity of ownership test. However, it will inappropriately lose access to the compliance cost benefits that arise under the concessional tracing rules for widely held companies and eligible Division 166 companies.

Proposed changes

35. It is proposed to amend section 166-230 so that it will continue to apply where the top interposed entity demerges.

36. That is, it is proposed to amend section 166-230 where:

- the top interposed entity is a company or a trust;

- a demerger (as defined in subsection 995-1(1)) happens to a demerger group, of which the top interposed entity is the head entity (as defined in subsection 995-1(1));

- as a consequence of the demerger, one or more entities that previously held an indirect stake in the tested company continues to hold an indirect stake, or begins to hold a direct stake, in the tested company;

- the demerged entities have the same classes of shares or other interests as the top interposed entity;

- if the top interposed entity demerges shares in the tested company or another company interposed between itself and the tested company, the shares are not redeemable shares; and

- each stakeholder holds the same proportion of total voting stakes, dividend stakes or capital stakes in the demerged entities immediately after the demerger as the stakeholder held in the top interposed entity immediately before the demerger.

37. In these circumstances, section 166-230 will apply as if, at the times the entity that holds or is taken to hold the demerged shares or other interests is also taken to have held that stake, the top interposed entity at all times held, or is taken to have held, a stake in the tested company;

38. As a result, the same entity will be taken to hold the stakes in the tested company before and after the demerger by the top interposed entity.

5.3 Entity interposed between a superannuation fund and the tested company

39. Concessional tracing rules also apply where a stake is held directly or indirectly by certain specified entities (section 166-245). The specified entities are, broadly:

- a complying superannuation fund;

- a foreign superannuation fund that is regulated under a foreign law;

- a complying approved deposit fund;

- a first home savers account trust;

- a special company – that is, broadly, a mutual affiliate company, a mutual insurance company, an Australian trade union or a sporting club; or

- a managed investment scheme.

40. In these circumstances, if the specified entity has more than 10 members, the tracing rules apply as if the specified entity were a person (other than a company or a trustee) who held the relevant stakes in the tested company.

41. If the specified entity has 10 or fewer members, each of the members is taken to hold an equal proportion of the specified entity's voting, dividend and capital stakes in the tested company. Each member is also treated as a person (other than a company or a trustee), regardless of whether the member is actually an individual.

42. If applying the rule for a specified entity with 10 or fewer members leads to each of those members being attributed with less than 10 per cent of the voting, dividend and capital stakes in the tested company, the tracing rules apply as if the specified entity were a person (other than a company or a trustee) who held the relevant stakes in the tested company.

43. However, these concessional tracing rules cease to apply if a holding company is interposed between the specified entity and the tested company (even though the ultimate beneficial owners of the tested company remain the same following the interposition of the holding company). This is because such an interposition will infringe the same share same interest rule in subsection 166-272(2), which requires that the only shares in the tested company that are taken into account are exactly the same shares and are held by the same persons. The shares in the tested company were held at the beginning of the tested company's test period by the specified entity, and at some point in the test period they start to be held by the interposed holding company. To overcome this problem, the tested company must rely on the saving rule in subsection 166-272(8).

44. The saving rule in subsection 166-272(8) requires the tested company to determine whether less than 50 per cent of the loss (or other attribute) has been duplicated by stakeholders in the tested company. This gives rise to additional compliance costs for widely held companies and eligible Division 166 companies.

45. If a holding company is interposed between the tested company and a specified entity, then the stakeholder will continue to hold an indirect stake in the tested company. In these circumstances, section 166-245 should apply to modify the ownership tests.

Proposed changes

46. It is proposed to amend section 166-245 where:

- a new entity (the interposed entity) acquires all the shares or other interests in the tested company;
- a specified entity acquires, directly or indirectly, all the shares or other interests in the interposed entity;
- the new interposed entity has the same classes of shares or other interests as the tested company;
- if the new interposed entity is a company — the shares are not redeemable shares; and
- in any other case — the specified entity holds the same proportion of total voting stakes, dividend stakes or capital stakes in the new interposed entity immediately after the acquisition as it held in the tested company immediately before the acquisition.

47. In these circumstances, the condition in paragraph 166-245(1)(a) (which requires a specified entity to directly or indirectly hold a relevant stake in the tested company) will continue to be satisfied for the purposes of applying section 166-245 to the specified entity, without infringing the same share same interest rule in subsection 166-272(2) and thus not having to satisfy the saving rule in subsection 166-272(8).

48. As a result, the interposition of the new entity between the tested company and the specified entity will not, of itself, cause a failure of the continuity of ownership test.

5.4 Bearer depository receipts

49. Bearer shares are negotiable instruments which accord ownership of shares in a company to the person who possesses the bearer share certificate. The owners of bearer shares are not recorded in the share register. Rather, the transfer of bearer shares occurs through the physical handover of the share certificate. Accordingly, it is not ordinarily practicable for a company to trace ownership through bearer shares.

50. Consequently, a concessional tracing rule applies to bearer shares carrying voting, dividend or capital stakes of 50 per cent or more in a foreign listed company that has a direct or indirect stake in the tested company, provided that certain conditions are satisfied (section 166-255). If the tracing rule applies, a single notional entity (being a person other than a company) is taken to control the voting power in, and have the right to receive any dividends or capital distributions from the tested company, that are carried by the bearer shares.

51. Due to regulatory requirements relating to the transfer of shares that apply in the Netherlands, shares in a Netherlands parent company are often held by a stichting (which has some legal features of an Australian company and some legal features of an Australian trust). In exchange for each share in the Netherlands parent company, the stichting issues a bearer depository receipt. The bearer depository receipt represents an economic and beneficial interest in the Netherlands parent company and is effectively equivalent to the ownership of a share. The bearer depository receipts are listed for quotation in the official list of an approved stock exchange.

52. Bearer depository receipts are essentially equivalent to bearer shares. However, the concessional tracing rules do not apply to bearer depository receipts because they do not satisfy the conditions in section 166-255.

Proposed changes

53. It is proposed to modify section 166-255 so that bearer depository receipts issued by an interposed foreign entity that are listed for quotation in the official list of an approved stock exchange are eligible for the same concessional tracing rules as bearer shares.

54. That is, it is proposed to amend section 166-255 so that the following paragraphs refer to bearer depository receipts (in addition to bearer shares):

- paragraph 166-255(1)(e);
- paragraph 166-255(1)(f);

- subsection 166-255(2) (before paragraph (a));
- paragraph 166-255(2)(a); and
- paragraph 166-255(2)(b).

6. APPLYING THE MODIFIED CONTINUITY OF OWNERSHIP TEST FOLLOWING AN ISSUE OF NEW SHARES

55. Under the modified continuity of ownership test, widely held companies and eligible Division 166 companies must maintain substantial continuity of ownership between the start of the test period and:

- the end of each income year in the test period; or
- the end of each corporate change in the test period (subsection 166-5(3)).

56. A corporate change can occur in a number of ways (section 166-175). One way that a corporate change can happen is if the company issues new shares resulting in an increase of 20 per cent or more in either the issued share capital of the company or the number of the company's shares on issue (paragraph 166-175(1)(d)).

57. Currently, when a corporate change is brought about by the issue of shares, the corporate change ends when the offer period for the issue of shares ends (paragraph 166-175(2)(c)). In some circumstances all the new shares may not have been issued before the end of the offer period. If the test is applied before all the new shares are issued, all changes in ownership arising from the issue of the new shares may not be captured.

58. It is likely that a company will have a significant change of ownership when a corporate change happens. Therefore, the modified continuity of ownership test is applied at that time to determine whether it causes a failure of the continuity of ownership test. Consequently, if the corporate change happens because of an issue of shares, it is clear that all of the new shares that are issued need to be taken into account when applying the continuity of ownership test.

Proposed changes

59. It is proposed to amend paragraph 166-175(2)(c) to clarify that, where a corporate change is brought about by the issue of shares, the corporate change ends when all of the new shares are issued.

7. Loss integrity rules – low value asset exclusion

60. If a change occurs in the ownership or control of a company that has an unrealised net loss, the loss integrity rules apply to prevent the company, to the extent of the unrealised net loss, having capital losses taken into account, or deducting tax losses, in respect of CGT events that happen to CGT assets that it owned at the time of the change, unless it satisfies the same business test (Subdivision 165-CC). For the purposes of applying Subdivision 165-CC, a company may choose to disregard CGT assets acquired for less than $10,000 (subsection 165-115A(1B)).

61. Similarly, when an alteration takes place in the ownership or control of a company, and significant equity and debt interests that entities (not being individuals) have in the company are realised, multiple recognition of the company's losses are prevented by the rules in Subdivision 165-CD. To apply Subdivision 165-CD, the company must work out its adjusted unrealised loss (section 165-115U). This requires the company to work out its notional losses in respect of CGT assets that it owned at the relevant time (section 165-115V). For the purpose of working out its notional losses, CGT assets acquired by the company for less than $10,000 are disregarded (subsections 165-115GC(6) and 165-115V(2)).

62. Where a company owns CGT assets that are membership interests in another entity (such as shares in a company or units in a unit trust), there is some doubt as to whether each membership interest is treated as a separate asset for the purposes of applying the loss integrity rules. If this is the case then the effectiveness of the loss integrity provisions is compromised.

Proposed changes

63. It is proposed to amend subsections 165-115A(1B), 165-115GC(6) and 165-115V(2) so that all membership interests (as defined in subsection 995-1(1) in an entity which are owned by the test company at the relevant time are treated as a single asset for the purposes of applying the $10,000 threshold test.

8. Application date

64. The proposed amendments will apply to tax losses that a company seeks to deduct, and net capital losses that a company seeks to apply, in the 2011-12 income year or in a later income year.

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ATO MINUTE	668/2010	17 DECEMBER 2010	IN CONFIDENCE
FORMAT	MINUTE NO.	ISSUE DATE	CLASSIFICATION

ATO MINUTE

FILE REF: [FILE NO.]

TO:	Paul McCullough, General Manager, Business Tax Division
COPIES TO:	Michael Monaghan, FAC, Corporate Relations, Australian Taxation Office (ATO); Treasuryatogateway@treasury.gov.au Atotreasurygateway@ato.gov.au Anthony Regan, Manager Company Tax Unit, Business Tax Division, Treasury Margaret Haly, Assistant Commissioner, Losses and CGT Centre of Expertise, ATO David Allen, Assistant Commissioner, Losses, CGT and Consolidation Segment, LB&I, ATO Julia Neville, Assistant Commissioner, Revenue Analysis Branch, ATO
TREASURY REF:	Email dated 22 October 2010 from Anthony Regan

FROM:	s22 Senior Tax Counsel, Law Design Team, ATO		
BUSINESS LINE:	Law & Practice	SECTION:	Losses & CGT Centre of Expertise
CONTACT OFFICER:	s22	CONTACT PHONE:	s22
CONTACT FAX NO:	(02) 9374 2277	CONTACT EMAIL:	s22 @ato.gov.au
OTHER REFS:	Emails dated 30 September, 1 and 22 October 2010 between Anthony Regan and s22 (ATO)		

CATEGORY:

- (●) Suggested legislative amendments
  - [x] Minor technical amendments to the law - not Tax Issues Entry System (TIES) issues
  - [ ] Policy/Law change suggestion - substantive change in policy or law
- ( ) Pre Policy Approval
- ( ) Legislative Measures Development
- ( ) General - includes advice in relation to outcome of litigation/courtcases and TIES issues

ISSUE DATE:	17 December 2010	RESPONSE DATE:	17 February 2011
SUBJECT:	Amendments to the Company Loss Recoupment Rules		

RECOMMENDATION

That Treasury consider amendments to remedy two minor defects in the operation of the company loss recoupment rules in the context of the 2011-12 Budget process.

BRIEF OVERVIEW OF ISSUE

1 This minute explains minor technical defects impacting on the application of the company loss recoupment provisions. In particular, the first issue provides for tax planning opportunities with a consequent unintended cost to the revenue. Both issues are relatively simple to correct, self contained and with minimal compliance cost impact.

2 This Minute formalises discussions between Anthony Regan and the ATO's Robin Roach.

BACKGROUND & EXPLANATION

s22

4 The second issue, which deals with the operation of section 166-175 of the ITAA 1997 in relation to certain corporate changes, is discussed in Attachment 2.

5 Details of these suggested legislative amendments have been provided to Revenue Analysis Branch (RAB) for their information. Should Treasury require revenue costings for these two proposals, a costing request can be forwarded to RAB via the Tax Analysis Division of Treasury.

REQUIRED ACTION

6 I would appreciate if you could advise me, with a copy to the First Assistant Commissioner Corporate Relations, of your initial views on these issues within two months of receipt of this minute.

Ben Kelly
Assistant Commissioner
Law Design Team
Law & Practice

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ATTACHMENT 2

BACKGROUND & EXPLANATION

Issue 2 – Section 166-175 and certain corporate changes

Section Reference:	Paragraph 166-175(2)(c) of the ITAA 1997
Type: Amendment = change effect Correction = change expression	Amendment
Priority: High/Med/Low	Low
Context and why amendment needed:	If a corporate change occurs under section 166-175, a company must test its ownership at the time when the corporate change 'ends' under subsection 166-175(2). Where there is a corporate change as a result of an issue of shares under paragraph 166-175(1)(d), this corporate change ends under paragraph 166-175(2)(c) "when the offer period for the issue of share ends". However, at this time, the new share issue has still not occurred and therefore any resulting changes in ownership will not be captured at the test time.
Suggested Wording:	Amend the end time under paragraph 166-175(2)(c) to 'when the new share issue ends'.
Date of Effect:	Prospective from date of announcement
Closely related amendments: (and section reference)	Nil
Background: (where raised/by whom)	The need for amendment became apparent as a result of an inquiry from a tax practitioner who identified the flaw with the existing drafting of paragraph 166-175(2)(c).
Additional Information: (where appropriate)	
Last Updated: (provide date)	10 December 2010