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The Board of Taxation
C/- The Treasury
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by e-mail: taxboard@treasury.gov.au

12 March 2010
Our Ref: AMK

Dear Sir/Madam,

Post-implementation review into certain aspects of the consolidation regime

Deloitte welcomes the opportunity to assist in the consultation on the Board of Taxation's (Board's) discussion paper "Post-implementation review into certain aspects of the consolidation regime Discussion Paper" (the Board's Paper).

We appreciate the efforts that the Board has gone into identifying the issues relating to the tax consolidation regime. Our responses to the Board's questions are contained in the attachment to this letter. We hope that our response will assist the Board in its post-implementation review.

We welcome the opportunity to discuss our response in further detail. We would also be happy to provide further details in respect of any of our responses, should the Board require.

Liability limited by a scheme approved under Professional Standards Legislation.

If you have any queries or would like to discuss any aspect of our submission further, please contact Alexis Kokkinos on +61 (0) 3 671 7127.

Yours sincerely

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1 Executive summary

1.1 Background

In general, the tax consolidation provisions have helped to simplify and facilitate intra-group dealings. They have removed the need to consider a number of complex provisions and have helped to reduce the instances of double taxation. However, the tax consolidation provisions are complex, and their interaction with the rest of the Tax Act is also very complex. 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.

1.2 Single entity rule

As a core provision, we believe that the single entity rule operates appropriately in the majority of cases. However, we have identified five main issues with the single entity rule that warrant further review by the Board.

The first issue identified relates to the interaction of the single entity rule with other provisions of the Tax Act. We have outlined a number of provisions that may not operate appropriately and that may require further review or additional interaction provisions.

The second issue relates to the operation of the single entity rule and the characterisation of arrangements undertaken by the tax consolidated group. We believe that this area of the law may require further clarification in order to achieve the intended policy outcome as outlined in the EM to the introduction of the provisions.

The third issue involves the treatment of intra-group arrangements and possible blackhole expenditure issues. We believe that the Board should consider whether additional supporting principles are required to resolve these issues. We have provided a number of recommended solutions that could be considered to address this issue.

The fourth issue involves the perceived inconsistent application of the single entity rule in relation to a number of transactions or arrangements. We believe that the Board should consider circumstances where there is a deviation in applying the single entity rule and whether such issues should be addressed by way of supporting principles.

The fifth issue involves the structure of the provisions and location of supporting provisions. We highlight that single entity rule modifications are contained in several locations, and that the Board should consider a central location to reduce compliance costs.

Finally, we note that the Board should consider a balance between equity and compliance. Accordingly, this needs to be taken into account when considering the complexity of any supporting provisions to the single entity rule.

1.3 Interactions with other parts

There are a number of areas where the tax consolidation provisions do not operate as intended when applied for the purpose of the remainder of the Tax Act. We have provided our view as to whether this occurs in respect of issues raised by the Board (i.e. in relation to trusts, foreign hybrids, non-resident CGT rules, CGT event J1, foreign currency provisions, and Division 230). We have also highlighted a number of additional interaction issues and some recommendations that could be considered by the Board.

1.4 Inherited history rules

Up until recently, there have been significant issues with the way in which the tax cost setting amount was dealt with under an inherited history model. In our view, this issue resulted in a preference towards considering an 'acquisition' model for the tax consolidation regime.

However, *Tax Laws Amendment (2010 Measures No. 1) Bill 2010*, which was recently introduced into Parliament, is expected to address many of these uncertainties. Accordingly, the recent introduction of these measures seems to reduce the impediment for a change from an inherited history model to an acquisition model.

If such issues are appropriately addressed by the bill, then our concern with changing to a clean slate model is that it may result in significant additional compliance costs for corporate taxpayers with little or no change to the outcomes of the existing model. Accordingly, in our view, such a significant change should be approached with caution.

If such a change is to occur, it may be preferable that it occur in stages, so that it is easier for taxpayers to comply with the changes. We have provided our recommendations in this regard in our detailed submission.

1.5 Small business

In our view, we believe it is important for the Board to clearly identify the range of SME taxpayers that it is seeking to target with its review. In our view, we do not believe that the tax consolidation regime should be targeted at SME taxpayers with less than $2 million turnover. It would seem more appropriate to target SME taxpayers with a turnover of between $10 to $100 million.

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).

2 Chapter 2: Background

2.1 Business efficiency and integrity

Question 2.1(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 assessing whether the tax consolidation regime has been affective in increasing business efficiency and integrity of the Australian tax system, we believe it is important to consider paragraph 1.9 of the Explanatory Memorandum (EM) to the *New Business Tax System (Consolidation) Act (No. 1) 2002*, that introduced the tax consolidated regime:

> "9. Consolidation will address both efficiency and integrity problems existing in the taxation of wholly-owned entity groups, many of which arise from this inconsistent treatment. These include compliance and general tax costs; double taxation where gains are taxed when realised and then taxed, again on the disposal of equity; tax avoidance through intra-group dealings; loss cascading by the creation of multiple tax losses from the one economic loss; and value shifting to create artificial losses where there is no actual economic loss." [emphasis added]

It is clear, at the time the provisions were introduced, that Parliament had a view as to how the tax consolidation provisions would address the efficiency and integrity concerns of the pre-tax consolidation regime. Accordingly, in considering this question, we believe it is important to analyse the points raised in paragraph 1.9 of the EM in further detail.

2.1.1 Compliance costs

Our detailed response in relation to compliance costs is contained in our response to Question 2.1(b) in Section 2.2 of this submission. In summary, we are of the view that the tax consolidation provisions have provided a reduction in compliance costs in respect of the day to day administration of the tax affairs of a tax consolidated group and the preparation of tax returns.

However, such compliance cost savings have not been overly significant. That is, due to the accounting requirements contained in AASB 112 and UIG 1052, entities within the tax consolidated group have had to report their own tax effect calculations for accounting purposes.

Furthermore, the tax consolidation provisions are intrusive and require consideration of how they interact with almost all provisions of the Tax Act. Accordingly, compliance costs have generally been significantly higher where the tax consolidation provisions have had to be considered as part of specific complex transactions. In relation to this last point, such compliance costs would be expected in relation to the introduction of any major piece of legislation. Over time, we would expect that these types of compliance costs are likely to decrease.

2.1.2 Double taxation issues

Prior to the introduction of the tax consolidation regime, double taxation issues arose where the sale of shares, and the separate sale of the underlying asset held by the entity, resulted in the same economic gain being taxed twice.

The tax cost setting process contained in Division 705 and 711 has largely been successful in reducing these instances of double taxation, where the assets in question are held by a subsidiary member of a tax consolidated group. Accordingly, in our view, the provisions apply appropriately to reduce the instance of double taxation for tax consolidated groups in the majority of these cases.

We note, however, that the policy objective is limited to gains and losses derived by the same tax consolidated group. Accordingly, it is still possible for double taxation to occur where the tax consolidated group deals with a party outside of the tax consolidated group, or where equity interests in the tax consolidated group are disposed of by a party outside of the tax consolidated group. This may occur at the shareholder level, or even where a tax consolidated group has anything less than a 100% interest in another tax consolidated group.

While this raises broader policy issues of double taxation that could be addressed through reforms to the Tax Act, we understand that such issues would be considered outside of the scope of this review.

Furthermore, while the tax consolidation regime has been effective in eliminating instances of potential double taxation, there have been instances of double taxation that have occurred due to shortcomings and drafting errors contained in the provisions. Examples include the interaction of the CGT rules with the tax consolidation rules in respect of straddle transactions, and interaction issues in the tax cost setting process in an exit calculation under Division 711 (e.g. where there have been service receivables).

While recent amendments will address many of these anomalies, it is noted that there are still operational issues that could result in double taxation consequences in an exit scenario[1]. In our view, however, such instances of double taxation are rare. Accordingly, in general, we agree that the tax consolidation regime has been successful in addressing issues of double taxation, but for some minor technical issues with the provisions.

2.1.3 Tax avoidance through intra-group dealings

Chapter 25 of the *A New Tax System*: *A Platform for Consultation* (PFC) report, outlined many problems associated with the pre-tax consolidation system. One of those issues identified was the possibility of being able to avoid tax through intra-group dealings, "for example, [by] manipulating dealings between group companies to reduce or defer tax".

While details of such arrangements were not articulated in the report, it is noted that this may have been possible in a pre-tax consolidation context, as the grouping provisions at that time did not group, ignore, or re-characterise transactions in many instances.

However, compared to the pre-tax consolidation grouping provisions, the single entity rule has a much broader effect on intra-group transactions. That is, the tax implications of such transactions are effectively ignored. We believe, therefore, that the single entity rule has been effective in achieving this policy objective.

This view appears to be supported by the lack of any taxation rulings or taxpayer alerts over the past 8 years that highlight integrity concerns with the operation of the single entity rule and intra-group transactions.

2.1.4 Loss cascading

The issue of loss cascading, pre-tax consolidation, was raised in Chapter 25 of the PFC report. Prior to the introduction of the tax consolidation regime, Subdivisions 165-CC and CD were introduced to deal with this issue. It is noted that these provisions are significantly complex in operation and significantly increasethe compliance costs of taxpayers.

The tax consolidation regime provided the opportunity to eliminate the need to utilise specific loss cascading provisions through the operation of Division 705 and 711 and the tax cost model. The EM to the introduction of the tax consolidation provisions stated that

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[1] For example, intra-group straddle arrangements and the treatment of DTLs under Division 711 may still give rise to double taxation issues as highlighted in this submission.

the operation of the tax consolidation regime would effectively address integrity issues such as loss cascading.

However, after the introduction of tax consolidation regime, integrity provisions were inserted into Division 715 of the Tax Act through the *New Business Tax System (Consolidation And Other Measures) Act 2003*. These provisions were inserted to reduce the extent to which loss cascading could still occur in a tax consolidated context. These interaction provisions added (and still add) a significantly complex layer of interaction between the tax consolidation provisions and Subdivisions 165-CC, 165-CD, and 170-D.

In our experience, these provisions will only operate in a number of discrete circumstances. However, in order to assess whether the provisions apply, a taxpayer must consider these very complex provisions in detail in formation, acquisition and disposals cases involving tax consolidated groups.

It is our view that, if the tax consolidation provisions were successful in addressing the issue of loss cascading, then such interactions would not be required. Accordingly, it is difficult to conclude that the provisions have been successful in this regard.

That being said, we believe that addressing the loss cascading issues targeted by Division 715 could be achieved in a more efficient and less complex manner. We would welcome a review of the operation of Division 715 by the Board in this regard, with a view to simplifying these interaction provisions.

2.1.5 Value shifting

As with the loss cascading provisions, Division 715 also contains complex interaction provisions that deal with value shifting provisions contained in Division 723 to 727. However, in the majority of cases, the extension of the single entity rule contained in section 715-410 is effective in removing the need to consider these provisions for transactions that occur within a tax consolidated context. Accordingly, we agree that, within a tax consolidated group, the tax consolidation regime has been effective in achieving this objective.

2.1.6 Summary

In general, as outlined above, the tax consolidation provisions have helped to simplify and effectively facilitate intra-group dealings. They have removed the need to consider a number of complex provisions and have helped to reduce the instances of double taxation. However, the tax consolidation provisions are complex, and their interaction with the rest of the Tax Act is also very complex. 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 it has also 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.

2.2 Compliance costs

Question 2.1(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?

As stated in the EM to the introduction of the tax consolidation regime, it was expected that the introduction of the tax consolidation provisions would reduce tax compliance costs.

> The measures in this bill are expected to reduce ongoing compliance costs by ensuring that: intra-group transactions are ignored for taxation purposes, so that taxation and accounting treatment are more closely aligned; administrative requirements, such as multiple tax returns and multiple franking account, losses, foreign tax credit, and PAYG obligations, are reduced; and integrity measures aimed at preventing loss duplication, value shifting or the avoidance or deferral of capital gains within groups do not apply within a consolidated group.

However, in our experience, the introduction of the tax consolidation regime has had a mixed effect on compliance costs for corporate groups. The expected benefits referred to in the EM are discussed in further detail below. Furthermore, we also discuss the effect that retrospective amendments have and are likely to have on compliance.

2.2.1 Ignoring intra-group transactions

In general, the operation of the single entity rule allows groups to undertake intra-group transactions and simple restructuring arrangements without having to consider complex provisions of the Tax Act. Accordingly, we agree that this has reduced the need to consider provisions such as Division 170, Subdivision 126-B, and other grouping provisions when undertaking simple intra-group transactions.

2.2.2 Alignment of tax and accounting treatment

The alignment of tax and accounting outcomes is only possible where the tax and accounting consolidated group is exactly the same. Under AASB 127, the consolidation of accounting entities is much broader than that of tax entities. Correspondingly, MEC tax consolidated groups would not prepare consolidated Australian accounts. While the tax consolidation provisions rely on accounting concepts, we don't believe that this has led to a greater alignment of tax and accounting outcomes for a tax consolidated group.

2.2.3 Administrative requirements

Administratively, tax consolidated groups are only required to lodge one tax return. One would expect that this would lead to compliance savings in respect of completing and lodging tax returns.

However, this benefit has been somewhat diminished by the requirements under the accounting standard AASB 112, together with UIG 1052. Under those authoritative documents, the accounting provisions still require entities in a tax consolidated group to apply tax effect accounting on an entity by entity basis. Accordingly, in the majority of cases, entities within a tax consolidated group are still required to produce tax effect accounting calculations.

The way in which this is done is also affected by whether an entity has entered into a tax sharing / tax funding agreement between members of the group. Accordingly, in our view, the accounting requirement of AASB 112 and UIG 1052 has offset some of the administrative compliance benefits that were originally expected from the tax consolidation regime.

Given the fact that the consolidated group is only required to lodge one tax return and is required to pay PAYG instalments based on one taxpayer, it would seem that this has reduced, to some extent, compliance costs for a tax consolidated group, in a limited way (i.e. a reduction in the preparation and lodgement of such returns).

2.2.4 Integrity measures

As outlined above in Section 2.1, the complex integrity provisions that are aimed at loss duplication, value shifting, etc, still apply in relation to tax consolidated groups. Accordingly, complex interaction provisions still need to be considered in formation, acquisition and sale cases. We have recommended that these interaction provisions be considered further by the Board of Taxation, with a view to simplifying their application. The operation of these provisions gives rise to unnecessary compliance costs for tax consolidated groups.

2.2.5 Complexity of provisions

On no stretch, the tax consolidation regime and its interaction with the rest of the Tax Act is quite complex. The fact that the ATO has released a significant number of taxation rulings, ATOIDs, Consolidation Reference Manual guides and other materials suggests that the consolidation provisions and supporting EM as introduced have lacked an element of certainty.

While such material has helped in the understanding of the provisions, taxpayers have still faced high levels of compliance costs in understanding and applying such provisions to their own tax affairs. We note that, over time, this compliance cost is reduced as taxpayers have become familiar with the application of the provisions to their own affairs.

Accordingly, going forward, significant compliance costs are mainly incurred by groups that form a tax consolidated group for the first time, or (for ongoing tax consolidated groups) in relation to understanding the application of the tax consolidation provisions for complex transactions (discussed below).

2.2.6 Complex transactions

As outlined earlier, the operation of the single entity rule has led to a reduction in compliance costs in relation to simple intra-group type transactions. However, as the single entity rule is a broad based rule with limited interaction provisions, complex transactions require a proper and appropriate analysis of the operation of this rule in conjunction with other provisions of the Tax Act.

For example, a typical complex transaction may involve a creeping acquisition, coupled with a straddle transaction, scrip-for-scrip rollover, and a debt re-organisation. The interaction of the single entity rule with other parts of the tax law that apply to all of these components of the transactions can be quite complex, especially where all provisions must be considered in the one transaction.

Furthermore, as outlined in this submission, there are occasions where the interaction of the tax consolidation provisions with other provisions of the Tax Act is uncertain. In such cases, it is often difficult to ascertain the tax outcome with any degree of certainty. This can give rise to increased compliance costs in determining the correct and appropriate outcome under the tax consolidation provisions.

While, arguably, taxpayers can obtain certainty through a private binding ruling in respect of certain transactions, most of these types of complex transactions are completed within a short time frame, making it difficult to obtain a ruling in the timeframe required.

We note that such complex transactions occur rarely in respect of any one tax consolidated groups. Furthermore, we also note that the ATO should be commended for its significant work in producing a significant number of taxation rulings, ATOIDs, analysis in the consolidation reference manual and other guidance materials on the interaction of the single entity rule with many provisions of the Tax Act.

Accordingly, while the application of the tax consolidation provisions to these transactions has been quite complex, we are thankful that the ATO has appropriately invested significant resources in assisting with the understanding of the law and the reduction of taxpayer compliance costs over time.

2.2.7 Retrospective legislative amendments

As expected with any complex piece of legislation, there will be occasions where amendments will be required to ensure that the provisions operate as originally intended. With tax consolidation, there has been a significant number of amending bills that have had retrospective application dates. It is noted that most of these retrospective amendments have been for the benefit of taxpayers.

However, the recently introduced *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* contains a number of significant amendments that have effect from 1 July 2002, which will require a revisiting of all formation and post formation entry and exit calculations. Some of these amendments apply mandatorily, while others are elective.

In particular, we highlight amendments that have been made to section 701-55, section 715-370, section 716-405, section 716-410 and section 705-25. We reiterate that many of these amendments are favourable to taxpayers as they clarify the intended operation of the law. However, it is noted that to comply with the amendments, and thus obtain the relevant intended outcome, will likely result in significant compliance costs associated with re-computations.

We understand that CGT event L6 provides an opportunity to save on compliance costs by taking an error on a reset cost base asset as being either a capital gain or capital loss. However, this outcome may not be appropriate where the reset cost base asset is otherwise a revenue asset.

2.3 Barriers to entry

Question 2.1(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

Our response to this question is addressed in Question 6.1.

3 Chapter 3: Operation of the single entity rule

3.1 Objectives of the single entity rule

Question 3.1(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?

Our comments made at Section 2.1 and 2.2 of this submission were made broadly in relation to the principles of tax consolidation. In those sections, we highlighted that the core principles of tax consolidation include the operation of the single entity rule and the inherited history rules.

Accordingly, our discussion in those sections of this submission is equally applicable here. 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. We have summarised the issues in four broad categories in Section 3.2 below.

3.2 Issues with the single entity rule

Question 3.1(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?

We believe that there are four broad categories of issues in respect of the single entity rule that the Board may wish to consider reviewing. While such issues do not arise frequently, we have outlined our concerns below.

3.2.1 Interaction of single entity rule with other provisions

As highlighted in the Board's Paper, there are a number of provisions that do not interact with the single entity rule appropriately. However, the Board's Paper has only identified a small number of these provisions. In Section 3.13 below, we have highlighted a greater number of provisions that may require further analysis and consideration by the Board. We note that uncertainty relating to the application of these provisions in relation to the single entity rule can give rise to higher compliance costs in applying the tax consolidation provisions.

3.2.2 Intra-group assets and liabilities

There are a number of intra-group arrangements that have been identified to date where the single entity rule may not apply appropriately. While the ATO provided a discussion paper on this issue on 23 November 2006, there is currently a lack of certainty in respect of how the provisions apply (or should apply) in relation to those types of transactions. Where such transactions do occur, they can generally result in blackhole expenditure for the consolidated group. This issue is discussed further at Section 3.7 below.

3.2.3 Single entity rule and character issues

To date, there has been little guidance as to the effect of the single entity rule on the character of transactions undertaken by the tax consolidated group. The only real guidance provided on this issue is contained in the original EM to the provisions. As outlined below, the provisions indicated that (in general) the tax consolidation provisions should not affect the character of a transaction entered into by the tax consolidated group.

> <u>Characterisation of assets and transactions</u>
>
> 2.26 Following an election to consolidate, the single entity rule has the effect that for the purposes of assessing the income tax position of the head company, the head company is taken to hold all the assets and liabilities of its subsidiaries and to enter into the transactions of its subsidiaries. This is because the subsidiary members are treated as if they are parts of the head company for income tax purposes.
>
> 2.27 With the exception of intra-group dealings, the mere act of consolidation is not expected to change the character of transactions, where assets continue to be held by a consolidated group in the same manner as held by a member of the group prior to consolidation.
>
> 2.28 As is the situation under current law, it may be relevant to consider the nature of a transaction undertaken by a subsidiary member of a wholly-owned group in the context of the activities of the group as a whole, in order to determine the income tax character of a particular act or transaction in an assessment of the consolidated group. The income tax character of a transaction undertaken by a consolidated group will continue to be a question of fact to be determined in the light of all the relevant circumstances.
>
> 2.29 It is possible for assets of the same type to be held for dual purposes within one wholly-owned group. For example, at any point in time one piece of land may be held as trading stock (e.g. for the purposes of land development) while another may be held as a capital asset (e.g. for the purposes of housing business premises) by a group. If that wholly-owned group chooses to consolidate, the current law will apply using existing principles and case law. Transactions under consolidation are subject to the same scrutiny for the purposes of characterisation as those involving a single taxpayer.

To demonstrate this issue of uncertainty, consider the simple case where a corporate group, before it consolidated, had a finance entity that provided finance to the group. Assume that the finance company only provided finance infrequently to non-wholly owned group entities. The finance entity would potentially have been considered to be in the business of money lending.

However, consider the position when the corporate group forms a tax consolidated group. While the finance entity still exists in the group, a question arises as to whether the single entity rule means the tax consolidated group would be considered to be in the business of money lending. In our view, and consistent with the EM, the single entity rule should not ignore the fact that the group conducts significant finance activities internally. Accordingly, the head company of the tax consolidated group should not be precluded from being considered to be in the business of money lending. This is consistent with TR 2007/2 which states:

> 18. Activities, undertakings and enterprises taking place within a consolidated group (not involving the derivation of income through dealings outside the group) will be relevant for characterising the business of the head company. This will be the case notwithstanding the fact that individual transactions between group members will not be recognised as happening under the same business test because of the single entity rule which treats group members as parts of the head company for the purpose of determining its income tax liability.

That being said, the ATO has not formalised such a view in respect of all intra-group dealings and has not effectively incorporated that view into its ruling on the operation of the single entity rule (TR 2004/11).

Accordingly, as outlined above, the issue of characterising the business and transactions of the head company can be somewhat uncertain under the single entity rule. We note that similar issues may also occur in relation to the sale of the shares in a subsidiary entity (i.e. in applying TD 2006/36), whether assets are held on revenue or capital account by the head company under the single entity rule, and whether assets are held as trading stock when such stock is sold between group members.

3.2.4 Inconsistent application of the single entity rule

There are a number of occasions where the single entity rule has been applied differently or inconsistently by the ATO. The Board's Paper limits the exception to debt instruments. However, this inconsistency occurs more frequently than suggested in the Board's Paper.

We believe that it is important for the Board to identify these inconsistencies at the first instance and then determine whether systemic issues need to be addressed in relation to the operation of the single entity rule. We highlight some of these inconsistencies below.

a *<u>Treatment of intragroup arrangements</u>*

The Board's Paper highlights a difficulty in the "Divisional model" and its application to certain types of transactions. One of those transactions is the treatment of debt like arrangements. Generally, the ATO has taken a view that the sale / assignment of an intragroup assets is treated as a disposal under CGT event A1 (per TD 2004/34, 2004/35, and 2004/39). However, the ATO hold that an exception occurs for debt like instruments, where the sale / assignment is treated as the creation of a right (TD 2004/33 and 2004/83).

However, we question whether this analysis is indeed correct and 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 the 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.

Accordingly, it would appear that such issues can be resolved if there is further legislative guidance provided in respect of the treatment of these types of arrangements.

b *<u>Treatment of intragroup debt arrangements</u>*

Example 3.1 of the Board's Paper is predicated on the view that the acquisition of an intra-group debt achieves the correct policy outcome where it does not result in an amount being recognised for tax purposes.

However, we question whether this view contained in the Board's Paper in fact does achieve the correct outcome. That is, the treatment of the debt arrangement under the single entity rule in this way does not produce similar results to an arrangement that is actually entered into by a single entity. That is, repayment of a debt instrument at a loss may give rise to tax consequence that is different where it is undertaken by a single entity as compared to a tax consolidated group. We demonstrate this at Section 3.7.2 below.

Inconsistent treatment of the single entity rule allows for multiple interpretations of the single entity rule for different circumstances, increasing the compliance costs of applying the provisions to intra-group arrangements. Accordingly, we highlight such instances for consideration by the Board. It would appear that such issues can be resolved if there is further legislative guidance provided in respect of the treatment of these types of arrangements.

c *Treatment of intragroup membership interests*

There are a few instances where membership interests are treated differently under the single entity rule. For example, paragraphs 5 and 6 of TD 2004/48 takes the view that the shares in a demerged entity can be recognised, even though the entity is to be treated as a part of the head company. Furthermore, in accordance with TD 2004/40, the sale of shares is not treated as an issue of shares, but rather results in CGT event A1.

This can be compared to paragraph 20 of TD 2006/47 in relation to MEC refinancing arrangements. The TD takes the view that the SER can be used to reconstruct the transaction involving the sale of shares. The sale of shares is seen as an effective issue of shares. The determination states:

> 20. In the context of the Roberts and Smith decision, from the head company's perspective, the payment for the shares in the ET-1 company is therefore like a repayment of the head company's share capital. Where borrowed funds are used to buy the shares, those funds are effectively seen as a replacement for a source of funding that was previously used in the business of the head company of the consolidated group. Therefore, the head company may be allowed a deduction for interest paid on those funds subject to the limitations expressed in TR 95/25 (for example, the limitations in paragraph 16).

While the views expressed in these TDs achieve, what we consider to be, the correct policy outcome in those circumstances, they represent an inconsistent application of the law to two different transactions. This inconsistency can make it difficult to determine the correct view of the operation of the single entity rule to the sale of an intragroup asset such as shares.

To demonstrate this problem, take the case where a subsidiary member of an eligible tier-one company is transferred to the top company (but remains a member of the group as an eligible tier-one company in its own right), a question arises as to whether the sale of the shares should be seen as a sale (and subject to CGT event A1) or an issue of shares. The treatment of the arrangement as an issue of shares produces the correct tax outcome (as the law does not allow a cost base to be recognised for the shares). This can be supported by TD 2006/47. However, the ATO has taken the view that the arrangement is a sale of shares and thus a taxable event under CGT event A1. As no cost base can be calculated for the shares, the ATO view results in a capital gain equal to the gross proceeds received. This clearly produces an inappropriate outcome.

As demonstrated above, the inconsistent views in respect of arrangements can result in uncertainty and, therefore, increase compliance costs from applying the single entity rule.

d *Preparation of accounts*

The ATO has also applied the single entity rule in an inconsistent manner in determining the relevant financial accounts that are to be used in applying certain tax provisions.

For example, in paragraph 5 and 6 of TD 2006/7 dealing with functional currency elections, the determination states that:

> 5. The single entity rule, by which subsidiary members of a consolidated group are deemed to be parts of the head company rather than separate entities while they are members of the group, operates only for the purposes of working out income tax liability and losses (per section 701-1 of the ITAA 1997). 6. The single entity rule does not affect the obligation to prepare reports under section 292 of the Corporations Act 2001. That obligation will apply to the head company where it is one of the entities covered by the section.

Therefore, the financial reports examined were the actual financial reports of the head company. However, this should be compared to the ATO's guide for thin capitalisation calculations, which states that:

> 'consolidated financial statements' are used for the purpose of working out thin capitalisation assets and liabilities of a consolidated group. The fact guide states "The values of assets and liabilities used by a group when calculating its thin capitalisation position are based on information that would be contained in a set of consolidated accounts prepared in accordance with the accounting standards. Because the consolidation rules only allow 100% owned entities to consolidate, the consolidated accounts prepared for accounting purposes may not be able to be used, without modification, for thin capitalisation purposes. The accounts are to take into account only those entities that can be grouped under the consolidation rules.

The fact guide effectively requires the consolidated group to reconstruct accounts using accounting standards, applying the single entity rule. While the pre-tax consolidation thin capitalisation grouping provisions contained a provision to achieve this outcome, this provision was repealed with effect from the introduction of the tax consolidation regime. Accordingly, the outcomes outlined above demonstrate a possible inconsistent application of the single entity rule to the preparation of accounts for tax purposes.

It is noted that a number of other provisions require an analysis of financial statements for tax purposes, including Division 230. Inconsistent application of the single entity rule to such requirements adds to the uncertainty in determining the correct set of accounts to be used. It is noted that this is a current issue for Division 230 purposes and that the

ATO has issued a discussion paper outlining its view on the single entity rule and the use of financial statements for Division 230 purposes.

e *Inconsistent supporting provisions*

The existence of certain provisions that complement the single entity rule may also give rise to uncertainties where the supporting provision contains an inconsistency. For example, consider section 701-25 which explicitly states that:

> "Note: In the case of assets other than trading stock, the fact that the head company ceases to hold them when the single entity rules ceases to apply to them would not constitute a disposal or other event having tax consequences for the head company."

However, under Division 230, a balancing adjustment event occurs in accordance with paragraph 230-435(1)(b) when all of your rights under the arrangement otherwise "cease". Subsection 230-440(4) was introduced to ensure that a member leaving a tax consolidated group would not trigger subsection 230-435(1). However, while this clarified the operation of Division 230, this specific amendment has raised a question as to whether section 701-25 operates as intended.

To demonstrate this issue, forex realisation event (FRE) 2 happens if you "cease to have a right, or a part of a right, to receive foreign currency". The words contained in the taxing event in section 775-45 are almost identical to those contained in section 230-435. Accordingly, one would question whether FRE2 applies when a subsidiary leaves a tax consolidated group, irrespective of the note to section 701-25. Furthermore, FRE4 can also apply to legal liabilities that are assets (i.e. in the money obligations). Accordingly, the same issue may occur in respect of those liabilities when a subsidiary leaves the tax consolidated group. Finally, this interpretation raises the possibility of CGT event C2 happening when a subsidiary member leaves or joins a tax consolidated group.

As demonstrated above, there are instances where supporting principles do not appear to apply consistently and appropriately.

3.2.5 Single entity rule amendments and location of provisions

There are various provisions that modify the application of the single entity rule. Division 701 contains "supporting" provisions, such as section 701-20 and 701-60, that modify the application of the single entity rule in respect of certain intra-group assets. However, other supporting provisions are contained throughout the Tax Act. This can make it difficult to determine the application of the single entity rule in respect of a provision.

To demonstrate, Division 715 contains extensions to the single entity rule for provisions in Subdivision 165-CC and 165-CD and the conduit foreign income provisions. However, Division 230 contains its own tax consolidation amendments that modify the operation of the single entity rule. For example, consider subsection 230-440(4) and section 701-25, which appear to have the same purpose as discussed earlier. It is difficult to reconcile why one of these supporting provisions is contained in Division 701, while the other is contained outside of Division 701.

Unless taxpayers are aware of the location of all modifications, we believe that this can give rise to uncertainty in the application of the single entity rule.

3.3 Improvements to the single entity rule

Question 3.1(c) How can the operation of the single entity rule be improved to ensure it achieves its intended outcomes?

The single entity rule represents a core principle, which is supported by a number of principles contained in Division 701, with extensions contained in Division 715 and elsewhere in the Tax Act.

We believe that, as a concept, the single entity rule does not itself require amendment. However, the shortcomings outlined in Section 3.2 above could be addressed by considering some of the options contained in Section 3.4 below.

3.4 Additional rules

Question 3.2(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?

We have provided a number of suggested additional rules that could be used to support the operation of the single entity rule. We believe that these additional rules could assist in addressing some of the issues outline in Section 3.2 above.

3.4.1 Interaction of single entity rule with other provisions

We recommend that the Board consider an extension to the single entity rule, for purposes other than core purposes, on a case by case basis.

Rather than *ad hoc* extensions similar to those contained in Division 715, we recommend that the extension be by way of a generic provision within in Division 701 [see Section 3.13 below for further detail].

3.4.2 Single entity rule and character issues

Consistent with the view in paragraph 18 of TR 2007/2, we recommend that the Board consider recommending a supporting provision to the single entity rule that allows one to consider "[a]ctivities, undertakings and enterprises taking place within a consolidated group (not involving the derivation of income through dealings outside the group)" when characterising the business of the head company. Accordingly, this allows the head company to effectively take into consideration intra-group transactions when considering its business activities.

We believe that this view is consistent with the EM to the bill that introduced the provisions. If applied more broadly, we believe that this would help to restore a degree of certainty in relation to character treatment under the single entity rule.

3.4.3 Treatment of intra-group arrangements

It is our view that the single entity rule and its current supporting provisions do not deal adequately with a certain category of intra-group transactions. We recommend that this category of arrangements be defined and that specific rules be inserted in Division 701 to cater for those arrangements [see Section 3.7 below for further detail].

3.4.4 Inconsistent application of the single entity rule

The Board should consider circumstances where there is a deviation in applying the single entity rule to certain transactions. We have highlighted a number of examples in Section 3.2.4 above. If the Board agrees that such instances result in an inappropriate treatment under the Tax Act, the Board should consider whether it is appropriate to address such deviations by way of supporting provisions in Division 701. For example, the thin capitalisation provisions could be amended to provide certainty as to how accounts are prepared for a MEC group. Alternatively, a supporting provision could be inserted to extend "core purposes" to the preparation of accounts and other material that is used in determining taxable income.

We note that any amendments suggested to the single entity rule would need to balance certainty with compliance costs.

3.4.5 Location of provisions

We recommend that all key amendments and supporting provisions to the single entity rule be contained in Division 701 and that appropriate links to other provisions be made through Division 701. A key example is the operation of section 701-60 together with Division 711. Accordingly, provisions such as subsection 230-440(4) should be moved to section 701-25. Furthermore, single entity rule modifications contained in Division 715 should also be moved to a centralised provision contained in Division 701.

Finally, the Board should consider whether other amendments to the tax consolidation provisions, such as subsection 230-280(3), should be moved to Division 715 (the modification provisions) or within the Subdivision to which they relate. Once the Board concludes on this issue, we request that this be consistently applied throughout the Tax Act, to ensure that taxpayers can more easily locate the tax consolidation modification provisions.

3.5 Exceptions to the single entity rule

Question 3.2(b) Should the income tax law contain specific exceptions to the operation of the single entity rule? If so, what should those exceptions be?

There will be occasions where the operation of the single entity rule may not apply appropriately in its interaction with other provisions. While section 701-85 provides a mechanism to allow for modification of the single entity rule, it is difficult to ascertain when this provision should apply. Furthermore, once the provision is applied, it may be difficult to limit the application of the provision.

Therefore, it is of no surprise that the ATO has never utilised section 701-85, even though the provision could have been used to remove some of the concerns and uncertainties associated with straddle arrangements or the calculation of net income of a trust that joins or leaves a tax consolidated group.

This does not mean, however, that section 701-85 should be repealed. The provision provides an important policy principle. That is, it allows deviations from the single entity rule where there is either an “express” or “implicit” requirement to do so. Accordingly, it allows for explicit rules to be introduced, like Division 707 that compliment the application of the single entity rule. Where a provision is not explicit, but it is abundantly clear that the provision operates without the single entity rule, then section 701-85 also has a role to play. It is noted that this second area can provide for uncertainty in the tax provisions, and we believe that care needs to be taken in applying section 701-85 to such “implicit” cases.

Accordingly, where difficult questions on the operation of the single entity rule exist, it may be more appropriate to resolve such questions by virtue of some minor technical amendments to the provisions. For example, TD 2004/48 recognises shares in a tax consolidated group for the purpose of the demerger provisions. The same principle may also apply in the case of a Subdivision 124-M scrip-for-scrip transaction. While TD 2004/48 states that it is unnecessary to utilise section 701-85 to achieve this outcome, it may be preferable for there to be minor technical amendment within the CGT provisions that allow for the recognition of shares in scrip / demerger arrangements.

3.6 Operation of section 701-85

Question 3.2(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?

Our comments in relation to section 701-85 are contained in Section 3.5 above.

3.7 Treatment of intra-group assets and liabilities

Question 3.3(a). What concerns, if any, arise in relation to the announced changes to section 711-40 of the ITAA 1997?

Question 3.3(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?

3.7.1 Overview of issue and suggested solutions

By way of background, we highlight that the tax consolidation provisions contain some mechanisms to deal with intra-group transactions. A number of these modifications are contained in Division 701. However, the rules seem to target either membership interests or vanilla loan arrangements. Where an arrangement consists of another intra-group asset or liability, or where it deals with a special component of those types of intra-group arrangements, it is our view that the provisions do not currently deal with the arrangements appropriately.

These arrangements are referred to in this section as “other intra-group arrangements”. Generally, such arrangements consist of an intra-group asset that is recognised for tax cost setting purposes. However, the associated intra-group liability or a component thereof, is generally one that obtains no tax recognition. For example, it may not be a liability for Step 2 purposes, or it may be a liability that does not require payment of the value of the liability.

To demonstrate this type of arrangement, consider an intra-group licence arrangement allowing the use of an asset for two years. The licence asset may receive a tax cost setting amount. However, the liability may not be one that is considered at Step 2. Furthermore, the market value of the liability is not generally an amount that needs to be paid, as it simply represents the provision of the asset for the period of two years. Accordingly, these "other intra-group arrangements" typically result in an economic cost to the group that is not recognised under the tax consolidation regime.

To address this issue, we believe that the Board should consider amendments to the tax consolidation provisions that are aimed at providing some tax recognition to be given to the economic cost of the "other intra-group arrangement" to the group. Our suggestions are demonstrated in our response to Examples 3.1 to 3.4 below and are summarised as principles in the following table.

Principle	**Comment**
Principle 1: Point of cessation of the arrangement	If the arrangement starts as a third party arrangement, and later becomes an intra-group arrangement, the tax laws should determine whether the "other intra-group arrangement" should be deemed to have ceased. Cessation of the arrangement would trigger tax consequences at that point in time. If the arrangement is not taken to cease, the provisions should then determine another point in time to recognise the tax outcomes (e.g. an actual disposal / cessation of the arrangement, or a sale of the subsidiary member).

Principle	Comment
Principle 2: Recognition of costs	Where the asset is or becomes an "other intra-group arrangement", tax recognition is required in relation to the cost or amounts paid in respect of the asset by the group. Such recognition cannot be limited to incidental costs of the asset and must be extended to amounts paid in respect of the asset (including amounts deemed to have been paid under subsection 701-55(6)). The Board should consider the mechanism that it believes is the appropriate provision to recognise such costs. This could be through section 40-880, section 8-1, CGT event C2, or by allowing the amount to be included in the relevant assets cost base. Alternatively amendments could be made to the ACA process to remove the requirement to allocate ACA to such assets or to provide a Step 2 amount in respect of the corresponding liability.
Principle 3: Recognition of a broader concept of liability	Care needs to be taken in amending section 711-40 to remove reference to these "other intra-group arrangements". If such arrangements are excluded from the exit calculation (where they are not accounting liabilities), this will result in further blackhole expenditure issues. Such items need to be recognised on exit appropriately. Amendments are also required to ensure that the D1 exclusion does not inappropriately apply where the head company (instead of the subsidiary) has included the gain under CGT event D1 due to the operation of the single entity rule.

Finally, we are not sure that intra-group loans should be treated differently to other intra-group arrangements. While Example 3.1 states that this produces an appropriate outcome, we question whether this is the case. Based on our comments below, we believe that the Board needs to consider this issue in more detail to determine the appropriateness of this ATO exception to the operation of the single entity rule.

3.7.2 Example 3.1 – assignment of debt

Example 3.1 of the Board's Paper ends with the conclusion that "This outcome is appropriate because both the asset and liability have been brought within the group." We are not sure that the conclusion contained in Example 3.1 is fundamentally correct in all circumstances. This is made even more difficult given the limited facts contained in the example. That is, the example does not disclose the actual cost of the original loan and whether there is an amount that is not recognised (i.e. blackhole expenditure) in respect of the repayment of the loan.

For example, assume that the third party (Third Party Co) loans an amount of $20 million to the member of the consolidated group (Sub A) at an interest rate of 10% p.a., at fixed rates. Assume market interest rates subsequently move to 8% so that the debt is a liability with a market value of $25 million. Accordingly, assume that Third Party Co agrees to assign the debt to Head Co for $25 million.

We note that the value of $5 million in respect of the loan falls within our definition of "other intra-group arrangement". That is, it is the value of the loan that does not give rise to a tax recognition under the tax consolidation regime (i.e. it would not be picked up under Step 2 where the historical cost of the liability is used and would not be an amount that is paid out if the loan is held to maturity). Accordingly, allocating $5 million of ACA to the asset, while receiving no recognition for the liability, would constitute a blackhole expenditure amount of $5 million.

Furthermore, the payment of $25 million by Head Co should be compared to an arrangement entered into by a single entity. As an assignment is not possible in this case where a single entity is concerned, the alternative transaction would be to close out the loan early for a payment of $25 million. Such a payment would result in an economic loss of $5 million. Such a loss may be given tax recognition under provisions such as section 8-1, Division 230, or section 40-880[2]. However, the Board paper seems to conclude that in a consolidation context, such recognition of the loss is inappropriate. Clearly, this view is inconsistent with the outcome that would otherwise occur in a non-tax consolidated single entity context.

Accordingly, in order to appropriately find solutions to the operation of the single entity rule in respect of these "other intra-group arrangements", we highlight that the Board needs to be clear as to the correct policy outcome in respect of arrangements by comparing the transaction to a single entity transacting on a similar basis. We believe that our three policy suggestions above could be extended to these circumstances where either the debt, or a component of the debt, is considered to be an "other intra-group arrangement".

[2] As the $5 million is not a return on a debt interest that would be excluded by subsection 40-880(9).

3.7.3 Example 3.2 – direct acquisition of an intra-group licence

In the example provided in the Board's Paper, double taxation occurs as there is no recognition for the $5 million paid by the consolidated group to acquire the licence as an "other intra-group arrangement". This problem could be resolved by applying the proposed three principles. The principles are demonstrated in further detail below.

a *Blackhole expenditure and section 40-880*

In the example, actual expenditure is incurred to acquire the licence. Assuming the amount is not a section 8-1 deduction and does not form part of the cost base of the relevant asset, then it would be concluded that there is no recognition of the $5 million cost in respect of the asset.

It would seem, therefore, that it would be appropriate to allow recognition under section 40-880 to allow the consolidated group a tax deduction for expenditure where it is capital in nature. This would be in accordance with Principle 2. Furthermore, Principle 1 would determine the time at which such expenditure is deductible (i.e. most likely on the incurrence of the expenditure).

The ATO provided a preliminary conclusion that section 40-880 cannot apply in respect of such expenditure in their paper dated 23 November 2006[3] (the Intra-group Discussion Paper). However, this view is debateable. This issue could be clarified such that section 40-880 is given specific application where an intra-group arrangement is acquired at an economic cost to the consolidated group.

b *Deemed cessation of an asset and recognition of the cost amount*

Under the single entity rule, the payment to acquire an "other intra-group arrangement" could be seen as a payment to "end" the relevant asset, akin to settling or buying back the relevant asset (Principle 1). This would treat the arrangement in the same way as if the group were a single entity transacting on a similar basis.

However, the ATO has highlighted various problems with this interpretation under the current law in its Intra-group Discussion Paper. Firstly, the ATO does not appear to consider the criteria in subsection 104-25(1) to be satisfied in respect of the transaction. Accordingly, under their view, CGT event C2 cannot happen to the arrangement. This shortcoming would be addressed by Principle 1. Furthermore, the ATO highlighted that

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[3] Discussion Paper, "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?", NTLG Consolidation Subcommittee Meeting, 23 November 2006

the payment is unlikely to be included in the calculation of a capital loss in respect of the asset (as the five elements of cost base do not include payments for the cessation of an asset). This shortcoming would be addressed by Principle 2.

Alternatively, if the asset is held on revenue account, then the ordinary net profit / loss concepts would be applied under Principle 1 and 2 to the cessation of the asset to allow the $5 million to be used in calculating the gain or loss in respect of the asset.

3.7.4 Example 3.3 – indirect acquisition

We believe that the example contained in the Board's Paper does not properly articulate the problem that occurs on acquisition of the subsidiary entity. Unless the problem is properly explored, we do not believe it is possible to identify appropriate solutions to this problem.

In the example, the asset is one that is allocated some value representing the future use of the asset. However, as time goes by, this value diminishes such that it will become nil at the time of maturity. In this example, the liability does not generally represent future economic outflows expected in respect of the arrangement. The value of the liability typically represents the value (alternative economic cost) to provide the asset to maturity. Where the arrangement runs its full course, the consolidated group incurs an actual cost which is not recognised for tax purposes, being the amount paid to acquire the asset (as this cost is not recouped on closing out the arrangement at maturity). If there is no tax recognition for this cost, this results in blackhole expenditure to the consolidated group.

In summary, a problem occurs under the single entity rule where the asset is recognised for tax cost setting purposes, but neither the tax cost is utilised nor the liability is recognised for tax purposes. In our view, this results in a one sided tax cost allocation problem, and thus blackhole treatment of the expenditure. This can be demonstrated by expanding on Example 3.3 of the Board's Paper.

a *Indirect acquisition of the asset and liability*

In this example, assume that the licence obligations are held by Sub B and that Sub B is also acquired at the same time as Third Party Co. The "asset" receives a tax cost equal to its market value. However, assume that the intra-group licence is not an "accounting liability" that has any value for the purpose of Step 2. Sub B will not obtain any ACA recognition for the liability amount. This treatment would result in an inappropriate one-sided ACA allocation amount to the asset as there has never been any recognition for the cost of the asset (while the receipt of the same amount has been considered a taxable event).

Applying Principle 2, Step 2 could be modified on an entry calculation to ensure that it also picks up the market value of these intra-group liabilities for Sub B. Another possible solution could be that, where no liability is recognised under Step 2, the asset <u>should not</u> be given a tax cost setting amount (allowing the ACA to be allocated to other assets). Alternatively, if the asset is given a tax cost setting amount, then the provision should operate to allow some recognition for that tax cost setting amount (i.e. contrary to section 701-58(2)). This could be through section 40-880, Division 230, CGT event C2, section 8-1, etc.

Any of the above modifications would help to ensure that the cost of the relevant asset is not treated as blackhole expenditure and provided some recognition under the Tax Act.

b *<u>Indirect acquisition of the asset only</u>*

Alternatively, assume that the liability is already a part of the tax consolidated group and that Third Party Co is acquired by the tax consolidated group. In this example, the allocation of ACA to the asset would also result in a one sided ACA entry, as the "liability" is not given any tax recognition. The ACA process would allocate the cost of the shares to the intragroup asset. Subsection 701-55(6) would treat such expenditure as a cost incurred to acquire the asset. However, if no tax recognition is provided in relation to the asset, this results in blackhole expenditure.

Principle 2 could be applied to this example to help alleviate this problem. That is, the ACA allocation provisions could be amended so that no tax cost is set in respect of this type of asset (allowing ACA to be allocated to other assets). Alternatively, if the asset is given a tax cost setting amount, then the provision should operate to allow some recognition for that tax cost setting amount (i.e. contrary to section 701-58(2)).

3.7.5 Example 3.4 – direct acquisition of an intra-group licence

Example 3.4 is an extension of Example 3.2. It examines what would occur if the entity is disposed of where it holds a "liability" that consists of the intra-group licence. However, it is predicated on there being no amendment to section 711-40. If section 711-40 is amended to include accounting liabilities only, it is questionable whether the arrangement would satisfy this provision. Unless Principle 3 is applied to this example, there is a risk that the sale of the membership interests in the subsidiary would give rise to double taxation consequences.

However, even if section 711-40 is not amended, the ATO do not appear to agree with the conclusion contained in the Board's Paper. In the Board's Paper, it is assumed that Step 3 applies appropriately in an exit so that the tax cost of membership interests is increased by the market value of the liability. However, in the Intra-group Discussion

Paper, the ATO state that subsection 711-40(3) still operates in this example due to a technical error in the provisions. This is explained in paragraph 23 and 24 of their paper.

> 23. Where the licence leaves the group with Coy Y (leaving entity), Division 711 determines the cost base of the membership interests in the leaving entity. When calculating the Step 3 amount of the exit ACA, subsection 711-40(1) specifies the use of the market value of the corresponding asset of the leaving entity where a liability is owed by members of the old group to the leaving entity. However, where subsection 711-40(3) applies to the liability, the Step 3 amount in relation to CGT event D1 is limited to the incidental costs incurred. Sub A's liability under the licence arose when the licence was granted. <u>Due to the SER Sub A (the member of the old group) did not make a capital gain for the CGT event when that liability arose [As a result of the SER, it was the Head Coy that made the capital gain for the CGT event when the licence was granted by Sub A]</u>. If the SER was disregarded, Sub A would have made a capital gain for the CGT event D2 and therefore subsection 711-40(3) applies to limit the Step 3 amount to the incidental costs incurred.
>
> 24. Use of the incidental costs incurred in relation to the licence at Step 3 of the exit ACA means that the head company makes a capital gain on the disposal of the membership interests in Coy Y. Under sections 701-45 and 701-60 the licence's tax cost is set in the hands of Coy Y (leaving entity) at its market value. <u>[emphasis added]</u>

Should the ATO be correct in their interpretation above, this would mean that subsection 711-40(3) could still operate inappropriately in Example 3.4 as contained in the Board's Paper. Accordingly, Principle 3 outlines that certain technical amendments would be required to subsection 711-40(3) to ensure that the provision operates appropriately in this case.

3.8 History of an intra-group asset and liabilities

Question 3.4(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?

When an intra-group asset or liability emerges, there are instances where the "purpose" to which the asset or liability is and has been used must be determined. For example, interest on monies borrowed are deductible where the funds are used for income producing purposes.

For example, where an intra-group debt emerges (e.g. where a subsidiary is sold out of the tax consolidated group), one must determine whether that debt is used for income producing purposes. As outlined in TR 95/25 and the case of *FC of T v. Roberts; FC of T v. Smith 92 ATC 4380*, "[t]he character of interest on money borrowed is generally ascertained by reference to the objective circumstances of the use to which the borrowed funds are put by the borrower." However, the subsidiary entity may have borrowed such funds from another group member during a period of time when the entity was a member of the tax consolidated group. Accordingly, when the debt re-emerges, history may be required in respect of the asset to determine the deductibility of the interest paid on the debt.

The above issue is not limited to intra-group debts. The issue occurs in respect of any intra-group asset or liability that re-emerges, where a deduction or assessment is dependent on the history of the asset or liability.

3.9 Modifications relating to history

Question 3.4(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?

In order to resolve the issue identified in Section 3.8, the Board should consider whether the "actual" history of the asset or liability can be considered on or after the time when the asset or liability re-emerges. In the example of the intra-group debt, if the debt actually funded the working capital of the subsidiary member, this could be taken into account as actual history when determining the deductibility of interest on the debt after the time when the debt re-emerges.

3.10 Third party dealings and the single entity rule

Question 3.5(a) Are there other situations which are not identified in this Chapter where a third party may be required to reconstruct intra-group transactions?

The single entity rule contained in section 701-1 applies only for core purposes, as defined, unless another provision of the Act operates to extend its operation[4]. As core purposes are restricted to determining the income tax position of the tax consolidated group and its members, it is not uncommon that third parties would need to reconstruct the intra-group transactions when considering the operation of the Tax Act.

Appendix A to this submission provides a summary of the operation of a number of provisions of the Tax Act that may require reconstruction of an intra-group transaction from the perspective of the third party. These provisions include (a) the various debt forgiveness provisions of the Tax Act,(b) the private company loan provisions contained in Division 7A, (c) the small business concession provisions contained in Division 152,

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[4] See for example section 715-410 of the 1997 Act.

(d) the share tainting provisions contained in Division 197, (e) provisions dealing with financial arrangements including Division 230 and 974, and (f) franking and imputation provisions.

3.11 Extension of single entity rule to third parties

Question 3.5(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?

It is difficult to assess whether there should be a blanket extension of the single entity rule to all third party dealings. This would require a review as to whether it is appropriate in all circumstances and whether third parties would have such information to be able to determine whether they are dealing with a tax consolidated group.

In our view, it is difficult to make a recommendation that the single entity rule be extended (in global) to all dealings with third parties without properly assessing all of the provisions of the Tax Act.

3.12 Extension of single entity rule to related third parties

Question3.5(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?

It is difficult to assess whether there should be a blanket extension of the single entity rule to all third party dealings with related parties. While related parties may have better access to information about the tax consolidated group, this option still requires an appropriate analysis of the relevant tax provisions.

In our view, it is difficult to make a recommendation that the single entity rule be extended (in all cases) to dealings with related third parties without properly assessing all of the provisions of the Tax Act.

3.13 Extension of single entity rule on a case by case basis

Question 3.5(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?

3.13.1 Overview

We believe that this option has merit. It ensures that the extension occurs where it is appropriate, after considering the relevant provisions. To date, this has been done for a number of provisions. For example, Division 715 contains a number of extensions to the single entity rule, as contained in section 715-75 (Subdivision 165-CC extension), section 715-215 (Subdivision 165-CD extension), section 715-410 (value shifting extension) and section 715-875 (conduit foreign income extension).

However, the review of provisions and the relevant extensions to date has been ad-hoc. We would recommend the following course of action to determine what other extensions are required.

3.13.2 Review of all tax provisions

It is our view that the Board should conduct a preliminary review of the operation of the provisions of the Tax Act and whether the single entity needs to be specifically extended to any those provisions. It is noted that the extension may be for the avoidance of doubt in respect of certain provisions.

3.13.3 Single provision for all extensions

As indicated above, Division 715 contains extensions to the single entity rule in a number of provisions. However, we would recommend that these sections be repealed and replaced with a central extension provision.

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. We would presume that the wording of the section would be based on the wording of other extension provisions contained in Division 715, such as the following:

> Subsection 701‑1(1) (Single entity rule) and section 701‑5 (Entry history rule) also have effect for the purposes of applying the provisions as contained in [*section containing the list of provisions*].

Using this centralised extension provision, we believe that the list of provisions could be expanded as and when they are reviewed or when issues are identified.

3.13.4 Future provisions

If our recommendation for centralised provision is accepted by the Board, we believe it would be imperative that Treasury consider this central provision whenever enacting new tax provisions into the Tax Act.

We would request that it be a mandatory requirement for Treasury to consider the operation of the single entity rule in respect of any new provision and whether it would operate as intended. It would also be helpful that such an analysis regarding the tax consolidation interaction be documented in the EM to the new provision. We believe that this will ensure that the tax consolidation provisions continue to interact appropriately with all new laws introduced.

4 Chapter 4: Interactions with other parts

4.1 Policy principles on assessing beneficiaries and trustees

Question 4.1 (a) How should the net income for a trust's non-membership period be assessed to beneficiaries and trustees?

Under the current law, section 701-65 applies to amend the operation of section 701-30 in relation to trusts and non-membership periods. However, the provision simply extends section 701-30 to the calculation of net income and was never intended to be a provision that determines the policy as to how income should be assessed to beneficiaries and trustees during the non-membership period.

Accordingly, absent a clear direction from Parliament to the contrary, it is our view that the consolidation provisions should produce an outcome that is both consistent with the operation of Division 6 and the tax consolidation provisions. That is, we believe that the provisions should operate to:

- Ensure that <u>all</u> 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 a 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.

4.2 Problems with the current law

> ***Question 4.1(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?***

It is our view that the current rules do not operate as intended to appropriately achieve the four objectives outlined in Section 4.1 of this submission. However, as mentioned earlier, the current provisions have not been drafted with appropriate consideration of how beneficiaries and trustees should be taxed in those circumstances. Per the EM to the provisions, section 701-65 is simply an extension provision and, accordingly, does not deal with a number of key problems with the interaction between Division 6 and the tax consolidation regime.

That is, the first problem is that the single entity rule is not extended to third party arrangements for the purpose of applying section 95 and 97. Accordingly, where the trust has beneficiaries outside of the tax consolidated group during a non-membership period, those beneficiaries do not apply the single entity rule (in respect of concepts such as determining net income) during the membership period. This can result in a different application of Division 6 for the beneficiaries during the non-membership and membership period.

The second problem is that section 701-65 only extends its operation to the determination of the net income of the trust during a non-membership period. However, the allocation of income under Division 6 is based on present entitlement to a share of income of a trust estate during the whole year of income (without modification). Accordingly, a beneficiary's share of the net income may be influenced by events that occur before or after the trust joins or leaves the tax consolidated group.

The third problem is that, in a joining case, many trusts may not be able to determine present entitlement to income by the end of the non-membership period. Accordingly, if no beneficiary is presently entitled to income of the trust by that time, the trustee may be inappropriately assessed on the net income during the non-membership period at the top marginal tax rate.

Finally, the fourth problem is that trust deeds may provide for a definition of income of the trust being "taxable income" as determined under the Tax Act. It is questioned whether this is determined with the modifications made by section 701-65 and section 701-30. Furthermore, it is questioned whether the single entity rule also modifies the application of the trust deed in determining income of the trust when the trust is a member of a tax consolidated group for part of the year of income.

In addition to the issues outlined above, the operation of section 701-65 is clouded with further uncertainty due to the pending High Court decision of *Commissioner of Taxation v Bamford* [2010]. The lower courts' have taken different views as to the definition of income of the trust estate and, accordingly, this has made it even more difficult to ascertain the appropriate operation of section 701-65.

Based on the above, we understand why this issue has not been resolved to date. This issue is very complex and we do not believe there is a simple solution. However, in working toward a solution, we have provided the Board with four possible methods of assessing the trustee and beneficiaries in Section 4.3 to this submission.

4.3 Possible solutions to assessing the beneficiary and trustee

Question 4.1(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?

As outlined above, the issue of assessing beneficiaries and the trustee is not a simple issue. In order for the Board to review alternative mechanisms, and their consistency with the policy intent of the provisions, we have provided four possible options below. Each of these options is explained in detail in Appendix B together with examples.

4.3.1 Option one: the deemed head company entitlement option

Under this first option, where a trust joins a tax consolidated group during an income year, the head company of the tax consolidated group would be deemed to be presently entitled to all of the income of the trust estate for the entire income year. This would be regardless of membership periods. Accordingly, any pre-joining time distributions would be treated as non-assessable distributions to those beneficiaries and, thus, subject to CGT event E4 and section 99B.

When a trust leaves a consolidated group, the net income of the trust would be calculated with reference to the non-membership period only. The operation of the single entity rule would be extended for all purposes. Furthermore, the provisions could be modified to ensure that the "income of the trust" is also only calculated with reference to that period.

This option would give rise to an outcome similar to that which would occur outside of the tax consolidation rules.

4.3.2 Option two: the deemed joining time option

Option two is similar to option one, except that the trust will only be taken to join a tax consolidated group on the first day of the following income year (the "trust joining time"). Accordingly, present entitlement to income of the trust during the income year would be calculated in the ordinary fashion under Division 6. The drawback of this option would be that the single entity rule would not apply to intra-group transactions for the period after acquisition until the trust's joining time.

Where a trust leaves a consolidated group, the rules could operate in the same way as proposed under option one.

4.3.3 Option three: the Division 6 modification option

The third option would involve a number of complex modifications to Division 6 to ensure that it applies appropriately to each non-membership and membership period. This option essentially tries to create a deemed present entitlement to income (and thus an allocation of net income) for those beneficiaries that are outside the consolidated group during the non-membership period. While we believe that this option may provide for an appropriate outcome, this option would be by far the most complex of all four options.

4.3.4 Option four: the administrative option

The fourth option involves the drafting of provisions to allow for an appropriate administrative determination of the amount of income. For example, each beneficiary (either the new / old beneficiaries after joining or leaving time and the head company) would be assessed on a reasonable portion of the net income of the trust, having regard to the circumstances. What is reasonable would depend on the circumstances and a number of factors. As this option would not provide any degree of certainty, we would only recommend this option if the other options are expected to be too complex to administer.

4.3.5 Comparison of options

As mentioned earlier, Appendix B provides further details in relation to these four options. A common example is used to demonstrate the application of the options and the outcomes that would occur. Furthermore, we compare what is considered a “reasonable” allocation with that provided by each of the options.

Given the complexities associated with Division 6 and trust law concepts, it is important that any option recommended by the Board maintains an appropriate balance between achieving the correct policy outcomes, and providing a solution that is simple enough for taxpayers to comply with.

In this respect, we believe that options one and two appear to provide this balance. We note that if option four is adopted, further administrative guidance could be drafted within the section, or the provision could be drafted broadly to allow the ATO to administer the provision appropriately.

4.4 Other trust joining and leaving issues

Question 4.1(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?

We highlight that there are some minor technical issues that can occur when a trust joins a tax consolidated group. These are due to some technical errors in the provisions contained in Division 713. Many of these issues have been previously identified[5]. We would recommend some minor technical amendments to correct these issues.

4.5 Income tax liability

Question 4.2(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?

The current consolidation provisions do not appear to work appropriately where a head company acquires the membership interests in a trust, and those interests that are discounted to accommodate an embedded tax liability.

In the case of a trust (and other flow through entities such as partnerships), the tax liability lies with the beneficiary, the trustee or the partners. Accordingly, this issue arises because Step 2 of Division 705 only includes liabilities of the entity (and not its members).

This issue is demonstrated in Appendix C. We believe that this issue could be resolved through some minor technical amendments, which would only apply to entities where

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[5] Kokkinos, A., "SMEs - the forgotten lost souls", The TAX Specialist Vol. 11 No. 1 August 2007, pages 28 to 30.

members may be liable to pay tax in respect of the income derived by the entity (for example, trusts and partnerships). Such amendments could be incorporated in Division 713 of the Tax Act.

4.6 Other trust cost setting issues

Question 4.2(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?

There are some minor technical issues that can occur when a trust joins a tax consolidated group. These are due to some errors in the provisions contained in Division 713. Many of these issues have been previously identified[6]. We would recommend some minor technical amendments to correct these issues.

4.7 Membership issues

Question 4.3(a) Does a trustee need to be a member of the same consolidated group as the trust? If yes, why? If not, why not?

4.7.1 Operation of section 960-100

We do not believe that a trustee needs to be a member of the same consolidated group as a trust. In our view, the operation of section 960-100 makes this clear and operates appropriately.

Subsection 960-100(3) states that an entity can have one or more legal capacities and in each of these different capacities the entity is a different legal entity. The note to the section specifically refers to the role of a trustee company. Subsection 960-100(1) then clearly identifies a relevant "entity" for the purpose of applying the relevant tax laws. This provision specifically includes a trust. Subsection 960-100(2) then specifies that the person who is the "entity", being the trust, is the trustee of the trust. In our view, these rules clearly identify the boundaries between the trustee company in its own capacity and the trustee company in its capacity as trustee (i.e. the trust).

There is no specific provision in the consolidation regime that states that a trustee must be a member of a group. The membership rules contained in subsection 703-15(2) states that an entity that is a company, a partnership or a trust can be a member of a

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[6] Kokkinos, A., "SMEs - the forgotten lost souls", The TAX Specialist Vol. 11 No. 1 August 2007

consolidated group (subject to certain conditions). The reference to an entity in this provision is a reference to section 960-100 (as per section 2-15).

Accordingly, a trust can be a member of a group so long as all the membership interests of the trust are beneficially owned by the consolidated group. ‘Membership interests’ are the interests and rights that are held by the beneficiaries and objects of the trust. Therefore, in our view, so long as the beneficiaries are all members of the group, the trust will become a member of the group as well.

The operation of section 960-100 in this manner does not require the trustee to be a member of the tax consolidated group. However, we don’t believe there are issues with this interpretation as the trustee, in its capacity as a trustee, becomes part of the consolidated group in that capacity.

A ‘trust’ is the term given to describe the circumstances where one person legally owns property (trustee) and is under an obligation to deal with that property for the benefit of another (beneficiary). Therefore, in our view, it is not possible to separate a ‘trustee’ from the concept of a ‘trust’ and say that a trust can be in a consolidated group and a trustee (in its capacity of trustee) is outside it. To cite Gummow J in the recent High Court transcript of Bamford, section 960-100 “seems to turn relationships between trustees and beneficiaries into a creature of itself’. A trustee (in its capacity as trustee a trustee) does not have an identity that is separate from the ‘trust’.”

In reality, what this means is that a trustee company must account for its activities separately under the Tax Act where it is acting in different capacities. That is, where the company is acting as trustee of a trust, its activities will be those of the tax consolidated group. Where the company is acting in its own capacity, its activities will be its own outside of the tax consolidated group. As it is not possible to mix these purposes, we do not see any issues arising where the trustee is not wholly owned by the tax consolidated group.

4.7.2 Practical issues

The Board’s Paper, at paragraph 4.27 seems to suggest that the view outlined above gives rise to problems in applying provisions of the Tax Act. For example, deductions for the decline in value of a depreciating asset are only available to the holder of the asset, which is the trustee company, and various CGT provisions only apply to the owner of an asset or specifically refer to the trustee.

However, we re-iterate that where the 'holder' of the asset is taken to be its 'legal owner' or specifically refers to a 'trustee', it is our view that this should be considered in context. Accordingly, if the trustee is the 'legal holder' of the asset in its capacity as trustee of the trust, under section 960-100, the holder would be the trust. Furthermore, if the CGT provisions refer to a trustee, the provision must be construed as a trustee in its capacity as trustee of a trust. Accordingly, this is the same as referring to 'the trust'. This means that subsection 104-80(3) does not result in the 'trustee' (in its own capacity) making a capital gain. Instead, this means that the 'trust' makes the capital gain (or the trustee does in its capacity as trustee).

In our view, we do not see any practical difficulty with the above interpretation and application of the principles. However, should the Board consider it necessary, we would support provisions that merely clarify the operation of the law.

4.7.3 Beneficially owned – direct interests

We believe that there may be some uncertainties around whether a trust (particularly a discretionary trust) can become a member of a consolidated group.

As stated earlier, to be a member of the consolidated group, the membership interests in a trust must be beneficially held by the head company and / or a member of a group. However, it may be unclear whether a beneficiary can actually ‘own' an interest in a discretionary trust or even a unit trust.

For example, in a discretionary trust, the trustee has a discretion to make distributions of the income of the trust estate to a number of beneficiaries, as specified under the trust deed. Therefore, can a beneficiary who may or may not receive a distribution be considered to have a interest in the trust? There is case law to suggest that beneficiaries in a discretionary trust do not have any ‘interest’ either individually or collectively in the property or income of the trust estate. The case of *Gartside v I.R. Commrs (1968) A.C. 553* provides useful commentary as to the concept of an interest in a trust.

The ATO has provided its views as to whether a discretionary trust can be a member of a consolidated group in a number of private binding rulings, specifically 46276 and 43177. In those rulings, the ATO overcomes the uncertainties around whether a beneficiary or object has an interest in the trust, by considering that the ‘rights’ that a beneficiary or object has against the trustee (i.e. the right to ensure proper administration of the trust and to be considered by the trustee in exercising its discretion) are the ‘rights’ that constitute the ‘membership interests’ under section 960-135. Consequently, the ATO has held that such membership interests are beneficially owned by the respective beneficiaries.

However, the views in these private binding rulings have not been incorporated into tax rulings or ATO interpretative decisions. Accordingly, while the rulings appear to provide the correct administrative treatment of trusts, there is some uncertainty as to whether this approach can be technically supported. Furthermore, taxpayers cannot rely on private binding rulings contained in the ruling register. Accordingly, in our view, taxpayers require some clarity on this issue. We believe that the Board should consider whether this issue should be clarified by way of an ATO ruling or through legislative amendment.

4.7.4 Beneficially owned – indirect interests

Where a consolidated group acquires the membership interests in a trust (first trust) which also holds membership interests in another entity (second entity), it is questioned whether the section 703-30 is satisfied in respect of the second entity. That is, the membership interests in the second entity must be "beneficially owned" by either the holding entity and / or wholly owned subsidiaries of the holding entity.

The ATO view contained in TD 2000/27, at paragraphs 1 and 2 would seem to make it problematic to satisfy. That is, the ATO state:

> 1. Under the existing law, if the trustee(s) of a discretionary trust(s) holds shares carrying between them 50% or more of the voting, dividend or capital rights in a company in the year in which a loss was incurred, or the year of income in which the loss is sought to be deducted, the company cannot satisfy the continuity of beneficial ownership test in subsection 80A(1) of the Income Tax Assessment Act 1936 (the Act).
>
> 2. This is because the shares are not beneficially owned by any persons: see Gartside and Another v . Inland Revenue Commissioners [1968] 1 All ER 121 and Re Weir's Settlement MacPherson and Another v . Inland Revenue Commissioners [1970] 1 All ER 297, which provide authority for the proposition that beneficiaries of a discretionary trust do not have any interest, either individually or collectively, in the property or income of a trust estate. It is for the trustee to determine, firstly, whether such beneficiaries will benefit at all under the terms of the trust and, secondly, to what extent the beneficiaries will benefit. Such beneficiaries have no more than a right to have the trust duly administered. This right does not constitute beneficial ownership.

An alternative argument to this would be that, once the discretionary trust becomes a member of the tax consolidated group, section 703-30 is applied taking into account the single entity rule. This would require the consolidated group to ignore the membership interests held by the trust and assume that such interests were instead held by the head company of the tax consolidated group. This approach would seem to overcome the technically absurd outcome that could result in applying TD 2000/27. We believe that the Board should consider whether this issue should be clarified by way of an ATO ruling or through legislative amendment to the consolidation provisions.

4.8 Operation of the core rules

Question 4.3(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?

As outlined above, we believe that the core rules and other tax rules operate appropriately in these circumstances. That is, as the trust (as an entity) is considered to be part of the tax consolidated group, any assets, liabilities, income and expenditure of the trustee in its capacity as trustee, is taken to be that of the head company under the single entity rule.

4.9 Membership where beneficiaries are not members of the group

Question 4.3(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?

This question seems to draw on the practical application of section 960-130(3) where a beneficiary of the trust (being outside the tax consolidated group) holds units that are considered a "debt interest" under Division 974. In such a case, the entity is not considered to be a "member", and accordingly it is arguable that the trust may join the tax consolidated group if all other membership interests are owned by the group.

As the non-member is still a beneficiary of the trust, this gives rise to whether the beneficiary is still to be assessed under section 97 in respect of distributions received from the trust on its debt interest.

However, without modification to section 97 and the tax consolidated provisions, we are unsure how the net income of the trust would be allocated between the tax consolidated group and such beneficiaries outside of the group. That is, under the consolidation regime, once the trust becomes a member of a consolidated group, the single entity rule applies such that the net income of the trust becomes the net income of the head company. Therefore, if a beneficiary outside the group becomes presently entitled to the income of the trust estate on its debt interest, there is arguably no net income of the trust to be allocated to the beneficiary (as it is taken to be assessable income of the head company under the single entity rule). Alternatively, one may argue that the single entity rule does not apply for the purpose of the third party. However, such an argument would mean that the beneficiary could be assessed on its share of income that may include an intra-group transaction that would otherwise be ignored under the single entity rule.

Should the Board consider that such arrangements are appropriate, modifications will be required to the tax provisions to ensure that they can operate in these circumstances.

This can be achieved by switching off Division 6 in its entirety. Any income received by the debt interest holder would therefore be assessed as ordinary income.

4.10 Modifications to the current provisions

Question 4.3(d) How can the current provisions be altered so they are workable and provide certainty?

We have outlined suggested modifications to the provisions in the prior sections to this question.

4.11 Foreign hybrid rules and non-residents

Question 4.4(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?

Section 703-15 outlines the requirements for an entity to join a tax consolidated group. Under this section, there are no requirements for a partnership to be resident in Australia. Accordingly, the partnership will join a tax consolidated group provided that all of the partners in the partnership satisfy the residency requirements.

A partnership may be considered to be a non-resident entity, but may still join the tax consolidated group if the partners of the partnership are resident of Australia. This policy intent appears fairly clear in respect of how section 703-15 is drafted. We believe that this is supported by the fact that the income of the partnership flows through to the respective partners (all being Australian residents) and that CGT events also flow through to those respective partners. The fact that the partnership is a non-resident for tax purposes appears to be irrelevant when considering the tax consequences of the income derived by the partnership from the perspective of the Australian residents (being the partners).

Therefore, where a foreign hybrid is treated as a partnership for Australian taxation purposes, we see no reason to deviate from this policy objective. Given the ATO view contained in ATO ID 2008/149, which provides that a US LLC which satisfies the foreign hybrid provisions can join a consolidated group, we would submit that this produces a correct policy outcome when such an entity is compared to a legal form partnership.

4.12 Concessional treatment

Question 4.4(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?

We don't believe that such an entity will be afforded or denied concessional treatment by becoming a member of a consolidated group. As discussed earlier, this treatment is on par with a legal form partnership.

However, we highlight that the operation of the tax consolidation provisions in the case of an actual partnership or a foreign hybrid partnership can be somewhat uncertain in its interaction with the remaining provisions of the Act.

For example, there are uncertainties around whether the partnership will constitute a 'branch' for tax purposes, whether distributions received by the foreign hybrid from another foreign company are subject to section 23AJ, whether transactions between the foreign hybrid and the consolidated group are ignored under the single entity rule, the effect of the application of the transfer pricing provisions to intra-group transactions, and the application of the treaty provisions.

As mentioned above, these uncertainties equally apply to a non-resident partnership that is not a foreign hybrid. The Board should consider whether the ATO should provide further guidance on the application of these provisions, with a view to providing certainty on the application of the single entity rule.

4.13 Integrity risks

Question 4.4(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?

We are not aware of any integrity risks associated with such entities forming part of the tax consolidated group. If the ATO has identified potential integrity risks associated with such arrangements, we would ask the ATO to provide an outline of such risks to enable a better understanding of any issues it may have with foreign hybrids joining a tax consolidated group.

4.14 Preventing such entities being members

Question 4.4(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 are unsure of this question, as it is predicated on entities not being members of a consolidated group. We believe that the word "cannot" has been incorrectly used instead of "should not".

Assuming that is the case, our response is that there has been nothing provided to date to indicate a reason why such foreign hybrids should be excluded from being a member of a tax consolidated group. Excluding such entities would be relatively easy (i.e. by way of section 703-20). However, we would stress that such an action should only be taken if the Board can be convinced that such entities pose an integrity issue and concern over and above that of the use of ordinary partnerships.

4.15 Non-resident CGT rules

Question 4.5(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?

We are unsure whether the example provided gives rise to integrity risks without the ATO providing its view on the operation of the existing law in respect of such arrangements. We note that two integrity provisions currently exist that counter arrangements that would otherwise pass the principal asset test.

Firstly, subsection 855-30(5) ignores assets transferred to or from the test entity if those assets are used to circumvent the principal asset test. Secondly, Part IVA can also apply where assets are transferred from a test entity to another entity, where the other entity would not be within the principal asset test.

If transfers are done for a commercial purpose, other than to obtain a tax benefit, then we would be concerned with integrity rules that would jeopardise international investment in Australia.

4.16 CGT rules where there is no change in beneficial ownership

> ***Question 4.6(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 note that the interposition of an entity for the sole or dominant purpose of obtaining a tax benefit under the tax cost setting process ACA pushdown is contained as an example to the ATO's consolidation Part IVA guide[7]. Accordingly, we believe that such integrity risks are covered by the operation of the GAAR.

On this issue, we note that the same concerns were provided by the ATO in respect of the application of Subdivision 124-M rollovers relating to public companies and restructuring arrangements. Complicated provisions have now been inserted into Subdivision 124-M to deal with such restructures (refer to Subdivision 715-W and sections 124-784A to C).

However, during and after consultation, it was (and has since been) acknowledged that it would be rare that a transaction would fall within such provisions where Part IVA would not otherwise apply. Accordingly, a significant amount of consultation time was devoted to provisions that practically have little or no effect. We request the Board to consider whether such integrity provisions are required over and above Part IVA and whether such issues pose a real integrity concern to the Revenue.

4.17 CGT event J1 – undesirable outcomes

> ***Question 4.7(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?***

The ATO has conducted a significant amount of work in respect of the application of CGT event J1. Over the course of the last few years, the ATO has released numerous papers on its application at NTLG meetings. Accordingly, we would be surprised if the ATO would not be in a position to outline whether CGT event J1 operates to produce undesirable outcomes, or whether CGT event J1 does not operate in circumstances that it otherwise should.

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[7] Consolidation reference manual, Section C9-1-220, "Application of Part IVA to elections to consolidate"

We note that, in the course of this review, we have previously submitted examples to the ATO where the operation of CGT event J1 is considered inappropriate. We have provided one example in Appendix D to this submission. We understand that further examples have been provided to the ATO.

4.18 CGT event J1 – shortcomings

Question 4.7(b) Are there situations that CGT event J1 does not apply to but should? If so, what are they?

Please refer to our response contained in Section 4.17 of this submission.

4.19 Foreign currency provisions

Question 4.8(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?

It is noted that a number of amendments are contained in *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* that deal with the interaction of the foreign currency provisions and the tax consolidation regime. These provisions include the new currency exchange rate effect provision (section 715-370), and the operation of the new tax cost setting rules (section 701-55).

We highlight that the main concern with Division 775 is that it does not seem to appropriately apply to a derivative contract (such as a forward contract) that is acquired after its inception. The cost rules in Division 775 do not seem to include any costs in acquiring such an arrangement. Accordingly, difficulties appear to occur in the interaction between section 701-55(6) and Division 775. However, that is not to say that such costs may not be taken into account under another provision (such as section 8-1 or the CGT provisions).

Given the extensive consultation on the provisions recently introduced, we believe that these provisions will operate to provide an appropriate outcome in applying Division 775 in a tax consolidation context. Accordingly, we believe that these amendments will address most of the interaction issues with tax consolidation and Division 775. However, in order to make this assessment, we believe it will be critical for the ATO to provide guidance on the interaction of these provisions with Division 775, especially on forward exchange contracts subject to forex realisation events 3 to 5 (which are not covered by the EM to the new provisions).

We understand that the interaction of these provision are complicated and that the ATO may not conclude that the provisions operate as intended. Accordingly, we would request that the Board consider an appropriate review of these interaction provisions where the ATO hold a view that results in inappropriate interaction outcomes between the relevant provisions.

4.20 Taxation of financial arrangements

Question 4.8(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?

On the introduction of Division 230, there was extensive consultation on the interaction provisions dealing with Part 3-90 and Division 230. This consultation resulted in a number of provisions being included within the Tax Act dealing with the interaction of these two parts.

A number of technical issues have subsequently been raised in relation to the interaction of these provisions in the NTLG TOFA subgroup. These issues can be found on the TOFA issues register of the NTLG.

Issues on that register include the operation of the hedging provisions to leaving and joining entities, the operation of the elective provisions where audited accounts are not prepared at the joining or leaving time, the operation of the inherited history provisions in respect of elections made by a tax consolidated group, and the operation of the single entity rule to the financial reports referred to in the elective methods.

To the extent that the examination of these issues by the NTLG does not result in a resolution of these issues, we would request that the Board consider an appropriate review of these interaction provisions by Treasury.

4.21 Other provisions

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 can they be resolved?

4.21.1 Sale of a subsidiary member of a MEC group to the top company

Where a subsidiary member of a MEC group is sold to the top company, the ATO has provided a view that this gives rise to a CGT event A1. However, as the subsidiary does not leave the group, no cost base is provided in respect of the membership interests under Division 711. Accordingly, the consolidated group may be taxable on the gross gain. We would recommend an amendment to the law to ensure an appropriate outcome in this circumstance. This can be achieved by either (a) treating the sale as an issue of shares, or (b) allowing the group to calculate a cost base under Division 711.

4.21.2 Subdivision 705-C

In the recently released ATOIDs 2009/160 and 2010/40, the ATO has held that Subdivision 705-C does not apply when a single entity acquires a tax consolidated group. In addition to this example, members have put forward at least four other scenarios where it is believed that Subdivision 705-C should apply.

Given the narrow view being taken by the ATO, we request the Board to consider recommending an expansion of Subdivision 705-C. We highlight that there appears to be no policy reason why the measures should not be expanded.

4.21.3 Elections

Subdivision 715-J contains exceptions to the entry history rule where choices have been made by a subsidiary member. In particular, where a tax consolidated group acquires another entity, specific rules apply to inconsistent choices that have been made by the joining entity prior to joining the new group.

It is highlighted that there are only a limited number of elections that are covered by that Subdivision. However, there are literally hundreds of elections that are made under the Tax Act. Accordingly, many elections that can be made and that are inherited under the inherited history rules are not contained within this Subdivision. Examples of elections that are currently topical include the transitional financial arrangements election and the early adoption election for Division 230.

We would recommend the Board consider a "principle" that allows for inconsistent elections to be cancelled or ignored.

4.21.4 Foreign hybrids

The foreign hybrid rules contain a tax cost setting rule in section 830-80. It is possible that the tax cost setting rules contained in Division 830 may apply at the same time as the cost setting rules in Division705. We note that while the provisions have a similar purpose, the two provisions generally result in different tax cost setting amounts for assets. While this overlap is not common, we highlight that the provisions do not currently appear to contain an order of application.

4.21.5 CGT event A1 and intra-group straddles

While recent amendments have been introduced in relation to straddle contracts, these amendments are limited to straddle arrangements involving assets that are recognised on applying the single entity rule. Accordingly, the recent amendments do not apply to intra-group straddle arrangements. An intragroup straddle arrangement occurs where a subsidiary of a tax consolidated group is disposed of, where that subsidiary has entered into a straddle contract in respect of the sale of an underlying subsidiary entity.

It is noted that this arrangement is technically within the parameters of the ATO's ruling TD 2008/29. That is, the TD does not apply "if the entities entering into the contract are members of the same consolidated group at either the contract time or the time just after the contract is completed." In the example provided, the straddle contract is between a member of the tax consolidated group and an external party.

While the recent amendments address the double taxation issues associated with straddle contracts, TD 2008/29 provides an administrative solution in paragraph 4. Unfortunately, however, the straddle of an intra-group asset is not specifically addressed in the taxation determination. Accordingly, the consequences of applying the ATO's views in these cases is still somewhat uncertain.

5 Inherited history rules

5.1 Difficulties under the inherited history model

Question 5.1(a) What difficulties, if any, arise under the inherited history rules?

5.1.1 Inherited history rules appropriate in a formation case

The entry history rule and exit history rule (collectively the "inherited history rules") are core rules in the tax consolidation provisions. The EM to the introduction of the tax consolidation provisions states that the inherited history rules were introduced to replace the clean slate rules due to problems associated with the change in character of various assets and expenditure:

> 2.7 The February 2002 exposure draft contained rules which provided that things that happened to a subsidiary entity before it joined the group could not be attributed to the head company for the purposes of working out its income tax liability or losses (entry clean slate rule). Similarly, when subsidiaries exited the consolidated group, they did so with a fresh income tax identity, so things that happened to them before they joined or while they were a member of a group cannot generally be taken into account in working out their post-consolidation income tax liability or losses (exit clean slate rule). Consultation identified that these rules created significant compliance costs as a consequence of certain assets and expenditure changing character from being on revenue account to capital account. As a consequence of consultation the clean slate approach was replaced with an inherited history approach.

In a formation case, such a concern would have appeared appropriate. That is, a consolidatable group may have existed for 20 years. In moving to a consolidation regime, the group would not have "acquired" the assets at that date, but would have had history associated with such assets. Accordingly, a change to a clean slate would have eliminated the 20 years of history and potentially change the character in respect of all assets and expenditure held. For example, the group may have held pre-CGT assets and pre-13 May 1997 CGT assets. The group may have also acquired an asset with a certain intention. Under the inherited history rule, the group could move into tax consolidation without worrying about a re-characterisation of its existing assets (at least in theory, noting our concerns raised at Section 3.2.3 on character issues).

Accordingly, we for this reason, the inherited history model appeared to be an appropriate model in formation cases.

5.1.2 Current model is a hybrid model

However, that being said, the tax consolidation regime contains a number of significant departures to the history model. For example:

- Section 701-55(2) effectively provides a hybrid approach for depreciable assets, with an acquisition model used for the cost of the asset and a history model used for choices and other information relating to the depreciable assets.
- Section 701-55(5A) provides an acquisition model for certain financial arrangement assets under subsection 701-55(5A) and (5B). Furthermore, the acquisition model is extended to financial arrangements that are liabilities under Subdivision 715-F.
- Section 165-212E, where the entry history rule does not apply to include the business of the joining entity under the same business test.

It is noted that the above is provided by way of example only and that there are many other examples. Accordingly, 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.

5.1.3 Difficulties with an inherited history model

Post formation cases, there are a number of difficulties that can arise in relation to an inherited history model. Some of these difficulties are summarised in the following paragraphs.

a *<u>Appropriate treatment of the tax cost setting amount</u>*

One of the more significant concerns with an inherited history model is whether the model provides for an appropriate outcome when an entity is acquired or disposed of by a tax consolidated group.

Up until recently, there have been significant issues with the way in which the tax cost setting amount was dealt with under section 701-55, particularly in respect of "other assets" under subsection 701-55(6). Other assets assumed by the head company under the entry history rule were provided a "cost", however there was uncertainty as to how that cost was treated under the remainder of the Tax Act.

In our view, the uncertainty of treatment of the tax cost setting amount in those cases, together with an inconsistent treatment as compared to a real acquisition of the asset, resulted in a preference towards an 'acquisition' model for the tax consolidation regime. That is, there was a view being created that a lot of the uncertainty would be removed if the entry history rule and section 701-55 were replaced by a rule that mimics the acquisition of assets (i.e. it ensured that the tax cost of assets were deemed to be a cost incurred to acquire the relevant asset).

However, *Tax Laws Amendment (2010 Measures No. 1) Bill 2010,* which was recently introduced into Parliament, includes a number of amendments that significantly change the way in which the tax cost setting amount is to be used under an inherited history model. It is expected that many of these amendments will help to provide a more appropriate recognition of the tax cost setting amount under an inherited history model.

Accordingly, the recent introduction of these amendments seem to reduce the impediment for a change from an inherited history model to an acquisition model. However, this conclusion is predicated on the basis that the ATO view on the application of these new provisions allows for an appropriate treatment of tax costs allocated to assets.

We highlight a number of additional difficulties with the inherited history model below. While these additional issues are not as significant as that contained in this section, we believe that the Board should consider all of these issues in some detail, to determine whether amendments to the inherited history rule are warranted to remove some of these problems identified.

b *Compliance and complexity*

The inherited history rule contains numerous exceptions and supporting provisions. In most cases, specific black letter law provisions have been inserted to deal with such items. We believe that this has led to numerous complex interaction rules to achieve the desired outcome of Parliament in respect of certain asset and liability categories.

For example, there is an exception for depreciable assets contained in section 701-55(2), which effectively places such assets within a hybrid acquisition type model. However, where such assets are pre-1 July 2001 assets subject to allowable capital expenditure, transport capital expenditure, exploration or prospecting expenditure, special transitional provisions were inserted in section 705-305 of the Transitional Act 1997 to ensure that the history model worked appropriately with the acquisition model. These provisions are complex, however, they are intended to achieve certain policy outcome that was considered appropriate. Accordingly, complex modifications to the inherited history rule were required to achieve this outcome.

c *Comparison of outcomes to an acquisition model*

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. For example, where a business is acquired, together with its assets and liabilities, the rules relating to the treatment of such assets under section 8-1 and the CGT provisions are generally well known. However, in a consolidation context, the application of those provisions is adjusted by virtue of section 701-55 together with an entry history rule. Accordingly, the acquisition of a pre-13 May 1997 asset provides for a different outcome as to its treatment under an inherited history model.

For completeness, we note that while the inherited history model contains a number of deviations from an acquisition model, in our view, such deviations appear to be warranted. For example, retaining access to franking credits, losses and bad debt deductions is justified on the basis that, if the assets were instead acquired, such tax characteristics would be retained by the vendor entity disposing of the relevant assets. That is, such characteristics are retained by an entity. Accordingly, if these characteristics were lost, the inherited history rule would not provide for an equitable outcome as compared to an acquisition of the assets.

While these deviations add to the compliance of reviewing the tax consolidation provisions, we believe that such deviations are justified on other policy grounds.

d *Application to intra-group assets*

A number of issues have been highlighted in respect of history that related to intra-group assets, where such assets are acquired by a tax consolidated group and then subsequently re-emerge. Such issues were discussed at the NTLG tax consolidation subcommittee meeting of June 2007 and were highlighted in Section 3.8. These issues occur where the such assets and liabilities do not obtain appropriate history under the inherited history model.

5.2 Modifications to the inherited history rule

Question 5.1(b) Should the inherited history rules be modified to address those difficulties? If so, how?

5.2.1 Appropriate treatment of the tax cost setting amount

As discussed earlier, the introduction of *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* into Parliament includes a number of significant proposed amendments to the application of the inherited history provisions. These include:

- The rights to future income amendment – which provides a specific rule dealing with tax cost allocated to such assets in section 716-405. This amendment helps to remove uncertainty on the application of an inherited history model for such assets.

- The other assets amendment – which provides that the tax cost setting amount for other assets is deemed to be a cost incurred to acquire an asset (subject to an entry history exception). This amendment helps to remove uncertainty in respect of the application of the inherited history model in respect of such assets.
- The currency exchange rate amendment – as contained in section 715-370, which ensures that only currency exchange rate effects from joining are taken into account in respect of such assets. This modification effectively places these assets on par the treatment of the gain or loss under Division 775 with those assets that are actually acquired.
- The bad debt amendment – as contained in section 716-400, which ensures that a bad debt deduction can be claimed in respect of debts brought into the group. This provision ensures a retention of the inherited history rule for such debts.

In our view, these amendments address some of the significant uncertainties that have occurred in an history model in respect of the treatment of the tax cost setting amount allocated to assets. These amendments have been introduced with a retrospective date of 1 July 2002 to address any problems with the tax cost setting rules that may have been prevalent since formation.

In our view, these amendments are likely to remove some of the pressure on introducing an acquisition model for the sole purpose of providing appropriate recognition of tax costs of assets. However, this conclusion will ultimately be dependent on the administration of these provisions by the ATO.

5.2.2 Compliance and complexity

As outlined earlier, the inherited history model currently involves a number of complex interaction provisions. It is noted that a lot of that complexity may have been relevant in relation to formation cases, but may not be seen as relevant post formation.

While the Board may not consider it appropriate to move to an acquisition model, at a minimum, we would recommend that the Board consider a review of some of the specific interaction rules in relation to the history rules, with a view to simplifying their operation.

To demonstrate, a recent amendment that would achieve this type of simplification of the inherited history model is the recent repeal of the over-depreciation rule as contained in section 705-50. Similarly, subsection 701-55(2) [dealing with the acquisition of depreciable assets] could be significantly simplified in an “acquisition” world, by repealing paragraphs (b) to (e).

We believe that the simplification of many of the interaction provisions could significant reductions in the complexity and compliance costs associated with the operation of the an inherited history rule, where such complexity is not as relevant in a post-formation world.

5.2.3 Dealing with intra-group assets

The inherited history rules should be amended to include specific rules that deal with how history is to determined in respect of assets, liabilities and business activities that become or cease to be an “intra-group asset”. This recommendation was covered in Section 3.9.

5.2.4 Deferred tax positions

The inherited history model deals with deferred tax assets and liabilities in a certain way, that may be inconsistent as compared to an acquisition of actual assets and liabilities. On entry, the operation of subsection 705-70(1A) for DTLs and the operation of subsection 705-35(2) in respect of DTAs has caused a number of concerns for both the ATO and tax practitioners. Furthermore, the operation of section 711-45 to deferred tax liabilities in an exit scenario (even where the DTL will cease to exist after the leaving time causes inequities and double taxation issues).

Many of these issues were highlighted in the ATO’s paper on deferred taxes[8]. While the ATO has been constrained in its review of the operation of these provisions, we believe that it would be worthwhile if the Board recommended a review of these provisions by Treasury, with the objective of determining whether DTAs and DTLs could be ignored under an entry history model.

5.3 Moving to a clean slate model

Question 5.1(c) Alternatively, should the consolidation regime adopt a deemed acquisition model, using clean slate rules?

Our major concern with changing to a clean slate / acquisition model is that it may result in significant compliance costs for corporate taxpayers, with little or no change to the outcomes of the existing model. For example, taxpayers would need to re-build models

[8] ATO Discussion Paper – NTLG Consolidation Subcommittee Meeting 26 February 2009, “Topic: Deferred Taxes in the Allocable Cost Amount (ACA) and the Tax Cost Setting Process”

associated with their tax consolidation calculations, and would also need to understand how the provisions apply to their transactions.

In theory, a clean slate / acquisition model would provide for a more neutral outcome as compared the acquisition or disposal of the net assets of an entity. However, it is difficult to conclude whether the cost of implementing an acquisition model is justified where there may (in effect) be limited changes to the ultimate result of the tax cost setting process.

On that note, we are mindful that such a change may be significant and that, subject to the Henry review, corporate taxpayers may be facing significant other tax law amendments in the near future. Accordingly, but for the theoretical advantage of applying an acquisition model as compared to the current hybrid history model, it is difficult for us to conclude that the Board should recommend wholesale change to the way in which the consolidation regime deals with the allocation of tax costs to assets.

5.4 Deemed acquisition model and exceptions

Question 5.1(d) How would a deemed acquisition model with clean slate rules work and what exceptions would be needed?

5.4.1 Overview

Should the Board recommend a move to an acquisition model, we highlight some of our high level thoughts on how such a model could be applied.

In our view, the acquisition model would require a number of limited exceptions to acknowledge the difference between actually acquiring assets and acquiring membership interests. For example, where an entity has franking credits, such credits are retained by the vendor entity where it's assets are disposed of. Where the shares are disposed of, it is not possible for the vendor to retain such franking credits. It is therefore appropriate to have a special treatment of franking credits under an acquisition model.

Accordingly, an acquisition model would require specific exceptions to ensure an appropriate outcome is achieved. While such a model may result in very similar outcomes as compared to the current inherited history model, we believe that an acquisition model may achieve this in a more simplified manner.

5.4.2 Mechanics in an entry case

Our proposed acquisition model would retain the entry history rule, but would work to ensure that the assets, liabilities and businesses would be deemed to be acquired by the new group (similar to the case where such items would otherwise be acquired). Accordingly, history would still be retained in respect of these items (i.e. that a previous party had owned the asset), but it would also inherit some new history, being the fact that a new owner acquired those items. To achieve this outcome:

- **Deemed acquisition of assets -** section 701-55 would be modified so that all assets would be deemed to be acquired for a payment equal to their tax cost setting amount. The assets would be deemed to be acquired as if all the assets of the subsidiary were acquired in an asset acquisition. This last rule would provide a context for the acquisition (e.g. whether the acquisition was on revenue or capital account).

- **Deemed assumption of liabilities** – section 701-55 would be expanded to liabilities, so that the entity would be taken to have assumed all liabilities of the joining entity (for a certain value). The provision would deem the liabilities to be used to fund the assets of the joining entity (or something similar), providing a purpose for the funding. A precedent for such a rule is contained in Subdivision 715-F.

- **Repeal of certain provisions** – the remainder of section 701-55 would be repealed. Accordingly, the tax cost setting amount would be covered by the general rule. Interaction of the tax cost setting rule with all other tax provisions would be determined by comparing it to a case of where the asset was in fact acquired.

- **Special interaction rules –** special rules for other assets may be required where a certain objective needs to be achieved. For example, section 701-55(5A) or (5B) may be retained, as those provisions are aimed at allowing the financial reports election to work where Division 705 otherwise results in an imperfect ACA allocation to the relevant financial arrangement.

- **Exceptions based on policy** – exceptions to the acquisition model will be required for policy reasons. At a minimum, the following exceptions should occur (consistent with the current model).

  - Given that ‘debtors’ could be retained in a vendor entity under a sale of assets, the acquisition model should still allow for a retention of the bad debt rules in relation to debts that are taken to be acquired under an asset acquisition case (given that no such choice is available where the shares are sold).

  - Given that tax losses would be retained in the vendor entity under a sale of assets scenario, it would be appropriate to provide an option to transfer losses to the new head company under Division 707 in an asset acquisition model.

  - The same policy argument would occur in respect of franking credits that are retained in the vendor entity.

- **Exceptions based on other grounds –** issues regarding the status of certain assets and liabilities would also need to be considered. For example, there would need to be a question as to whether pre-CGT assets, pre-13 May 1997 CGT asset, pre-Division 775 and pre-Division 974 arrangements all retained their status in the new consolidated group.

5.4.3 Mechanics in an exit case

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.

Furthermore, this process would also require all assets identified to be valued to ensure that the proceeds are appropriately split. As it is unlikely that this split is provided for in a share sale agreement, this additional tax “valuation” requirement would result in additional compliance costs.

If the Board considers it necessary to determine appropriate character, it would also seem appropriate to extend this analysis to the CGT L events. Currently, those events only provide for gains and losses to be treated on capital account. For example, CGT event L5 results in a capital loss (even where the assets are wholly on revenue account). Splitting the CGT L events into character would also increase the level of complexity.

Under the current operation of Division 711, the treatment of the gain as being wholly on revenue or capital account appears to provide a balance between equity and compliance. Accordingly, in our view, we would not recommend any changes to the operation of the exit provisions under an acquisition model.

5.5 Transitional issues

Question 5.1(e) What transitional issues would arise if the inherited history approach was replaced by a deemed acquisition model with clean slate rules?

As with the introduction of all provisions, there is likely to be significant transitional rules. However, such rules would be dependent on how the proposed deemed acquisition model would interact with the rest of the provisions of the Tax Act and which provisions were to be repealed or amended as a consequence.

In our view, we don't envisage there being a significant number of transitional provisions. However, one of the key issues would be the application date of the new model. This will be particularly important where entities are acquired over a period of time through a creeping acquisition. Furthermore, providing taxpayers some lead time into the new provisions may also be important. Accordingly, providing an optional start date may require a retention of existing provisions for a period of time.

5.6 Compliance costs

Question 5.1(f) What compliance cost implications would arise from the adoption of a deemed acquisition model with clean slate rules?

As outlined earlier, our concern with adopting a deemed acquisition model would be the effect on compliance costs. In our view, it is very difficult to ascertain the exact effect that a shift to an acquisition model would have on compliance costs.

With that being said, there are a significant number of rulings and ATO guidance on the way in which the tax consolidation provisions operate. A significant change to provisions may result in a number of rulings and other ATO guidance becoming redundant and the application of the law becoming uncertain. Accordingly, this could have a dramatic effect on compliance costs associated with applying the provisions.

However, we note that it is quite possible that such a change would ultimately help to reduce compliance costs by simplifying the way in which the tax consolidation provisions work. By ensuring that the model mimics an acquisition of assets, a significant amount of guidance may not be required. That is, the existing law that applies on an actual acquisition would likely be applied under an acquisition model.

Alternatively, a move to an acquisition model can occur over a period of time. For example, section 701-55 could be modified over a period of time so that certain categories of assets are treated as if they are "acquired" with no history. This would be an easy modification for depreciable assets under subsection 701-55(2). Certain other amendments could be slowly implemented, rather than wholesale change at one time. This may make it easier to comply with and for taxpayers and the ATO to slowly adopt to the changes in the existing model.

In conclusion, without a thorough review of an acquisition model and its effect on an acquisition / disposal case, it is not possible to determine whether such a model would give rise to additional compliance costs or not.

6 Chapter 6: Small business

6.1 Difficulties faced by SMEs

Question 6.1(a) Are any aspects of the consolidation regime causing particular difficulties for small businesses?

The tax consolidation provisions are a very complex set of provisions. Not only is there an abundance of legislation and explanatory material, but the provisions are intrusive and change the way the whole of the Tax Act is applied. Accordingly, to apply the tax consolidation provisions requires a fairly detailed understanding of how the provisions work.

This is made even more difficult for small medium enterpresises (SMEs), as there are currently no short cuts or simplified provisions of the rules for SMEs and consequently, they are expected to apply the consolidation regime in the same way that an ASX top 100 company would. Furthermore, the consolidation provisions are dependent on market valuations and the application of accounting standards, both resulting in significant costs where the entity would not otherwise obtain or apply such methods.

The complexity of the legislation and the interaction uncertainties with the rest of the Tax Act (for example, Division 7A, trust distribution provisions and the small business CGT rules) further represents a significant difficulty for SME taxpayers.

In addition, there were a number of impediments upon the introduction of the regime that did not entice SMEs to consolidate. Firstly, the pre-CGT factor proportion methodology diluted pre-CGT interests. An amendment has now been introduced to address this problem, with effect from 1 July 2002. However, this amendment will not entice certain SMEs to now form a tax consolidated group simply because the original transitional concessions have now expired (e.g. utilisation of the stick method, loss donation rules and unfranked profits at Step 3).

6.2 Simplifying the tax consolidation regime for SMEs

Question 6.1(b) Should the consolidation regime be simplified for small businesses? If so, how?

6.2.1 What is an SME taxpayer for consolidation purposes?

The first question that needs to be addressed by the Board is their definition of “small business” or SME taxpayer. We don’t believe that significant changes should be made to the consolidation regime for entities with a turnover of less than $2 million. As indicated in the Board report, less than 30% of small business entities within this bracket operate use a corporate structure. Accordingly, the use of other flow through vehicles would allow these types of groups to effectively consolidate the taxable income. As the tax consolidation provisions interact with the whole of the Act, the regime will always have some elements of complexity. Accordingly, the Board should more appropriately define the scope of the SME taxpayers that it would be targeting with a simplified regime.

Taking into account the above, it is noted that Diagram 6.1 of the Board’s Paper indicates that only approximately 50% of groups with $10 to $50 million of turnover have chosen to consolidate. Furthermore, only approximately 65% of groups with $50 to $100 million of turnover have chosen to consolidate. We would have thought that these numbers would be of concern to the Board, given that these groups are comparatively large, yet have chosen to stay out of the regime.

Accordingly, in our view, it would be appropriate to consider this range of SME taxpayers when considering ways in which to simplify the tax consolidation provisions.

6.2.2 Simplified consolidation regime

For the purpose of this section, we refer to an SME taxpayer as a taxpayer that has a turnover of between $10 million to $100 million.

As outlined above, the current consolidation provisions are significantly complex and can act as a deterrent from the consolidation regime for SME taxpayers. We believe that, for this group of taxpayers, the consolidation provisions could be made more “SME friendly” by providing a simplified regime for SMEs. The simplified regime could be contained in a separate Division, for example Division 704. It could then provide an outline as to how the whole of Part 3-90 can be applied by SMEs, with additional shortcuts. Accordingly, an SME taxpayer would only be concerned with considering the

SME division, (e.g. Division 704) and its cross references to the remainder of the Act. The following table demonstrates how this could occur.

Existing division	Simplified 'short cut' for SME's
Division 701: Core rules	• Applied without modification • The core rules are essential for the consolidation regime
Division 703: membership rules	• Applied without modification • The membership rules are similar to pre-tax consolidation grouping rules
Division 705: Tax cost setting on entry	• Shortcut tax cost setting methods could be provided • Election to apply the 'stick' method • Simplification of the 8 steps contained in section 705-60 • Removal of complicated interaction provisions • Ability to use non-AIFRS accounts of the SME • Shortcut valuation methods that can be used rather than market valuations
Division 707: Losses	• A simplified way of testing COT and SBT on acquiring an entity • A simplified method of utilising losses (e.g. a 1/5 method over five years)
Division 709: Franking	• An extension of the core rules to franking issues • Removal / simplification of other complicated interaction provisions • Simplification of the bad debt deduction provisions for SMEs
Division 711: Tax cost setting on exit	• A simplified manner of calculating the cost base of membership interests • Ability to use non-AIFRS accounts of the SME in the ACA calculation
Division 715: (interaction with other provisions e.g. Subdivision 165-CD)	• An exception from applying the loss integrity rules for SMEs • Simplified loss integrity rules for SMEs • Appropriate interactions with SME provisions (Division 7A etc)

In our view, we believe it is possible to have a simplified tax consolidation regime contained in one Subdivision, that applies the provisions in a manner that is more SME friendly. We believe that this simplified regime could provide more certainty and reduced compliance costs for an SME group and accordingly may help to entice more SMEs into the tax consolidation regime.

6.2.3 Alternatives to a simplified consolidation regime

As highlighted earlier, the tax consolidation provisions contain core rules that interact with the whole of the Tax Act. Accordingly, it is often difficult to simplify the operation of the tax consolidation regime, simply due to its intrusive nature.

In our view, the Board should consider this issue and alternative options for allowing SME groups to effectively consolidate their tax affairs. We highlight two alternative options below.

a <u>*Option 1 – simplified grouping rules for SME taxpayers*</u>

It is possible to provide a simplified set of "grouping" provisions for SME taxpayers for the purpose of applying the Tax Act. That is, the Board could consider the merits of allowing:

- Tax loss grouping for wholly owned groups, similar to the Division 170 pre-tax consolidation provisions
- Tax rollover relief for asset and liability transfers between wholly owned groups, similar to Subdivision 126-B rollover relief
- Transaction grouping between wholly owned groups in relation to income and deduction amounts.

While complex value shifting interaction provisions would need to be re-considered, many SME taxpayers feel more comfortable with these limited types of grouping provisions, as they don't require a complex knowledge of how all provisions of the Tax Act operate with a set of core rules. That is, tax losses can be grouped using a special grouping rule without having to learn about complex other interaction provisions, like ACA pushdowns and the interaction of the single entity rule on the application of Division 7A.

This simplified regime would have its shortcomings. For example, it would not effectively deal with issues such as duplicated gains. However, this limitation would be at the discretion of the SME taxpayer (i.e. the SME taxpayer could instead choose to consolidate to help remove instances of double taxation). This result would also be no different to offering a "stick" option for SMEs, which would also likely result in duplication of gains (i.e. as taxpayers would obtain a blackhole treatment for the cost base of shares that is not otherwise pushed down on underlying assets).

Furthermore, we understand that this would also mean that complex provisions such as Subdivision 165-CC and CD would still be required to deal with issues such as the duplication of losses. However, as these SME groups are already outside of the tax consolidation regime, such provisions already need to be considered by such taxpayers. In addition, such provisions were also given their full force through Division 715 when an entity joined a tax consolidated group using the "stick" transitional option (i.e. see section 715-70 for the rule that occurred on formation with transitional stick entities). Accordingly, this would likely be the same result that would occur if the stick option were retained for SME taxpayers, unless Division 715 were otherwise simplified for SME taxpayers.

b *Option 2 – entity flow through taxation regime*

The Board could also consider the adoption of a simpler flow through taxing model for SMEs. An entity flow through model would enable an operating entity to flow through the taxation consequences of transactions to the owners of the entity, essentially being treated as a tax law partnership with the added benefit of limited liability for such owners.

Under such a regime, multi-tiered groups could elect to be treated as flow through entities, thereby providing a quasi-tax consolidation regime that is likely to be significantly less complex than the current consolidation provisions. Such a regime has been previously submitted to the Government by the Institute of Chartered Accountants together with Deloitte[9].

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[9] A joint report from the Institute of Chartered Accountants in Australia and Deloitte, "Entity flow-through (EFT) submission", April 2008

7 Appendix A

7.1 Extending the single entity rule to other provisions

7.1.1 Overview

This section provides an overview of provisions that may require an extension of the single entity rule. These provisions are in addition to those identified in the Board's Paper. We recommend that the Board consider the application of these additional provisions in its review.

7.1.2 Franking and imputation issues

Division 709 contains a number of interaction provisions that effectively extends the single entity rule to franking and imputation issues. However, it is questioned whether these provisions could be simplified if the single entity rule and entry history rule were instead simply extended to such franking and imputation issues.

For example, Subdivision 709-A effectively results in only the head company of a consolidated group operating a franking account. The subsidiary members' franking accounts do not operate while they are subsidiary members. The Subdivision contains 10 operative sections to achieve this outcome. However, most if not all of these provisions could be repealed (on one view) if the single entity rule was simply extended to Part 3-6 of the Tax Act.

Accordingly, the Board should consider whether it is possible to simplify the interaction provisions contained in Division 709 by simply extending the single entity rule and entry history rule to Part 3-6 of the Tax Act.

7.1.3 Division 7A

In TD 2004/68 ,the ATO concludes that the single entity rule does not apply if a private company, that is a member of a tax consolidated group, makes a payment or a loan, or forgives a debt to a shareholder (or shareholder's associate) external to the consolidated group. This is because the rules operate to treat the transaction as a dividend to the shareholder or associate and is therefore outside of core purposes.

7.1.4 Division 152

In TD 2004/47, the single entity does not affect the application of the controlling individual test in paragraph 152-10(2)(a). While this issue is effectively overcome by amendments contained in paragraph 152-10(2)(b) (i.e. through an indirect test), it is noted that in TD 2004/47, an extension of the single entity rule would ensure that the sale of the shares in the subsidiary entity would ordinary fall within the direct test (paragraph 152-10(2)(a)). The extension of the single entity rule to Division 152 would ensure that the provisions are simplified (i.e. would remove the requirement to apply the complex indirect tracing provisions).

7.1.5 Division 197

Where the share tainting provisions contained in Division 197 give rise to un-tainting tax issues, it is questionable whether the single entity rule modifies the operation of the tainting provisions (i.e. as this is could be considered a purpose outside of core purposes). Accordingly, while a subsidiary member is part of a tax consolidated group, the share capital account of the subsidiary may become inadvertently tainted due to an intra-group transaction (e.g. a debt forgiveness transaction). Where this is the case, the share capital account of the subsidiary would appear to remain tainted upon leaving the tax consolidated group.

From a policy perspective, we are unsure why the single entity rule would not be extended to the share capital tainting provisions while a subsidiary is part of a tax consolidated group.

7.1.6 Division 230

a *Transactions with consolidated groups*

A taxpayer (which may be a consolidated group) may also contract with members in another tax consolidated group. It is questioned whether the single entity rule should be extended to ensure symmetrical treatment of the arrangement.

To demonstrate, assume Aco (head company of the Aco consolidated group) loans $100 to Bco (the head company of the Bco consolidated group). Further assume that Aco assigns 50% of the rights to receive payment to Xco, a subsidiary member of Bco for $60 (being the market value of 50% of the debt).

Applying Division 230 from Aco's perspective, a balancing adjustment in respect of the loan would likely occur under subsection 230-435(1) due to the assignment. A gain of $10 would likely be recognised on the transaction. However, from Bco's perspective, tax consolidation would make it difficult to recognise the assignment. This is because it would be difficult for Bco to have the debt assigned to itself (being the debtor). Accordingly, Bco may see the transaction as being a repayment of the loan of $60. Applying Subdivision 230-B, Bco would need to determine whether the amount gives rise to a realisation gain or loss under section 230-180.

7.1.7 Division 974

There are a number of single entity application issues in relation to Division 974. These are outlined below. The Board should consider whether a more appropriate treatment would occur if the single entity rule was specifically extended to Division 974 for all purposes.

a *Application of subsection 974-75(6)*

The turnover test contained in subsection 974-75(6) is used to determine whether an arrangement is debt or equity. However , it is queried whether the single entity rule can apply to the turnover threshold, such that it would group the turnover of the whole of the tax consolidated group. For example, the instrument in question may be an "interest free" loan, which does not give rise to a tax deduction or assessable amount. Accordingly, irrespective of whether the arrangement is a debt or equity interest, the arrangement would not affect "core purposes".

b *Section 974-80*

Section 974-80 requires consideration of a number of entity's, including a company, a target entity and connected entities. It is questioned whether the single entity rule should be extended to the application of this provision.

For example a company (Aco) may issue a debt interest to a connected entity outside of the tax consolidated group (Xco). In turn Xco may issue an equity interest to Wco, being the wholly owned parent of Xco. Assume that Wco and Xco are part of the same tax consolidated group.

Under the ATO view on the operation of section 974-80, Wco would be considered a target entity and Xco would be considered the connected entity. If the single entity rule is not extended to Aco, then it is likely that this would result in the application of section 974-80 to Aco to treat the debt interest as an equity interest. This result appears inappropriate, given that (in reality) the tax consequence of the arrangement is simply a debt interest between Aco and Xco for tax purposes.

c *Non-share distributions*

When a company issues a non-share equity interest, payments made in respect of the instrument do not affect core purposes. Accordingly, it is unlikely that the single entity rule applies from the perspective of either the issuer or the holder. This means that the third party is taken to hold an equity interest n the subsidiary member of the tax consolidated group.

This can then result in a complex series of interactions. Under section 709-85, any non-share distribution is considered to be that of head company for franking purposes only. However, whether the distribution can be franked is determined by reference to the profits of the subsidiary member under section 215-20. Subsequently, when applying section 974-115, the non-share distribution is treated as a distribution by the subsidiary member. Furthermore, Division 164 requires the subsidiary member to maintain the non-share capital account in respect of the equity interest.

It is queried whether the single entity rule should be extended for the whole of the operation of Division 974. This would result in the equity interest being taken to have been issued by the head company, would remove the requirement of section 709-85, would allow the consolidated group to consider its group profits for the purpose of section 215-20 and would require the head company to maintain non-share capital accounts.

8 Appendix B

8.1 Taxing trust income – possible options and examples[10]

8.1.1 Option one: the deemed head company entitlement option

a *Trust joins a tax consolidated group*

Under this option, when a trust is acquired 100% by a tax consolidated group during an income year, the head company could be deemed to be presently entitled to all income of the trust for the whole income year (irrespective of which beneficiaries have received trust distributions).

Consequently the head company would be taken to be presently entitled to the whole of the net income for the non-membership period. Any distributions of income of the trust that had been made prior to the joining time would be treated as a non-assessable distribution, and thus subject to CGT event E4 or section 99B in respect of those beneficiaries.

In practice, as the head company would be assuming the tax liability in respect of the acquired trust, the purchase price would generally be adjusted to take into account this acquired liability. It may also be necessary to make an adjustment to the step 2 amount so that this tax liability can be recognised (see the analysis on question 4.2 for further details).

b *Trust leaves a tax consolidated group*

When a trust leaves a consolidated group, the net income of the trust would be calculated with reference to the non-membership period only. That is the operation of the single entity rule would mean that the net income derived during the membership period would be income of the head company and not that of the trust. To accommodate this provision, the single entity rule would need to be extended for all purposes. Accordingly, the net income of the trust during the remaining non-membership would be allocated in the to the beneficiaries based on present entitlement as determined at the end of the income year in the ordinary fashion.

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[10] Note that these examples have been applied assuming that the proportionate view of taxation under Division 6 is the correct approach – this is currently being considered by the High Court.

8.1.2 Option two: the deemed joining time option

a *Trust joins a tax consolidated group*

Option two is similar to option one, only that the trust instead will only be taken to join a tax consolidated group on the first day of the next income year (the new joining time). Accordingly, present entitlement to income of the trust during the income year would be calculated in the ordinary fashion under Division 6. The drawback of this option would be that the single entity rule would not apply to intragroup transactions for the period after acquisition until the new joining time.

b *Trust leaves a tax consolidated group*

Where a trust leaves a consolidated group, the rule could operate in the same fashion as those proposed under option one.

8.1.3 Option three: the Division 6 modification option

a *Trust joins a tax consolidated group*

This option involves complex modifications to Division 6 so that its interacts with the tax consolidation provisions more appropriately. We have developed the following six steps that could be used in allocating the net income of the trust in a joining case.

- Step 1: The SER is extended to third parties for the purposes of applying Division 6 and other applicable provisions (for example section 115-215).
- Step 2: The trust calculates its net income, exempt income and the non-assessable non-exempt income of the trust for the non-membership period. This amount is deemed to be the 'net income of the trust' for the entire income year.
- Step 3: The trust calculates its income for the non-membership period as if that period was a discrete income year – this amount is deemed to be the 'income of the trust'.
- Step 4: The trustee determines whether beneficiaries, other than members of the consolidated group were made presently entitled to an amount during the income year (this is the distribution amount)
- Step 5: Determine the amount that any "non-tax consolidated" beneficiaries are presently entitled to during the non-membership period:

- Step 5a. If the distribution amount is *less than* the deemed 'net income of the trust' the beneficiary is deemed to be presently entitled to the distribution amount.

- Step 5b. If the distribution amount is *more than* the deemed 'net income of the trust' the distribution amount should be proportionately reduced so that it doesn't exceed the deemed 'net income of the trust' – any excess will be treated as a non-assessable capital distribution under CGT event E4 or section 99B.

- The head company is deemed to be presently entitled to the remaining income of the trust for the non-membership period.

b <u>*Trust leaves a tax consolidated group*</u>

On leaving a tax consolidated group, the modification proposed to Division 6 above would be generally the same. However, Step 4 would be modified so that the trustee is required to determine whether beneficiaries were made presently entitled to an amount during the non-membership period (i.e. excluding any membership periods).

8.1.4 Option four: the administrative option

This final option would allow for an administrative solution to the problem. For example, each beneficiary (either the new/old beneficiaries after joining or leaving time and the head company) would be assessed on a reasonable portion of the net income of the trust, having regard to the circumstances. What is reasonable would depend on the circumstances and a number of factors. This option would be equally applicable to both joining and leaving cases.

As this option would not provide any degree of certainty, we would only recommend this option if the other options proved too complex to administer.

8.2 Example 1: Trust joins a tax consolidated group

8.2.1 Facts of the example

In this example, assume the AB unit trust has two beneficiaries Hco (a head company of a tax consolidated group) and Bco. Each beneficiary owns 50% of the units. On 30 November 2007, the trust makes an interim cash distribution to its beneficiaries of $4,500 each. On 1 December 2007, Hco acquires all the units from Bco. Accordingly, at this time, the AB unit trust becomes a 100% subsidiary of Hco. During the income year, assume that the AB unit trust earned the following income:

	1 July 2007 to 30 November 2007	1 December 2007 to 30 June 2008	Total
Net income	12,000	13,000	25,000
Income of the trust	10,000	10,000	20,000
Cash distribution	9,000	11,000	20,000

8.2.2 Applying the example

Based on the above table, it would seem reasonable to allocate $12,000 of the net income of the trust between the beneficiaries that existed during the non-membership period and for the head company to be taxable on the remaining $13,000 during the membership period. In trying to achieve this outcome, the four options are applied to this example below.

8.2.3 Option one

Under option one, Hco is deemed to be presently entitled to all of the income of the trust estate during the non-membership period. Therefore, Hco will include and be taxed on the $12,000 during that period. The remaining $13,000 will be included in Hco's assessable income under the single entity rule. Accordingly, Hco would be assessed on the whole of the $25,000 of net income of the trust estate.

The distribution that Bco received ($4,500) would be potentially assessable under CGT event E4 or potentially assessable under section 99B to Bco. As Hco is acquiring a tax liability when purchasing the units from B Co, the purchase price would be adjusted to take this into account.

8.2.4 Option two

Under option two, the trust is not taken to have joined the consolidated group until the first day of the next income year. Therefore, at the end of the income year, Division 6 is applied in the ordinary fashion. As Bco is presently entitled to $4,500 and Hco will (presumably) be made presently entitled to the remainder of the income (i.e. $15,500), under Division 6, Bco would be entitled to 22.5% of the income of the trust. Accordingly, Bco would include $5,625 of the net income of the trust (4,500/20000) under section 97. Hco would be assessed on the remaining 77.5%, being $19,375.

8.2.5 Option three

Under option three, Division 6 is modified by the six steps proposed. The calculation is shown in the table below.

Step	Modification
Step 1: Extend SER to all parties	N/A
Step 2: Net income for the non-membership period	$12,000
Step 3: Income for the non-membership period	$10,000
Step 4: Distribution of net income to non-tax consolidated members	$4,500
Step 5a: Adjusted distribution amount to non-tax consolidated members	$4,500
Step 5b. Non-assessable distributions to non-tax consolidated members	$-
Step 6: Distribution amount of income to tax consolidated group	$5,500

Based on the above, Bco is deemed to be presently entitled to $4,500 of the income of the trust, while Hco is deemed to be presently entitled to the remaining amount of income, being $5,500. The net income of the trust during the non-membership period, being $12,000, would be allocated to Bco based on their proportionate share of the income of the trust. Accordingly, under section 97, Bco would be assessed on $5,400 (being $4,500 / $10,000 x $12,000) and Hco would be assessed on $6,600 (being $5,500 / $10,000 x $12,000). Hco would also be assessed on the remaining $13,000 during the membership period under the single entity rule (as the $13,000 of income would be deemed to be derived by Hco).

It is noted that the outcome under this method is broadly similar to that provided by Option two.

8.2.6 Option four

Under option four, Hco and Bco would be assessed on the amount of the net income of the trust estate that is fair and reasonable, having regard to the facts and circumstances. In this example, the amount of net income derived by the trust during the relevant periods and the distributions received by the beneficiaries during those periods would be important facts and circumstances.

It may seem appropriate to allocate 45% of the net income of the trust estate during the non-membership period to Bco (i.e. $5,400), 45% to Hco (i.e. $5,400) and the remainder to be assessed to the trustee at top marginal rates (i.e. $1,200).

The net income of the trust during the membership period would automatically be attributed to Hco under the single entity rule (i.e. $13,000).

8.2.7 Comparison of the four options

The following table provides a comparison of the outcomes that would occur under the four options of assessing the beneficiaries and the trustee.

Option	H Co	B Co	Trustee	Total	E4 / 99B
Option one	$25,000	-	-	$25,000	$4,500
Option two	$19,375	$5,625	-	$25,000	-
Option two	$19,600	$5,400	-	$25,000	-
Option four	$18,400	$5,400	$1,200	$25,000	-

8.3 Example 2: Trust leaves a tax consolidated group

8.3.1 Facts of the example

Assume that the AB unit trust is 100% owned by Hco and is subsidiary member of the Hco tax consolidated group. On 30 November 2007, the AB unit trust makes an interim distribution of $9,000 to Hco.

On 1 December 2007, Hco sells 50% of its units to Bco, and the AB unit trust leaves the tax consolidated group. At the end of the income year, AB unit trust makes Bco and Hco presently entitled to 50% of the income of the trust estate each. During the income year, assume that the AB unit trust earned the following income:

	1 July 2007 to 30 November 2007	1 December 2007 to 30 June 2008	Total
Net income	13,000	12,000	25,000
Income of the trust	10,000	10,000	20,000
Cash distribution	9,000	11,000	$20,000

8.3.1 Applying the example

Based on the above table, it would seem reasonable to assess Hco on the whole $13,000 for the membership period, and then on 50% of the net income for the non-membership period (i.e. $6,000). It would also appear reasonable to assess Bco on 50% of the net income from the non-membership period, being the remaining $6,000. In trying to achieve this outcome, the four options are applied to this example below.

8.3.2 Option one

Under option one, the net income of the trust estate for the non-membership period, and the thus the income year, would be deemed to be $12,000. The income of the trust would also be deemed to be $10,000 for the same period. Hco and Bco would be taken to be presently entitled to 50% each of this amount. Accordingly, applying section 97, both beneficiaries would include $6,000 of net income in their assessable income. As the cash distribution is more than the distribution of "income of the trust", this could give rise to a capital return to the beneficiaries. One would need to therefore consider whether CGT event E4 or section 99B would apply to the distribution of $500 of cash to each beneficiary.

Hco would be assessed on the remaining $13,000 of taxable income from the membership period applying the single entity rule.

8.3.3 Option two

Under Option two, the outcome is identical to that of Option one.

8.3.4 Option three

Under option three, Division 6 is modified by the six steps proposed. The calculation is shown in the table below.

Step	Modification
Step 1: Extend SER to all parties	N/A
Step 2: Net income for the non-membership period	$12,000
Step 3: Income for the non-membership period	$10,000
Step 4: Distribution of net income to non-tax consolidated members	$5,500
Step 5a: Adjusted distribution of income to non-tax consolidated members	$5,000
Step 5b. Addition cash distributions to non-tax consolidated members	$500
Step 6: Distribution amount of income to tax consolidated group	-

Based on the above, both Bco and Hco are deemed to be presently entitled to $5,000 of the income of the trust. The net income of the trust, being $12,000, would be allocated to Bco based on their proportionate share of the income of the trust. Accordingly, under section 97, Bco would be assessed on $6,000 (being $5,000/ $10,000 x $12,000) and Hco would be assessed on $6,000 (being $5,000 / $10,000 x $12,000). The additional cash distribution received by both beneficiaries of $500 would require consideration of CGT event E4 or section 99B.

Hco would also be assessed on the remaining $13,000 during the membership period under the single entity rule (as the $13,000 of income would be deemed to be derived by Hco).

It is noted that the outcome under this method is broadly similar to that provided by Option two.

8.3.5 Option four

Under option four, Hco and Bco would be assessed on the amount of the net income of the trust estate that is fair and reasonable, having regard to the facts and circumstances. In this example, the amount of net income derived by the trust during the relevant periods and the distributions received by the beneficiaries during those periods would be important facts and circumstances.

It may seem appropriate to allocate 50% of the net income of the trust estate during the non-membership period to Bco (i.e. $6,000), 50% to Hco (i.e. $6,000). The net income of the trust during the membership period would automatically be attributed to Hco under the single entity rule (i.e. $13,000).

8.3.6 Comparison of the four options

The following table provides a comparison of the outcomes that would occur under the four options of assessing the beneficiaries and the trustee.

Option	Hco	Bco	Trustee	Total	E4 / 99B *
Option one	$19,000	$6,000	-	$25,000	$1,000
Option two	$19,000	$6,000	-	$25,000	$1,000
Option two	$19,000	$6,000	-	$25,000	$1,000
Option four	$19,000	$6,000	-	$25,000	$1,000

** CGT event E4 and section 99B would need to be considered in respect of the additional cash distribution of $500 to each beneficiary, which is over and above the distribution of income of the trust (i.e. the return of capital amount).*

It is interesting to note that all four options appear to provide the same answer in respect of the allocation of net income in the example provided. Furthermore, each of the options also seems to provide a reasonable allocation of the net income of the trust.

9 Appendix C

9.1 Example 1: Inherited deferred tax liabilities

9.1.1 Facts of the example

AB unit trust has one beneficiary (Cco). AB unit trust has one depreciable asset with an original cost base of $1000, a tax written down value of $400 and an accounting written down value of $500. Cco sells all of its units in AB unit trust to Hco and consequently the unit trust becomes part of HCo's consolidated group.

9.1.2 Application of section 705-70

The example is constructed so that there is a deferred tax liability prior to the joining time of $30. However, as the trust does not pay tax, this amount is not recorded as a liability in the accounts of the trust.

There are essentially two options for Hco to acquire the depreciating assets of the AB trust – it could purchase the asset outright for $500 or it could purchase the units from Cco. If the asset is purchased directly, there would be no embedded DTL as the new accounting and tax values would be the same. Furthermore, if the units are acquired for $500, the same result would occur, as Hco would push down $500 to the underlying asset based on Step 1 of the ACA process.

An issue would only occur if Cco discounts the units to take into account the embedded deferred tax liability prior to the joining time. In this case Hco may only pay $470. If this were the case, then Step 2 would not operate to include the $30 DTL, as it is not a liability of the joining entity. While it is unlikely that this may occur commercially, the issue is highlighted for completeness.

9.2 Example 2: Inherited current tax liabilities

9.2.1 Facts of the example

AB unit trust has one beneficiary (Cco). AB unit trust has one depreciable asset with an original cost base of $1000, a tax written down value of $400 and an accounting written down value of $400. Cco sells all of its units in AB unit trust to Hco halfway during the income year. Consequently the unit trust becomes part of Hco's consolidated group. At the time of joining, income and net income of the trust is equal to $10,000. The trust has retained the net income in a bank account ($10,000).

9.2.2 Application of section 705-70

The example is constructed so that there is a tax liability prior to the joining time on the $10,000 of net income. This may give rise to a tax liability to the trustee or Hco, depending on the application of section 97 to the tax consolidated group.

If the trustee is assessable on the $10,000, then this would appear to be a "liability" of the trust (i.e. a liability of the trustee in its capacity as trustee of the trust). Accordingly, a liability of $4,650 should be included at Step 2 of the ACA calculations. The purchase price paid by Hco is likely to be discounted for the inherited tax liability. This would seem to provide for an appropriate result.

If Hco is assessable on the $10,000, then this would not be a liability of the trust, but rather a liability of the tax consolidated group. Under the current operation of provisions, it is unlikely that this would occur. However, under a number of our proposed options, we have proposed that Hco be assessed on a portion (if not all) of the $10,000. As Hco will be liable to pay tax on this amount, it would also discount the purchase price of the shares for the estimated future tax. However, this liability would not be included at Step 2 of the ACA calculations, as it is not a liability of the joining entity. This would not provide an appropriate ACA result. In this case, Step 2 should be modified to ensure that any current tax liability inherited by the tax consolidated group in respect of net income of the trust acquired should be included at Step 2 of the ACA process for the relevant rust.

10 Appendix D

10.1 Example 1: MEC group roll-downs and CGT event J1

10.1.1 Facts of the example

Assume that foreign Top Company owns 100% of the shares in Aco and Bco, both being eligible tier-one companies of the Aco MEC tax consolidated group. Assume that the entities held the following assets at 1 July 20X1.

For the purpose of the example, the asset held by Bco is real property. Top company then sells its interests in Bco to Aco for its market value of $100, so that Aco acquires all of the membership interests in Bco. The rollover is done under Subdivision 126-B. Aco uses $100 of cash to acquire the interests in Bco. After the transaction, Aco's only asset is the shares in Bco.

10.1.2 Application of the pooling rules

Subdivision 719-K applies on the roll-down of Bco. The pooling rules would act to reset the cost base of the shares in Aco at $75. Effectively, this amount constitutes 50% of the pooled cost base of $150. This also results in the cost base of shares in Bco being reset at $75 as well. However, as Bco remains a member of the MEC group, Subdivision 705 is not applied to reset the cost of the asset held by Bco. Essentially, this results in a wastage of $25 of cost base (i.e. the difference between the cost base of the shares in Bco being $75 and the cost base of the underlying assets in Bco being $50). This wastage of cost base can otherwise be viewed as a blackhole expenditure amount.

10.1.3 Sale of Aco

Assume that Aco is subsequently disposed of to Xco, an Australian resident company (non-consolidated). The sale of Aco gives rise to a taxable event given that the shares in Bco are TARP under section 855-25. Foreign Top Company derives a capital gain of $25 under CGT event A1, being equal to the difference between the market value of the shares of $100 and the pooled cost base of $75. The sale of Aco requires Bco to perform an exit calculation. Applying Division 711, the cost base of the shares is calculated to be $50. CGT event J1 will apply to crystallise a capital gain of $50 under CGT event J1, being the difference between the cost base of the shares under Division 711 ($50) and the market value of the shares (being $100).

The total taxable gain in respect of the sale of Aco is $75. In this example, the economic gain is only $50, being the combined market value of Aco and Bco separately ($200) less the combined original cost base of the shares in Aco and Bco of $150. The application of CGT event J1 results in a duplication of the capital gain of $25, represented by the $25 of ACA pushdown foregone on the roll-down of Bco (i.e. the blackhole cost base amount).

Accordingly, in our view, the example demonstrates an inappropriate application of CGT event J1 in respect of a MEC group roll-down.

Finally, we note that this example was first provided to the ATO on 16 November 2006 by the Institute of Chartered Accountants in Australia.