

12 March 2010

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

By email: taxboard@treasury.gov.au

Post-implementation review into certain aspects of the consolidation regime

Dear Sir

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

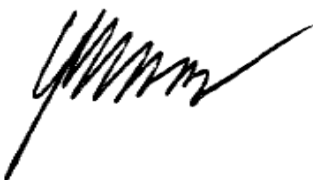
Our submission which addresses each of the questions in the Board's discussion paper is attached as follows:

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

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

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

Yours sincerely



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Post-implementation review into certain aspects of the consolidation regime

Summary of key points

The key points of our submission are set out below.

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

- The consolidation regime has increased business efficiency and reduced compliance costs. However unnecessary compliance costs are still being incurred in respect of the simple restructures or acquisitions where:
 - The legislation mandates that a consolidated group deconsolidate and reconsolidate
 - A consolidated group acquires another consolidated group which has a transitional foreign held subsidiary.

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

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

- There are various reasons why corporate groups have chosen not to consolidate. In no particular order these include:
 - Insufficient need/insufficient benefits from choosing tax consolidation
 - Costs of adopting tax consolidation outweigh perceived benefits
 - Uncertainty with the tax consolidation law which has caused some groups to defer entry or not to enter to date
 - Inability to apply transitional concessions for groups that delayed consolidation pending clarification of tax consolidation law
 - Inability to choose to consolidate on a retrospective basis for groups that delayed consolidation pending clarification of tax consolidation law
 - Complexities and inequities in applying tax cost setting rules
 - Complexities and inequities in applying loss rules
 - Potential traps for MEC groups/consolidated groups with group losses.

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

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

Chapter 3 – Operation of the single entity rule

- On the whole the single entity rule (SER) satisfies the policy objective of simplifying the tax system, reducing taxpayer compliance costs and increasing the economic efficiency and integrity of the tax system in respect of dealings between consolidated groups and third parties. This is more evident for groups which deal mainly with third parties and have limited transactions involving intra-group assets.
- We do not believe that additional rules are needed to support the basic operation of the SER. However, modifications to the existing provisions are likely to be required to ensure appropriate outcomes in particular cases
- In relation to the announced changes to section 711-40, we agree with the proposed amendment to subsections 711-40(2) and (3) in respect of third party incidental costs and capital expenditure in relation to intra-group assets. However, we do not agree that amendments should be made to limit the step 3 amount of the exit allocable cost amount (ACA) to those intra-group liabilities owed to a leaving entity that are “accounting liabilities”.
- In our view, in certain cases, it would be appropriate to recognise the SER from a third party perspective and achieve a proper balance between equity, efficiency and simplicity, e.g. to resolve the commercial debt forgiveness problem identified in the Board’s Paper. However, we do not consider that this approach would be suitable in all cases.

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

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

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

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

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

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

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

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

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

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

Chapter 5 – Review of the inherited history rule

- At this stage, and based on current experiences, we do not advocate the replacement of the entry history rule with a clean slate rule. There are particular aspects of the consolidation law that interact with the inherited history rule in ways that result in anomalous outcomes, for example:
 - Accelerated depreciation
 - Privatised assets
 - Uniform capital allowance (UCA) and mining assets

and these require consideration.

Chapter 6 – Operation of the consolidation regime for small business

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

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

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

Post-implementation review into
certain aspects of the consolidation regime

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

Question 2.1(a)

The Board seeks stakeholder comment on:

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

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

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

Question 2.1(b)

The Board seeks stakeholder comment on:

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

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

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

General impediments to achieving reduced compliance costs

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

Legislative delays:

- result in additional compliance costs not only because of the need to deal with the uncertainty between the time of announcement and ultimate enactment of the law, but also in potentially having to revisit prior year tax positions and apply law retrospectively and
- create issues for financial reporting purposes, e.g. to the extent that the amendments currently before Parliament impact prior year tax positions, they will need to be reflected in current and

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

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

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

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

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

Specific areas of the law which create unnecessary compliance costs

Compliance cost issues associated with simple restructures or acquisitions

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

- a non-resident company, which owns 100% of a consolidated group, becomes eligible to be a head company of a consolidated group
- a consolidated group becomes 100% owned by a single company due to the cancellation of minority interests, or
- a consolidated group becomes 100% owned by another consolidated group due to the cancellation of minority interests¹.

The legislation also results in additional compliance costs for consolidated groups which acquire another consolidated group which has a transitional foreign held subsidiary². The existence of such an entity means that the acquiring consolidated group cannot avail itself of Subdivision 705-C unless, prior to acquisition, the subsidiary is identified and appropriate restructuring (which may include deregistration of the company) is undertaken.

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

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

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

Question 2.1(c)

The Board seeks stakeholder comment on:

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

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

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

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

These issues are explored in more detail below.

Insufficient need/insufficient benefits from choosing tax consolidation

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

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

Costs of adopting tax consolidation outweigh perceived benefits

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

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

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

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

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

- additional guidance materials from the ATO. In this regard we would encourage the ATO to continue to maintain its Consolidation Reference Manual
- better education of tax agents (especially smaller practitioners so that they may be able to provide appropriate services at a reduced cost).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Complexities and inequities in applying tax cost setting rules

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

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

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

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

Complexities and inequities in applying loss rules

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

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

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

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

Potential traps for MEC groups/consolidated groups with group losses

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

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

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

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

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

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

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

Chapter 3 - Operation of the single entity rule

Question 3.1

The Board seeks stakeholder comment on:

- (a) Is the operation of the single entity rule effectively meeting its stated policy intent of simplifying the tax system, reducing taxpayer compliance costs, and increasing the economic efficiency and integrity of the tax system?
- (b) If not, in what circumstances is the single entity rule failing to meet its intended policy objectives, and what is the practical impact of this failure on consolidated groups?
- (c) How can the operation of the single entity rule be improved to ensure it achieves its intended outcomes?

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

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

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

Question 3.2

The Board seeks stakeholder comment on:

- (a) Are additional rules needed in the income tax law to support the operation of the single entity rule (section 701-1) to ensure the rule achieves its policy intent? If so, what supporting principles are needed?
- (b) Should the income tax law contain specific exceptions to the operation of the single entity rule? If so, what should those exceptions be?
- (c) Does section 701-85 of the ITAA 1997, which sets out the approach to the interpretation of the core consolidation provisions, increase uncertainty in the application of the single entity rule? If so, how can this uncertainty be alleviated?

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

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

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

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

Examples of inappropriate outcomes under the SER

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

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

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

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

- although capital expenditure associated with the internal transfer of depreciating assets (or trading stock) is technically included in the CGT cost base of such assets (under subsection 110-35(10)), any capital gain or loss from their subsequent disposal is disregarded (sections 118-24 and 118-25)
- since there is no equivalent provision to subsection 110-35(10) within Division 40 to allow capital expenditure to be included in the asset's cost for Division 40 purposes, such expenditure is not always able to be taken into account in the cost of the depreciating asset. This affects ongoing entitlements to depreciation deductions and balancing adjustment amounts on the subsequent disposal of assets to a non-group member
- although expenditure incurred in respect of the transfer of the applicable asset would typically meet the positive requirements for deduction under section 40-880, because such expenditure would form part of the CGT cost base of the applicable asset, paragraph 40-880(5)(f) operates to prevent any section 40-880 deduction for third party costs.

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

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

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

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

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

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

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

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

Question 3.3

The Board seeks stakeholder comment on:

- (a) What concerns, if any, arise in relation to the announced changes to section 711-40 of the ITAA 1997?
- (b) In what circumstances, if any, do you consider the taxation outcomes that arise when intra-group assets are acquired or disposed of to be inappropriate? What do you consider the appropriate outcome to be?

Section 711-40

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

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

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

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

Inappropriate outcomes on intra-group assets

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

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

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

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

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

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

It may not always be possible for the transaction to qualify for Subdivision 126-B roll-over relief. For example, in instances in which the transferred-up entity is not an indirect Australian real property interest, it will not represent taxable Australian property and the roll-over conditions will not be met³.

We note that in cases where a MEC group is created as a result of the transfer-up of a former subsidiary of the consolidated group, amendments proposed in *Tax Laws Amendment (2010 Measures No 1) Bill 2010* ensure that although the general rule to ensure that the conversion of a consolidated group to a MEC group (and vice versa) is to be seamless, an integrity rule *requires* that Division 711 (ie exit) calculations are undertaken to recognise the tax cost of the membership interests of the former subsidiary member⁴.

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

Question 3.4

The Board seeks stakeholder comment on:

- (a) Are there any circumstances, in practice, where the history of an intra-group asset (other than its history as a divisional arrangement) is relevant to determine its tax treatment when it ceases to be owned by the group?
- (b) If any other history of an intra-group asset is relevant, are any modifications to the income tax law required to allow that history to be recognised?

No specific comment.

Question 3.5

The Board seeks stakeholder comment on:

- (a) Are there other situations which are not identified in this Chapter where a third party may be required to reconstruct intra-group transactions?
- (b) Should the single entity rule be extended to all third parties who have dealings with a consolidated group? If so, would any exceptions be required?
- (c) Alternatively, should the single entity rule be extended to third parties who are directly related to a consolidated group (such as shareholders)? If so, would any exceptions be required?
- (d) As a further alternative, should the operation of the single entity rule outside the consolidation provisions be considered on a case by case basis?

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

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

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

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

³ s126-50(5)

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

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

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

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

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

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

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

"Internal straddle" contracts

The ATO has issued three Taxation Determinations⁵ dealing with the tax consolidation and CGT implications of straddle contracts, including guidance on whether the asset that is the subject of the contract is recognised for consolidation purposes at the joining or leaving time. The ATO's Consolidation Reference Manual⁶ explains how the consolidation cost setting rules apply to these assets identified in relation to a straddle contract. In addition, specific measures are currently before Parliament in relation to straddle sale arrangements entered into on or after 8 May 2007⁷.

However there is currently no guidance available in relation to the treatment of "internal straddle" arrangements (the Determinations that have been issued are expressly stated not to apply to internal straddles). Such arrangements arise when the CGT asset that is the subject of a purchase or sale contract is a CGT asset of the same consolidated group that the relevant entity is joining or leaving, at either the contract time or the time just after the contract is completed.

Accordingly, we submit that further consideration needs to be given in relation to the interaction between the consolidation and CGT provisions in relation to internal straddle arrangements, with a view to providing further guidance (which may be guidance from the ATO in the form of Taxation Determinations) or legislative amendments to clarify the operation of the law in these circumstances.

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

⁶ Part C2-1-080, ATO's Consolidation Reference Manual

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

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

Question 4.1

The Board seeks stakeholder comment on:

- (a) How should the net income for a trust's non-membership period be assessed to beneficiaries and trustees?
- (b) Do the current rules need to be amended to achieve an appropriate outcome? For example, are specific provisions needed in the consolidation rules to align the calculation of the income of a trust with the method used for calculating the net income for the trust's non-membership period? If so, is there a simple approach that can be used that produces an appropriate outcome?
- (c) Should a single set of rules apply to assess all beneficiaries on a share of the trust's net income for a non-membership period? If so, what should the rules be?
- (d) Are there any other issues which are not identified in this Chapter that arise when a trust joins or leaves a consolidated group part way through an income year? What is the best way of resolving these issues?

Question 4.2

The Board seeks stakeholder comment on:

- (a) When working out the allocable cost amount for a trust, should the head company recognise its liability for income tax payable on its share of the net income of the trust as a cost of acquiring the joining entity? If yes, do the current cost setting rules need to be amended to achieve this outcome? If so, how?
- (b) Are there any other issues which are not identified in this Chapter that arise with the way the cost setting rules apply to trusts when they join or leave a consolidated group? If so, how can these be overcome?

Question 4.3

The Board seeks stakeholder comment on:

- (a) Does a trustee need to be a member of the same consolidated group as the trust? If yes, why? If not, why not?
- (b) If a trustee is not a member of the same consolidated group as the trust, do the core rules and other tax rules operate appropriately to deem the income and expenditure of the trust to be that of the head company?
- (c) Should a trust be a member of a consolidated group if it has beneficiaries that are not members of the group? If yes, what other issues need to be resolved? If not, why not?
- (d) How can the current provisions be altered so they are workable and provide certainty?

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

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

Possible solutions to the interaction problem could include:

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

Question 4.4

The Board seeks stakeholder comment on:

- (a) Should non-resident entities that satisfy the foreign hybrid rules be members of a consolidated group? If yes, how is this consistent with the Government's policy intent that limits the types of entities that become members of a consolidated group?
- (b) Would non-resident entities that satisfy the foreign hybrid rules effectively gain or be denied concessional treatment by becoming a member of a consolidated group?
- (c) If these entities can become members of a consolidated group, are there any integrity risks that need to be addressed? If so, what are they and what is the best way to resolve them?
- (d) If these entities cannot be members of a consolidated group, what is the most efficient way of preventing non-resident entities from being members of a consolidated group?

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

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

Question 4.5

The Board seeks stakeholder comment on:

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

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

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

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

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

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

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

Question 4.6

The Board seeks stakeholder comment on:

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

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

Question 4.7

The Board seeks stakeholder comment on:

- (a) Are there circumstances in which CGT event J1 produces undesirable outcomes? If so, how can the income tax law be amended to overcome these concerns?
- (b) Are there situations that CGT event J1 does not apply to but should? If so, what are they?

No specific comment.

Question 4.8

The Board seeks stakeholder comment on:

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

Foreign currency

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

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

In the case of a MEC group, eligibility for functional currency is problematic as there is not one set of financial reports prepared for an Australian MEC group. Even if the reports were aggregated, it may be the case that there is no sole or predominant functional currency across the varying entry points into Australia. Although the ATO has issued a Tax Determination⁹ indicating that the "applicable functional currency" for the head company of a consolidated group is determined by looking at the accounts of all the members of the consolidated group, rather than the 'accounts' of the head company only, applying this to a MEC group is not so easy.

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

⁹ TD 2007/24

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

Taxation of Financial Arrangements

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

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

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

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

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

Question 4.9

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

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

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

Interaction with loss rules

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

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

Deemed failure of continuity of ownership test for MEC groups

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

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

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

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

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

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

Interaction with thin capitalisation rules

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

In practice, except for foreign banking groups which are catered for in the legislation¹⁰, most MEC groups simply “aggregate” the consolidated accounts of each ET1C for the purposes of the safe harbour calculation. However, the legal basis for this approach is far from clear.

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

Interaction with CGT rules

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

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

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

The effect of subsection 705-65(5B) is to ensure that the step 1 amount is increased by the amount of any deferred acquisition payments actually made.

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

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

¹⁰ Section 820-611

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

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

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

Limited access to Subdivision 126-B roll-over

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

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

This seems anomalous given that the Australian companies do not form part of a consolidatable group. The only way that the transfer of assets between the resident companies could occur without tax consequences is if the companies formed a MEC group (which may not be possible if there are cross-shareholdings¹²).

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

Measures needed to appropriately deal with intangible “economic” assets

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

These assets are not “depreciating assets” for Division 40 purposes¹⁴ or “CGT assets” as defined in section 108-5 (ie they are not property, or a legal or equitable right that is not property). However, they are identifiable as assets having economic value and for accounting purposes are treated as being separate from goodwill. Similarly, as explained in the following paragraphs, these intangibles are generally also recognised as separately identifiable “assets” for consolidation purposes to which a tax cost setting amount is allocated at an entity's joining time.

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

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

¹¹ Section 126-50

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

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

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

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

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

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

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

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

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

Chapter 5 – Review of the inherited history rule

Question 5.1(a)

The Board seeks stakeholder comment on:

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

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

The inherited history covered by the entry rule¹⁵ is quite broad (it covers everything that happened to a subsidiary before the joining time) whereas the exit rule¹⁶ is more limited (it covers history in relation to an asset, liability, business or R&D registration that the subsidiary takes with it). However, the inherited history rules (and other core rules) may be overridden or modified by another provision of the ITAA that so requires, either expressly or impliedly¹⁷. For the purpose of this submission other provisions which adopt a modified inherited history approach are also treated as an inherited history rule¹⁸.

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

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

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

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

Policy difficulties

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

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

- For a reset depreciating asset there is no ability to change the pre-joining time depreciation method, and the effective life may not be able to be changed in some cases¹⁹.
- The mining industry is particularly disadvantaged by a specific inherited history rule which operates to exclude mining, quarrying or prospecting rights or information held before 1 July 2001 from being treated under the uniform capital allowance (UCA) rules notwithstanding that there is

¹⁵ Section 701-5

¹⁶ Section 701-40

¹⁷ Section 701-85

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

¹⁹ Ibid

another rule that otherwise deems depreciating assets to be acquired at the joining time for the purpose of applying the UCA rules²⁰. Similar to the position with the over-depreciated asset rules, which are proposed to be repealed under amendments contained in *Tax Laws Amendment (2010 Measures No 1) Bill 2010*, these mining transitional rules have long since served their purpose and should be repealed.

- The acquirer of a privatised group has to contend with the potential continued application of the applicable privatised asset rules which may limit depreciation deductions. There is a worthwhile exemption for acquisitions of privatised subsidiaries that are acquired from an unrelated consolidated group after a 2 year holding period²¹. However, ATO Interpretative Decision ATOID 2007/74 highlights that the ATO will apply a technical literal interpretation to deny the benefit of an exemption in circumstances where the privatised entity is acquired through a creeping acquisition which technically results in the acquired entity being an associate of the acquiring group just before the joining time.

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

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

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

Interpretative difficulties, anomalies and interaction issues

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

Blackhole deductions and the exit history rule

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

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

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

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

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

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

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

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

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

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

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

There is an equivalent issue in respect of the ongoing application of the limited recourse debt rules in Division 243, where a subsidiary member that held a depreciating asset had triggered the application of Division 243 before the joining time (termination of debt). An ATO Discussion Paper released in 2006 takes the view that the limited recourse debt provisions can apply²². It is unclear whether expenditure incurred before the joining time can now be overridden by the tax cost setting amount at the joining time for the purpose of applying the relevant tests in Division 243, taking into account the effect of the proposed amendments to subsection 701-55(6) contained in *Tax Laws Amendment (2010 Measures No 1) Bill 2010*.

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

Question 5.1(b)

The Board seeks stakeholder comment on:

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

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

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

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

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

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

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

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

Question 5.19 (c)

The Board seeks stakeholder comment on:

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

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

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

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

Question 5.1(d)

The Board seeks stakeholder comment on:

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

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

Question 5.1(e)

The Board seeks stakeholder comment on:

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

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

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

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

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

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

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

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

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

- This transitional choice would require groups to identify reset assets that are still held at the date of commencement, and to exclude non-reset assets including the head company's own assets, assets held by transitional chosen entities and assets acquired by subsidiaries after the time they joined the tax consolidated group. We query whether tax asset registers maintained by corporate groups would be capable of identifying relevant assets.
- As indicated above not all assets held by a consolidated group will necessarily be subject to the application of the tax cost setting rules, such as assets held by the head company (however, it should be noted that the head company's own assets fundamentally reflect a clean slate model).

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

Question 5.1(f)

The Board seeks stakeholder comment on:

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

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

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

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

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

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

Chapter 6 – Operation of the consolidation regime for small business

Question 6.1

The Board seeks stakeholder comment on:

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

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

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

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

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

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

Complexity and cost

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

In particular, we highlight the fact that small proprietary companies²³ are not generally required to prepare financial statements in accordance with the accounting standards. A choice to consolidate by SME corporate groups may therefore require them to prepare accounts which comply with accounting standards when this would not otherwise be the case. This of itself results in additional complexity and compliance costs.

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

Pre-CGT interests

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

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

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

Lack of transitional concessions

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

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

Interaction between the consolidation and other small business provisions

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

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

Question 6.1

The Board seeks stakeholder comment on:

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

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

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

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