8 December 2010

Post-implementation review of certain aspects of the consolidation regime
The Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

email: taxboard@treasury.gov.au

Dear Sir or Madam

Post-implementation review of certain aspects of the consolidation regime

The Institute of Chartered Accountants in Australia and the Taxation Institute of Australia (the **Joint Bodies**) welcome the opportunity to comment on the positions and questions posed in the Position Paper entitled "Post-implementation review of certain aspects of the consolidation regime" (the **Position Paper**) released for consultation on 13 October 2010.

Given the significance of the some of the issues raised in the Position Paper and, in particular, the adoption of an asset acquisition approach, it is vital that particular care be given to dealing with the issues raised and formulating the specific legislative provisions. Therefore, we request that the Board include a specific recommendation that the formulation of the relevant provisions be the subject of extensive consultation including the release of exposure draft provisions.

The Joint Bodies would welcome further consultation with the Board on any of the issues raised in the submission prior to the Board finalising its report to the Government.

Please do not hesitate to contact at first instance either Susan Cantamessa from the Institute on 02 9290 5625 or Peter Murray from the Taxation Institute on 03 9288 6677 to discuss any aspect of the submission.

Yours sincerely

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Peter Murray
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The Joint Bodies comments on the Board's positions and questions posed in its Position Paper are set out below.

References throughout are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise specified.

CHAPTER 2: POLICY FRAMEWORK FOR THE CONSOLIDATION REGIME

Position 2.1

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

Question 2.1

The Board seeks stakeholder comment on:

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

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

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

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

The Joint Bodies agree with the Board's conclusion that the current inherited history framework operates effectively in the majority of cases to achieve the primary objectives of the consolidation regime.

However, there are some instances where unclear policy rationale has led to inappropriate outcomes and the anomalies need to be rectified.

We also discuss below the fact that, following the large package of consolidation amendments included in *Tax Laws Amendment (2010 Measures No 1) Act 2010*, there appears to be lack of clarity in relation to the implementation of the amendments. We submit that the Board should consider the current position and whether further action is required.

While we see merit in the adoption of an asset acquisition approach, we share the concern that there will inevitably be a need for administrators, practitioners and taxpayers to adjust their knowledge of the existing framework in the event of a change. While the changes may be relatively insignificant compared to those that would be required if the acquisition approach were adopted, it is not immediately evident that these changes will not come with some disruption and adjustment.

The asset acquisition approach is intended to provide a principled approach for determining the tax outcomes associated with the tax cost setting amount allocated to assets and to provide policy direction as to how any future general modifications to other income tax provisions should apply to an asset's tax cost setting amount under the tax consolidation regime.

We believe that there needs to be solid and considered support that these objectives will be obtained before an asset acquisition approach is adopted and that this will present an improvement from the existing framework for the majority of taxpayers in the majority of situations.

Rectifying anomalies and providing a policy framework is important

Whether or not the asset acquisition approach is adopted, there is nonetheless a need to ensure that certain anomalies in the current framework are addressed.

As noted in the Board's December 2009 discussion paper "A3.8 The entry history rule is modified to reach an appropriate tax outcome in some situations." This confirms the practice of ongoing policy modifications.

One anomaly relates to the former Government's proposal to apply the entry history rule to determine the time that depreciable assets of a joining entity are acquired by the head company of a consolidated group. That proposal has been accepted by the current Government but not yet implemented.

The effect of this proposal would be to preclude the 200% diminishing value uplift rate where depreciating assets were originally acquired by a joining entity prior to 10 May 2006. This is despite the fact that purchases of second-hand depreciable assets are eligible for accelerated depreciation. In our view, this outcome is inappropriate and anomalous. This problematical policy outcome would be resolved quite simply by not proceeding with the announced amendment.

Anomalies also arise in relation to depreciation on pre-1 July 2001 mining rights and Division 58 capital allowances for depreciating assets previously owned by an exempt entity. In the latter case "integrity measures" were introduced in section 705-47 which add 100 lines of legislation and, more significantly lead to highly inequitable outcomes in legitimate commercial situations.

In our view, there is no inherent bar under the current system to making policy adjustments to ensure appropriate treatment of certain assets. The history of the existing model shows that it is relatively flexible and can accommodate adaptations as they are required, for example rights to future income.

Delivering certainty following amending law in 2010

Of particular concern to the Joint Bodies is ensuring that the implementation of an asset acquisition model fully delivers the certainty required by its users.

The *Tax Laws Amendment Act (2010 Measures No 1) Act 2010* delivered, in Schedule 5, a major package of tax consolidation amendments.

The implementation of the recent changes enacted by that Act shows that despite numerous consultations, taxpayers will not have certainty where there is still room for fundamental differences in interpretation, after enactment. Outstanding examples of this are found in the treatments of right to future income and consumables, where there are various views on the basic tax implications. The Board should consider how best the requisite certainty of treatment is to be obtained, whether by law or extrinsic material. Certainty in design and delivery is fundamental to taxpayers.

Rectifying anomalies if asset acquisition model is adopted

Our support for the asset acquisition approach is based on the assumption that it will address a number of current anomalies. Therefore, we request that it be specifically clarified/confirmed in your recommendations that the asset acquisition approach is intended to address the anomalous treatment that applies under the existing provisions in the context of certain Division 40 depreciating assets, such that in respect of post-implementation joining times a deemed asset acquisition will apply so that:

(a) the 200% diminishing value uplift rate will apply;
(b) pre-1 July 2001 mining rights would become depreciable; and
(c) Division 57 treatment would be terminated.

In relation to Question 2.1(b), we agree that in respect of certain types of assets it may be appropriate to modify the asset acquisition approach where there has not been a change in majority underlying ownership. We recommend that a modified targeted treatment applies to certain assets as is currently the case in specific circumstances under section 701A-5 and section 701A-10 of the *Income Tax (Transitional Provisions) Act 1997*.

As identified by the Board, such modifications may be required where there has not been a change in majority underlying ownership in respect of a pre-CGT asset of the joining entity or certain types of depreciating assets of the joining entity.

However, we believe that particular care should be taken in determining when a continuity of majority underlying ownership should be regarded as applying in this context, because in creeping acquisitions and on-market public company takeovers the purchaser will always at some time own more than 50% of shares in the joining entity before ultimately acquiring its remaining shares.

With regard to other important matters of detail associated with the asset acquisition approach, we have had the opportunity to consider the joint submission by the Corporate Tax Association and the Minerals Council of Australia dated 30 November 2010, and we concur with their comments in relation to doubtful debts, leaving entities, liabilities and non-asset deductions, and previous private binding rulings.

Given the significance of the asset acquisition approach, it is vital that particular care be given to dealing with the range of issues discussed above and formulating the specific legislative provisions. Therefore, we request that the Board include a specific recommendation that the relevant provisions be the subject of extensive consultation including the release of exposure draft provisions.

Recommendations

- Whether or not the asset acquisition approach is adopted, there is a need to ensure that certain anomalies in the current framework are addressed, such as those discussed above.
- As well, the Board should consider how best the requisite certainty of treatment is to be obtained in relation to the matters covered by amending law in 2010, whether by law or extrinsic material. Certainty in design and delivery is fundamental to taxpayers.
- We support the adoption of the asset acquisition approach provided it represents an objective improvement on the existing model for the majority of taxpayers in most cases.
- Where it is appropriate to modify the asset acquisition approach, for example, where there has not been a change in majority underlying ownership, we recommend a modified targeted treatment apply to certain assets.
- The Board should recommend extensive consultation in relation to the formulation of relevant provisions to give effect to the asset acquisition approach, including the release of draft legislation.

CHAPTER 3: OPERATION OF THE SINGLE ENTITY RULE

Position 3.1

The Board considers that:

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

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

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

Question 3.1

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

We understand that the Board's proposals for the treatment of intra-group assets (*excluding membership interests*[1] *and presumably debt interests*[2]) in relation to joining and leaving entities are as follows:

- under the proposed asset acquisition model an intra-group asset would come to an end at the joining time for a payment equal to the tax cost setting amount of the asset (paragraph 2.53) but the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group;
- the entry history rule would be retained so that liabilities would be transferred to the group at the joining time based on their accounting value (query whether this would apply to intra-group liabilities);
- intra-group assets that emerge from the group would be taken to be *created* at the time they emerge (paragraph 2.56); and
- when an entity leaves a consolidated group, the consolidated group would be taken to *dispose* of the membership interests held in the leaving entity.

Our comments in respect of Position 3.1 are based on an assumption that the proposals will not apply to intra-group assets that are debt interests. If this assumption is not correct then we would be pleased to provide the Board with our comments on the implications of the proposal in relation to debt interests.

Our comments in respect of the various questions raised by the Board are as follows:

(a) Intra-group assets eligible for this proposal

We understand that the Board's proposed test for an eligible intra-group asset would cover situations where an undeducted "tax cost" arose for an intra-group asset (as outlined in paragraph 3.27) such as the following:

- direct acquisition of an asset that becomes an intra-group asset as a result of the acquisition of the asset from a third party during consolidation; and
- indirect acquisition of an intra-group asset which is brought into the group on formation or joining (and potentially reset in the hands of a joining subsidiary member).

Under either of those scenarios a tax cost would arise under existing provisions, such as the tax cost setting rules (ignoring the application of section 701-58) or other relevant provisions (e.g. Division 110 CGT cost base rules).

Under existing provisions, intra-group assets created while the relevant entities were members of the consolidated group do not generally obtain tax cost and would therefore be outside the scope of this proposal. Third party incidental costs would generally be deductible under section 40-880. However, there should be an exception for the special category of intra-group assets that are severed from recognised assets during consolidation: this is considered in section (d) below.

The Board's position is to exclude from the scope of the proposal an intra-group asset that has a corresponding accounting liability which is recognised elsewhere in the consolidated group.

[1] Chapter 3 of the Position Paper focuses on intra-group assets other than membership interests (paragraph 3.9).

[2] Debt interests are identified as a separate category of intra-group asset in the Position Paper at paragraph 3.8. Although not expressly stated we have assumed that Chapter 3 also does not apply to intra-group debt interests.

It is unclear how that proposed exclusion may apply. Presumably, this exclusion would require some form of income tax recognition of the corresponding accounting liability by the consolidated group, either before or around the time that the tax cost of the asset is to be recognised.

As noted in the Position Paper (at paragraph 3.42) one form of potential recognition of the corresponding liability would be in the allocable cost amount (**ACA**) calculation of the other group member that holds the corresponding liability - specifically ACA Step 2 - if that entity was required to reset the tax cost of its assets.

However, there will be various situations where asset tax cost setting does not apply when an entity becomes a member of a consolidated group: becoming a head company of a consolidated group; an eligible tier-one (**ET-1**) company of a MEC group; a transitional foreign held subsidiary; or a chosen transitional entity.

This highlights that the identification of eligible intra-group assets will not be straight forward.

However, another fundamental issue is whether the tax treatment of intra-group assets should differ because of the status of the entity holding the corresponding liability. In particular:

- if the entity holding the liability was required to calculate its ACA, where the relevant liability is taken into account in ACA Step 2, the liability would be taken into account for income tax purposes so the corresponding intra-group asset would be excluded under the proposal; and
- if the entity holding the liability did not reset the tax cost of its assets (e.g. the head company of a consolidated group or ET-1 company in a MEC group) then the corresponding intra-group asset would not be excluded.

It is not readily apparent why there should be a difference in the treatment of the intra-group asset in these alternative scenarios – using one common rule would simplify compliance.

It appears that the exclusion for an intra-group asset with a tax recognised corresponding liability would apply even if the amount of the liability changes over time. This is desirable, otherwise complex liability tracking rules may need to be employed, such as those used in subsection 711-45(8) which deals with liabilities in a leaving entity's exit ACA calculation that were also taken into account in the entry ACA calculation.

Recommendations

- It is not clear to us why the eligibility for the recognition of an intra-group asset should differ depending on whether any corresponding accounting liability has been recognised for income tax purposes. We would prefer for this condition to be excluded.
- If an intra-group asset with a tax-recognised corresponding liability is to be excluded, we expressly support the lack of any requirement to test subsequent events or changes in value of the liability. This is imperative to minimise compliance costs.

(b) Recognition of intra-group asset tax cost on disposal or cessation

The Board's position is that the tax cost of an eligible intra-group asset should be recognised either when the consolidated group disposes of the asset or the asset lapses. The justification for this approach is a perceived adverse impact on revenue if the asset remains in the group indefinitely (paragraph 3.39).

Where the intra-group asset has a specified term, the tax cost of the asset should in our view be recognised over the term of the asset on a straight line basis. This would produce a better matching of the benefit of the asset and the recognition of the cost of the asset.

Where an intra-group asset has an indefinite term, we submit that consideration could also be given to amortisation, rather than deferring recognition until disposal or lapsing of the asset. Potential amortisation periods could be 5 years (based on the blackhole expenditure rule in section 40-880) or

10 years (based on the right to future income rules for contracts with no set term under section 716-405).

The position of eligible intra-group assets in respect of an indirect dealing is unclear. Where the intra-group asset leaves the consolidated group with a leaving entity, it would appear that any undeducted tax cost should be recognised under exit ACA Step 3 and the tax cost of the asset for the leaving entity should be determined under section 701-45 and section 701-60 (table item 3)).

Recommendations

- Where the intra-group asset has a specified term, the tax cost of the asset should be recognised over the term of the asset on a straight line basis.
- For an indefinite term intra-group asset the tax cost of the asset should be amortised over 5/10 years.
- Outcomes in respect of an indirect dealing with the intra-group asset should be confirmed.

(c) What history, if any, is relevant for intra-group assets

Under the asset acquisition model intra-group assets that emerge from the group are taken to be *created* at the time they emerge (paragraph 2.56). The Board's position is that the income tax history that an intra-group asset had prior to coming into the consolidated group is irrelevant when it is subsequently disposed of or lapses (paragraph 3.43). We note that in paragraph 2.51 the Board comments that the inherited history rules are retained for everything except assets.

This raises the issue of how the tax characterisation will be determined in respect of an intra-group asset. The Board's paper suggests that the capital/revenue treatment of any amount received on the disposal of the asset would be determined on the basis of the consolidated group's treatment of the asset (paragraph 3.43),

On that basis, the income tax history that an intra-group asset had prior to coming into the consolidated group would be irrelevant when it is subsequently disposed of or lapses.

Recommendation

We agree with Position 3.1(c) for the reasons set out above.

(d) Treatment of intra-group assets severed from recognised assets during consolidation

As noted in section (a) above, a tax cost for the special category of intra-group assets that are severed from recognised assets during consolidation should be recognised.

Non-recognition of the tax cost of such an intra-group asset would have inappropriate consequences for the calculation of the exit ACA of the grantee of the asset. Secondly, in relation to the sale/assignment of an intra-group asset by the subsidiary grantee of an asset to a non-group member, the operation of the single entity rule (**SER**) has consequences for the calculation of any balancing adjustment amount.

The deficiencies can be illustrated using the example of the granting of rights to use telecommunications infrastructure between group members. The granting of these rights is a common incident of the telecommunications industry, with the rights given recognition in the ITAA 1997 as depreciable assets (being Indefeasible Rights to Use (**IRU**) or Telecommunications Site Access Rights (**TSAR**)).

Background: Granting of IRUs and TSARs

The Uniform Capital Allowance (**UCA**) provisions contained in Division 40 provide (in section 40-115) that a single depreciating asset may be split into two or more assets. In that case, the holder is deemed to stop holding the original asset and start holding the two (or more) new assets. This applies where part of an asset is granted to a third party.

The application of this to IRUs and TSARs has given rise to some uncertainty (in part as a result of the removal of former Division 44 which specifically applied to the splitting of IRUs, which was repealed in the process of the introduction of the UCA provisions). However, on the assumption that the asset splitting contemplated in Division 40 is taken to apply to IRUs and TSARs, it would operate as follows. The underlying asset, being the telecommunications system, would be deemed to have been "split" into two (or more) assets immediately before the grant of the rights. One asset will be that part of the telecommunications system that the grantor continues to hold and use; the other asset will be the IRU or TSAR that the grantee has acquired rights which provides it with rights to use the telecommunications system. The adjustable value of the original asset is then apportioned between the two new assets on a reasonable basis.

The Single Entity Rule

The operation of the SER gives rise to problems in relation to the grant of an IRU or TSAR between members of the same tax consolidated group. The key concern relates to the time at which the grant of the rights is recognised for tax purposes and whether it is possible to allocate a reasonable proportion of cost base to those rights when they are recognised.

As a result of the SER, where an asset is created through a grant of rights by one group member to another group member, the transaction is ignored for income tax purposes. TR 2004/11, TD 2004/34 and TD 2004/35 explain that the consequences of the transaction are only recognised when the asset (or the member that holds the asset) is sold / transferred to a non-group member. The cost base of the asset (such as a licence, or in the case of an IRU or TSAR, a right of use) is said to be limited to the incidental costs incurred in transferring the right to the non-group member.

By way of comparison, outside the consolidation regime, the creation of an asset by a grant of an IRU or TSAR from one entity to another will be recognised for income tax purposes immediately. The tax cost of the two resulting assets will then be recognised for the purposes of Division 40.

Exit from the group by the subsidiary which has been granted rights under the IRU / TSAR by another group member

When the subsidiary member holding an IRU or TSAR is sold, a CGT event will happen to the head company of the group in relation to the disposal of the shares in that member. As the grantee will cease to be a member of a tax consolidated group, this will require a resetting of the tax cost of the shares in the leaving entity. The capital gain that arises in relation to the disposal of those shares will depend on the reset cost of those shares.

The tax cost setting amount for the membership interests in the leaving subsidiary will be based on the leaving entity's ACA (section 711-15). One of the key components of the ACA is the terminating value of the assets of the leaving entity. The terminating value of an asset is determined in accordance with sections 711-30 and 705-30 and, in the case of depreciating assets (such as IRU / TSAR), the terminating value should be the adjustable value of the asset at the leaving time.

By virtue of the SER, the leaving entity will arguably not have a terminating value in the IRU / TSAR as the split that would otherwise be deemed to occur by Division 40 will not have been recognised until leaving time and the leaving entity is unlikely to have provided any consideration (that is recognised by virtue of the SER) for the grant of the IRU / TSAR. The adjustable value of the IRU / TSAR may therefore not be taken into account in determining the ACA of the leaving entity.

Accordingly, and consistent with the reasoning in TR 2004/11 (and related determinations TD 2004/34 and TD 2004/35), when a subsidiary member leaves a tax consolidated group, the subsidiary member may be argued to have a nil or negligible cost base in the IRU or TSAR, with the consequence that the head company will be taken to have a nil or negligible cost base in the shares in the subsidiary member so far as they relate to the IRU / TSAR (other than costs incurred in transferring the entity to the third party).

The effect of the rules operating in this manner is that the tax cost setting amount attributed to the leaving entity is not an accurate reflection of the ACA attributable to it.

Furthermore, the true economic value of the remaining depreciating asset is not recognised. Having granted the use of part of the asset to the grantee, it is unclear whether the grantor would be entitled to claim deductions for decline in value of the underlying asset under the UCA provisions in respect of that part of the underlying asset over which the IRU / TSAR has been granted. If the grantor were so restricted, part of the adjustable value of the existing asset will effectively have been "lost" as it would not have been taken into account in determining the ACA of the leaving entity nor will the grantor be able to claim deductions for depreciation of that part of the underlying asset.

Recommendations

- In our view, the issues identified above can be addressed by an amendment to Division 40 excluding the provisions relating to IRUs and TSARs from the SER. The effect would be to allow recognition of the tax cost of the asset at the time of grant, instead of at the time the subsidiary (or the asset) leaves the group.
- This would operate as follows. The granting of an IRU is in effect the creation of a right by splitting an asset. The grant of the right results in two new assets being created, each being recognised as having a tax cost in the amount of the proportion of the value of the original single asset ascribed to it. Upon the subsidiary leaving the group, the terminating value for the IRU / TSAR is the amount of the proportion ascribed to it.
- The exit ACA for a subsidiary member of a consolidated group will include the value ascribed to the IRU / TSAR. The ACA will therefore be appropriately determined by recognising a split of the cost of the underlying asset over which the rights have been granted when that member (or the asset) exits the consolidated group.
- Further, if considered appropriate, the treatment could be extended to other assets that can be split in a similar fashion. There seems no reasonable basis to restrict a consolidated group from being able to recognise two assets that would have otherwise been deemed to have been split by the relevant provision of the ITAA 1997 but for the operation of the SER.

Position 3.2

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

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

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

Question 3.2

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

Position 3.2 relates to an indirect disposal of intra-group assets held by a leaving entity. This is relevant for intra-group assets including debt interests but excluding membership interests.

We understand that the Board's position is effectively to amend exit ACA Step 3 (subsection 711-40(1)) so that it would apply to an intra-group asset (receivable) that has a liability owed by a member of the old group. The term 'liability' is not defined, which has created some uncertainty as to whether it applies to obligations of the leaving company. As well, the Government announced a proposal to limit the term to liabilities recognised in financial statements (accounting liabilities).

The Board's proposal to recognise a corresponding liability or other similar obligation is broader than the existing subsection 711-40(1) and, if adopted, the current Government announcement would not need to be implemented.

We support the Board's proposed approach, as there may be situations involving valuable intra-group assets where there is no corresponding accounting liability owed by members of the old group to the leaving entity (as noted in paragraph 3.47).

At paragraph 3.49 the Board notes that situations can arise where the market value of a liability is recognised which could result in a gain not being recognised for tax purposes, "which would seem inappropriate". However no example is provided. It is difficult to comment on when such an outcome may arise and its appropriateness. We would welcome a worked example to illustrate the issue the Board perceives.

Recommendation

- We generally support the Board's proposed approach. However, a worked example should be provided to illustrate the inappropriate outcome described at paragraph 3.49 of the Position Paper.

Position 3.3

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

Question 3.3

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

We generally agree that a tax loss should not be recognised in respect of the direct or indirect disposal of an asset whose value has been reduced as a result of intra-group arrangements that place encumbrances on an asset. However, this should depend on whether a "not incidental purpose" of the arrangement was to create a tax loss or reduced gain on the disposal of the asset.

It would appear that a limited range of transactions may be of concern. In these circumstances, our view is that any proposed integrity measure should be specifically targeted and limited to such arrangements.

In respect of any indirect disposal of such an asset through a leaving entity, we consider the existing loss integrity rules, specifically Subdivision 165-CD as modified by Subdivision 715-B, would suitably deal with such situations.

We caution against the application of the general value shifting rules to intra-group arrangements. This would impose significant compliance burdens on consolidated groups to address what would appear to be a relatively specific problem.

Recommendations

- Any integrity measure should be specifically targeted to particular arrangements of concern which are not adequately dealt with under existing provisions.
- We caution against the application of the general value shifting rules to intra-group transactions to avoid compliance burdens which do not appear to be justified.

Position 3.4

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

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

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

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

Question 3.4

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

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

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

(a) Extension of single entity rule to shareholders and liquidators of the head company of a consolidated group

We support the proposal to extend the application of the SER to shareholders of the head company of a consolidated group where it is appropriate to do so. We also support extending the application of the SER to liquidators of the head company of a consolidated group as this would remove significant uncertainty in the application of section 47 of the *Income Tax Assessment Act 1936* (**ITAA 1936**).

Specifically, we recommend that the SER apply to shareholders for the purpose of applying specifically identified provisions of the income tax law (rather than providing blanket recognition of the SER to shareholders for all purposes of the law subject to specific modifications or exceptions).

Provisions where the SER should be applied to shareholders would be for purposes of applying CGT event K6[3] and the CGT discount concession[4]. Extension of the SER to both of these provisions was announced by the then Minister for Revenue on 8 May 2007 and accepted by the Government in its announcement of 13 May 2008 where it indicated that the amendments would apply to CGT events from 8 May 2007. Given the delay in the development of these proposals, we recommend that taxpayers be given the option of applying the amendments from the date of announcement, in the event that the Board's position is accepted.

We would also support the extension of the SER for purposes of applying the CGT small business concessions in Division 152.

(b) Potential exceptions

As noted above, our preference is that the SER apply to shareholders for specifically identified provisions of the income tax law. This approach is preferred to extending the SER to shareholders for all purposes other than listed exclusions.

Although Position 3.4 does not make specific mention of MEC groups, we presume that the position as outlined is also intended to apply in a MEC context. In this respect, the extension of the SER to foreign shareholders of a MEC group, without specific clarification or modification to it, may result in inappropriate outcomes. For instance:

- applying the SER to an entity that is a shareholder of an ET-1 company that is not the provisional head company of the MEC group may be legislatively problematic as the company (and its

[3] Section 104-230

[4] Division 115

wholly-owned subsidiaries) would be taken to be a part of the head company in which the shareholder may have no membership interests;
- foreign residents in a MEC group would have difficulty and added complexity in applying the CGT rules (under Division 855) as further commented in this submission in respect of Position 4.7; and
- difficulty would also arise for foreign resident shareholders seeking relief under any of Australia's double tax agreements, particularly for those MEC groups which have foreign shareholders from multiple jurisdictions (see further comments in this submission in respect of Position 4.12)

In the event that the SER would extend to foreign shareholders of a consolidated (and MEC) group for purposes of applying Division 855 where intra-group assets would be disregarded, this would result in an inequitable treatment as compared to foreign shareholders in an unconsolidated group.

Recommendations

- We support the extension of the SER to liquidators of a consolidated group and also to shareholders in appropriate circumstances.
- The extension of the SER to shareholders should be for specifically identified provisions (as opposed to a blanket extension with specific carve-outs).
- The Board should consider recommending that consolidated groups have the option of applying previously announced measures from the date they were originally announced;
- Extending the SER to foreign shareholders of a MEC group (which we assume is intended) raises specific issues which need to be addressed.

(c) Should the SER extend to dealings between consolidated groups and related third parties

The commercial debt forgiveness grouping provisions in Subdivision 245-G of Schedule 2C of the ITAA 1936 were not rewritten into new Division 245[5]. Accordingly for the 2010-11 and later income years, the problems that the commercial debt forgiveness rules created for related entities on the forgiveness of an intra-group debt[6] no longer remain.

However, there is still merit in having the SER recognised for related third parties for any forgiveness of intra-group debts prior to the 2010-11 income year. Although this would raise issues of retrospectivity for taxpayers, this could be dealt with by way of optional application. As noted in the Board's December 2009 Discussion Paper, the application of the debt forgiveness rules on the intra-group debt to a third party, where the debt is intra-group debt, is inappropriate.

Recommendation

- Consideration should be given to recommending that the SER be recognised for related third parties in respect of the forgiveness of intra-group debts prior to the 2010-11 income year.

[5] *Tax Laws Amendment (Transfer of Provisions) Act 2010*

[6] As highlighted in the Board's December 2009 Discussion Paper at paragraphs 3.83 and 3.84.

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

Position 4.1

The Board considers that:

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

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

Question 4.1

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

Position 4.2

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

Question 4.2

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

Our responses to the questions in relation to Positions 4.1 and 4.2 have been combined, due to the close relationship between the two positions. Together these positions seek to clarify the law in relation to how net income of a trust is to be apportioned between members of the trust between the non-membership and membership period.

While the Board's positions seek to avoid complicated interaction issues and to achieve a reasonable allocation of net income of a trust which joins or exits a consolidated group during a year, we are concerned that the proposed solution has not been appropriately workshopped and tested.

In our view targeted consultation is required to ensure that appropriate outcomes are achieved in all scenarios, regardless of the terms of a trust deed or the terms on which units in a trust (or its unit holders) are bought or sold by a consolidated group. Furthermore, we are concerned that SER interaction issues will not be resolved by the adoption of the Board's positions.

We recommend that the Board consider extending the SER to Division 6, so that the net income for an income year is limited to the amount derived by the trust in the non-membership period. As the vendor beneficiary is neither a shareholder nor a related third party at the end of the year of income, there is a concern that the SER interaction issue will not be resolved by the Board's propositions.

The Board would then need to consider modifications to the "attribution" principle to more appropriately attribute net income during the non-membership period.

Recommendation

- We recommend that the Board consider extending the SER to Division 6, so that the net income for an income year is limited to the amount derived by the trust in the non-membership period. The Board would then need to consider modifications to the "attribution" principle to more appropriately attribute net income during the non-membership period.

Position 4.3

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

Question 4.3

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

Yes. We believe that this is the correct policy outcome.

While the position proposed by the Board is limited to income tax liabilities, we believe that it should extend to deferred tax liabilities inherited by the head company. This is likely to occur where they relate to other liabilities of the joining entity (e.g. a future forex gain that is inherited on a loan under the entry history rule).

The easiest mechanism to address this issue may be to extend subsection 705-70(1A) or a similar provision to both income tax liabilities and deferred tax liabilities of the trust. However, as the trust would not have recorded such liabilities previously, the desired outcome could be achieved by allowing such liabilities to be "nil" just before the joining time in applying subsection 705-70(1A). This would ensure that real tax liabilities and only real deferred tax liabilities that are actually inherited and recorded subsequently by the head company will be picked up at Step 2 on entry.

Recommendation

- We agree with Position 4.3 but consider that it should cover not only income tax liabilities but also deferred tax liabilities inherited by the head company. A possible mechanism to achieve this outcome is set out above.

Position 4.4

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

Question 4.4

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

The background to the issue which Position 4.4 seeks to address arises because an entity may be a member of a consolidated group where "the entity [is] a company, trust or partnership"[7] and, where the entity is a trust, all the beneficiaries, unit holders or objects of a trust are members of the consolidated group. There is no requirement for the trustee of a trust, which is the legal owner of the trust property, to also be a member of the tax consolidated group.

[7] Section 703-15(2)(b) item 2

The Board's December 2009 Discussion Paper indicated this resulted in a number of uncertainties including:

- how the SER applies to income tax provisions that operate on the basis of legal ownership, e.g. deductions for the decline in value of a depreciating asset which are available to the holder of the asset which is the trustee and various CGT provisions that apply to the owner of an asset or specify the trustee; and
- the tax cost setting rules in Part 3-90 which apply "to each asset that would be an asset of the entity at the time it becomes a subsidiary member of the group, assuming that subsection 701-1(1) (the single entity rule) did not apply"[8] (*our italics*). In a consolidation context, the "entity" would be the "trust" and therefore the reference is to an asset of the "trust".

It is arguable that the existing law operates effectively in relation to most interaction issues when regard may be had to the concept of an "entity" in section 960-100[9]. This is because, where an entity is a trust, the effect of subsection 960-100(2) is to treat the trustee in that capacity at any given time as the trust entity. Subsection 960-100(3) confirms that a legal person can act in a number of different capacities so that the trustee would also be an entity in its personal capacity as an individual or company.

Position 4.4 proposes legislatively deeming a trustee of a trust, in its capacity as such, to be a member of the consolidated group. Providing that this is done for the purposes of clarifying the existing law, the Joint Bodies support this position. Any amendments would need to be done in a way which ensured that:

- a change in the trustee does not create a tax consequence; and
- the deeming a trustee to be part of a tax consolidated group does not impact on joint and several liability and way the tax sharing agreements are currently drafted.

The only additional point we would make is that it is becoming increasingly likely that the trust provisions contained in Division 6 of the ITAA 1936 will be rewritten, presumably as part of the ITAA 1997. If the main area of uncertainty arises because of the interaction of the consolidation provisions dealing with trusts and Division 6 or other provisions of the ITAA 1936 which do not adopt the "entity" approach[10] then these issues may be addressed in due course.

Recommendation

- The Joint Bodies support a provision which deems the trustee of a trust to be a member of a consolidated group to clarify the existing law and provide certainty.

Position 4.5

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

Question 4.5

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

Under section 960-130, an entity is not a member of another entity just because it holds interests or rights in that other entity that are debt interests i.e. debt interests do not constitute membership

[8] Section 701-10

[9] See paper by Alexis Kokkinos "SMEs and consolidation" TIA , 5th Consolidation Symposium, 14 October 2010 at 7.4. That paper suggests that the real issue is that the word "entity" is not used in the 1936 Act. So, for example, it is not certain that should a trust which is a member of a consolidated group accumulate income, the trustee could avoid tax under section 99 of ITAA 1936 because of the SER.

[10] See paper referred to at footnote 9.

interests. The Explanatory Memorandum to the Bill introducing section 960-130[11] provides that "debt interests are disregarded because these interests do not establish control and therefore should not be considered when contemplating the ownership structure of the group". This would appear to support the principle that only the true economic owners of a corporate group should be entitled to tax consolidation benefits.

Thus, under the current law, debt interests held by beneficiaries are not membership interests and are therefore disregarded when determining whether an entity is a wholly-owned subsidiary. The exclusion of debt interests held by beneficiaries from being membership interests is therefore consistent with the treatment of debt interests in a company.

The Joint Bodies acknowledge the difficulties and potential complexities that may arise if debt interests in trusts (e.g. certain redeemable units) are held outside the group, e.g. the uncertainty in relation to the allocation of the net income of the trust between the consolidated group and the debt beneficiaries outside the group where the trust does not have net income for trust purposes after it joins a consolidated group.

An alternative proposition might be to consider whether debt beneficiaries should be excluded from Division 6 of the ITAA 1936.

The proposal to include debt beneficiaries to be part of a consolidated group is itself not without complexities and further consideration needs to be given to the following issues:

- The extent to which a debt beneficiary should be jointly and severally liable to a group liability under a tax sharing agreement;
- To ensure there is clarity in the law such that there is no double counting of the same ACA twice, e.g. in Step 1 and Step 2 of the entry ACA calculation.
- Whether any outcomes will be consistent with the Board's review of managed investment trusts.

Recommendation

- The Joint Bodies generally agree that all beneficiaries, including debt beneficiaries, unit holders or objects of a trust, should be subsidiary members of the consolidated group providing that issues which this creates are adequately addressed.

Position 4.6

The Board considers that:

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

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

Question 4.6

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

Similar to trusts, it was considered appropriate to include partnerships as part of a consolidated group on the basis that income generally maintains its character as it flows through the partnership, i.e. partnerships are simply conduits through which amounts flow-through to the partners[12].

[11] *New Business Tax System (Consolidation) Act (No 1) 2002*

[12] Paragraph 3.55 of the EM to *New Business Tax System (Consolidation) Bill (No. 1) 2002*

In addition, it was considered that no residency test should apply to partnerships (other than corporate limited partnerships) because a partnership will be a resident partnership for most income tax purposes where at least one of the partners is a resident. In a consolidation context, this will mean that a partnership whose partners are subsidiary members (having satisfied the Australian residence requirements themselves) will be a resident partnership for most income tax purposes. It is therefore was considered unnecessary to impose a further residency test on partnerships.[13]

With the introduction of Division 830 certain non-resident entities or 'foreign hybrids' are treated as a partnership for Australian tax purposes. As a result, these entities could become members of a consolidated group. This position is confirmed in ATO ID 2009/149.

Given a foreign hybrid takes on the character of a partnership for tax purposes, this outcome would seem to be broadly consistent with the principle that partnerships should not be precluded from forming part of the consolidated group, provided the Australian partners are members of that same group.

The treatment of foreign hybrids in a consolidation context would be consistent with the treatment of a general foreign partnership (i.e. a non-foreign hybrid partner).

We note that Appendix E of the Position Paper indicates that certain tax cost setting issues for foreign hybrids are outside the scope of the Board's review. Other interaction issues between the foreign hybrid and tax consolidation provisions that need to be addressed include the following:

- It would seem the character of the foreign entity for Australian tax purposes at the time of joining a tax consolidated group may be dependent on whether there is a foreign hybrid at the end of the income year (section 830-15). For example, if the foreign hybrid was sold before the end of the income year to a non-resident, a foreign hybrid that takes on a partnership character may not exist at the time of joining (if that occurred in that same income year). Thus, there is a question as to whether the tax cost setting rules apply to the joining entity as a partnership or company at the joining time.
- A tax administration issue arises as to whether a foreign partnership tax return needs to be lodged if a foreign hybrid is part of a consolidated group.

Recommendation

- We agree with Position 4.6. However, given the interaction issues which arise in relation to the consolidation and foreign hybrid rules, we suggest that the Board formally recommend in its report to the Government that Treasury and the ATO take the necessary action to resolve these issues as soon as possible.

Position 4.7

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

Question 4.7

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

We note the acknowledgement by the Board that the interaction of the policy behind the tax consolidation law to allow the tax-free transfer of assets and the limitation of Australia's CGT regime to Australian real property interests by foreign residents can create distortions. However, we re-emphasise the concerns raised in our Joint Submission and in a number of other submissions on the Board's Discussion Paper that additional integrity measures such as that put forward by Position 4.7 may inappropriately affect legitimate commercial structures of foreign residents.

[13] Paragraph 3.62 of the EM to the *New Business Tax System (Consolidation) Bill (No. 1) 2002*

While a specific integrity proposal would potentially eliminate any inappropriate distortions, the proposed option would also result in a number of inequitable outcomes such as:

- higher costs of compliance. The foreign resident would be required to obtain valuations of assets held by other entry-points into Australia (not necessarily held directly or indirectly by the foreign resident which has the relevant CGT event);
- a disincentive for inbound investors to form a MEC group (and if not formed, no ability to obtain group relief in respect of losses and CGT asset transfers);
- adverse outcomes for existing MEC groups. They are unable to revoke the decision to form a MEC group or those ET-1 companies which chose to form the MEC group;
- potential for loss of revenue in respect of disposals of interests in entities that would have otherwise been regarded as an indirect real property interest; and
- added complexity to the law.

All of the above issues need to be appropriately taken into consideration before concluding that the solution is to take into account all assets of the MEC group when applying the principal asset test.

If it is considered that the existing integrity provisions in the law (i.e. Part IVA and/or s855-30(5)) are insufficient to address the collective policy objectives of the consolidation and CGT regimes for foreign residents, we submit that in addition to the proposal put forward in Position 4.7, some further options be considered. For instance, consideration should be given to whether it is possible to modify subsection 855-30(5) having regard to asset transfers within the MEC or consolidated group prior to the relevant CGT event to achieve the desired policy objectives.

We would also recommend that the additional interaction issues as raised by the Board's Position Paper in connection with the extension of the single entity rule to shareholders[14] and the interaction of the consolidation regime with double tax agreements[15] also be addressed at the same time as any further consideration is given to the Board's Position 4.7.

Recommendations

- The adoption of Position 4.7 raises a number of concerns which need to be addressed prior to it being recommended to the Government.
- In these circumstances, consideration should be given to other possible options, including possible modifications to subsection 855-30(5) along the lines outlined above.

Position 4.8

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

Question 4.8

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

We accept that denying the application of the tax cost setting rules to an entity that joins another consolidated or MEC group where there is no change in the underlying beneficial ownership of the asset would remove certain integrity risks, namely, the disregarding of a capital gain by the vendor due to the application of Division 855.

However, this approach has the potential to distort investment decisions as compared to a tax-free disposal to an unrelated consolidated group. Accordingly, this may impede business or asset

14 Position 3.4

15 Position 4.12

restructures within Australia, particularly for multinational groups that choose to operate in Australia through separate inbound investment streams (legally and from a tax perspective).

As indicated in our Joint Submission (dated 12 March 2010) and in a number of other submissions on the Board's Discussion Paper[16], any restructure undertaken within a multinational group with the sole or dominant purpose of facilitating the resetting of the tax cost of assets of the transferred entity to their market value should be addressed through the general anti-avoidance provisions of Part IVA of the ITAA 1936.

If Position 4.8 is adopted the following issues would need to be addressed:

- in the interests of equity, any limitation on setting the tax cost of the assets of the transferred entity on joining the new group should also apply in cases where a capital loss is disregarded in respect of the transferred entity under Division 855;
- the test for a change in underlying beneficial ownership;
- membership interests that might already be held in the joining entity by the joined group prior to any acquisition of remaining membership interests held by the foreign resident; and
- the manner in which any tax cost limitation is to be applied should also be considered - that is, how should the cost base of the assets be determined?

We also note that as part of a global acquisition it is not uncommon for a multinational group to acquire entities at the non-resident level and subsequently rationalise its ownership structures in relevant jurisdictions. The effect of Position 4.8 is that these groups would be disadvantaged as compared to the possible outcomes that would have emerged had the Australian consolidated group made the acquisition from the third party (a position that is not always commercially possible). To avoid this situation, if Position 4.8 is adopted, we recommend that it only apply in cases where relevant assets have been beneficially owned for more than 24 months. We also recommend that suitable transitional rules apply for pre-existing ownership structures.

Recommendations

- If the mischief to which Position 4.8 is directed could be dealt with under Part IVA then its adoption may unnecessarily distort investment decisions.
- However, should Position 4.8 be recommended by the Board, in our view:
  - it should only apply where relevant assets have been majority beneficially owned for more than 24 months;
  - suitable transitional rules should apply for pre-existing structures; and
  - the issues outlined above will need to be addressed.

Position 4.9

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

We agree with this recommendation, as it will address an acknowledged longstanding anomaly in relation to the application of CGT event J1.

Question 4.9

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

16 Question 4.6

Position 4.10

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

Question 4.10

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

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

The Joint Bodies agree with the Board that double taxation can arise when CGT event J1 applies where an ET-1 company leaves a consolidated group.

Recommendation

- We believe that the most appropriate way of addressing this issue would be to reduce the taxable gain otherwise realised by the non-resident vendor of the shares in the exiting ET-1 by the amount of the CGT event J1 gain, and then to reduce the post-divestment MEC cost base pool by an equivalent amount. Via this mechanism, not only would the double taxation issue be addressed, but by correspondingly reducing the MEC cost base pool there would not be an inappropriate advantage provided to such groups.

Position 4.11

The Board considers that:

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

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

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

Question 4.11

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

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

We concur with the Board that determining the most appropriate way of seeking to apply CGT event J1 where the relevant rolled over assets are disregarded by the SER raises a number of difficult legislative drafting and compliance issues. However, on balance we support an approach of seeking to instead apply CGT event J1 to certain underlying assets of the rolled over entity that continue to be held by the group from the relevant roll-over time through to when CGT event J1 is triggered.

We recommend that this revised "underlying asset" approach not apply in respect of trading stock, depreciating assets and other assets. It is likely that such assets would in any event be disposed of in a relatively short period of time (negating the need to apply CGT event J1), or that roll-over would have limited the reset tax value of depreciating assets and hence reduce depreciation deductions claimed. This approach would also avoid the impracticality and compliance costs of seeking to track the ongoing ownership status of "trading" assets of this nature.

In this context of Question 4.11, we have had the opportunity of considering the submission to the Board prepared by the Corporate Tax Association and the Minerals Council of Australia, and we concur with their equivalent recommendation in this regard.

In addition, we also share the concern that such an approach could have very significant and inequitable impacts if in effect it was to apply retrospectively. Therefore, we also recommend that such a measure only apply in respect of roll-overs of intra-group membership interests that have occurred since this potential legislative issue was first raised by the Board of Taxation in its initial Discussion Paper on 9 December 2009.

Recommendations

- The Joint Bodies support an approach of dealing with the issues raised by the Board which focuses on applying CGT event J1 to certain underlying assets.
- We also recommend that such a measure not apply retrospectively.

Question 4.12

Do stakeholders consider that issues which currently arise because of CGT event J1
could be resolved if:
• a time limit applied to the provision;
• minority interest divestments were exempted from the provision; and
• the sub-group break-up exemption applied where less than 100 per cent of the
interests in the sub-group is disposed of to non-group entities?

We agree with the Board that the majority of the current issues arising in relation to CGT event J1 (other than specifically in the consolidation context as noted above) could be resolved if:

(a) the time limit applied to the provisions;
(b) majority interest divestments were exempt from the provisions; and
(c) the sub-group break-up exemption applied where less than 100% of the interest in the sub-group is disposed of to non-group entities.

Particularly important in this regard is the time limit proposal. In similar group restructuring circumstances various stamp duty provisions apply a three year "claw-back" limitation. We believe that this would provide an appropriate balance between the policy objectives of protecting tax integrity (i.e. addressing anti-avoidance type concerns) while at the same time recognising compliance cost issues.

An additional issue which could similarly be readily addressed in this process involves roll-overs within one wholly-owned group that is subsequently taken over by another group. If an entity that holds the relevant rolled over asset is subsequently transferred from the group that has been taken over, up to a higher level entity in the acquirer's group, then CGT event J1 can be triggered inappropriately.

Recommendation

We agree with the Board's Position 4.12.

Position 4.12

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

Question 4.13

Do stakeholders agree with Position 4.13? If not, why not?

We support the recommendation, with appropriate consultation with other affected stakeholders.

Recommendation

- The proposed review should, in particular, address the issues which emerge for MEC groups, particularly in respect of MEC groups which are derived from multiple jurisdictions.
- As noted previously in this submission, the implications emerging from Position 4.7 in connection with CGT for non-residents should also be addressed.

Question 4.14

The Board seeks stakeholder's comments on:

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

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

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

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

In response to all the paragraphs in this question, our initial observations are as follows:

- The recognition of deferred tax assets (DTAs) and deferred tax liabilities (DTLs) in an ACA calculation creates complexity for taxpayers. For example, the iterative process that needs to be applied under Section 705-70(1A) is unduly complex and problematic from a taxpayer perspective.
- However, like many issues in the tax law, there is often a trade off between equity versus complexity.
- In our view, neither the Board's Position Paper nor the ATO's discussion paper referred to in paragraph 4.83 of the Board's Position Paper provides any significant analysis on the application of deferred tax balances sufficient to make an informed decision on whether DTA/DTLs should be removed altogether from the ACA and tax cost setting process.

Recommendation

- Our recommendation is for Treasury/ATO to undertake a separate process, whereby the ATO's discussion paper is taken as a starting point and modified with the view of producing a revised discussion paper outlining the pros and cons of various alternative options available on the treatment of DTAs/DTLs in the ACA and tax cost setting process (e.g. removing DTAs/DTLs altogether or creating some type of optional short cut etc that potentially strikes a balance between compliance cost savings versus achieving the right outcome).

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

Position 5.1

The Board considers that on-going formation concessions should be available for wholly-owned corporate groups with an aggregated turnover of less than $100 million and assets of less than $300 million in an income year.

The formation concessions should be available to an eligible wholly-owned corporate group that forms a consolidated group by the end of the income year following the income year that it exceeds the threshold test. The concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

If a group elects to apply the concessions, the election should apply to all subsidiary members of the group. If an election is made:

- the existing tax costs of assets for all subsidiary members should be retained; and

- losses held by subsidiary members that are transferred to the consolidated group should be able to be utilised over three years.

Question 5.1

(a) Do stakeholders agree with the Board's Position 5.1? If not, why not?

(b) Do stakeholders agree with the removal of the 'entity-by-entity' election for eligible wholly-owned groups? Are there situations where such an approach may unfairly disadvantage these groups?

The Joint Bodies welcome proposals to simplify barriers for entry into the consolidation regime for entities meeting the SME threshold. However, we do not believe that the propositions completely deal with the SME issues and accordingly, unless such issues are dealt with, SMEs will still be reluctant to form tax consolidated groups. We therefore request the Board to consider the following propositions.

Date of application

As a public proposition for stick and 1/3 losses has been released, SME groups looking to consolidate now will need to consider delaying their formation. If the propositions become legislation in, say, three years time, the circumstances for the group may have changed so dramatically that group may have considered other alternatives to tax consolidation.

In our view, the SME proposals should be escalated to the Government and should be part of a separate reform process. We would be surprised if the measures (as a standalone package) would have a revenue cost and accordingly, we see no reason why the Government would not support implementation of the recommendations earlier rather than later. In our view, it is therefore critical for the Board to consider fast tracking these recommendations (similar to the capital account election under the MIT reform).

Stick versus spread election – entity by entity

We understand the concerns raised by the Board on compliance in relation to stick versus spread choices. However, we highlight that these concerns were valid where the groups seeking to consolidate under a stick versus spread regime were not SME type entities. We understand that the majority of remaining SME groups outside of the tax consolidation regime do not have complicated and significant corporate groups with a large number of entities. Accordingly, in our view, where a corporate group has less than five entities in total, the Board should consider recommending an option to stick or spread on an entity by entity basis, as this would not result in higher compliance as compared to what is being proposed.

If this is not accepted, the Board should at a minimum recommend a choice to stick or spread for entities that have been recently acquired. That is, for any entities that have not been majority owned for the last five years, the Board should allow an option to use stick for that entity. From our review and experience, very few entities would fall within this "choice", and this would ensure that compliance costs would be kept to a minimum. If the definition of "majority owned" as contained in transitional section 701A-1 is used, we believe that this would ensure that "re-organisations" could not result in a choice.

Subsequent acquisitions – majority owned entities

SME groups will often own at least 50% of shares in an entity in partnership with another "related" entity. If the interests are subsequently acquired by the tax consolidated group, this would result in a subsequent acquisition and (under Position 2.1) would result in a full acquisition and ACA calculation. The consequences of this would be:

- Pre-CGT goodwill would be converted to post-CGT goodwill;
- Small business concessions timing (e.g. 15 year concession) would recommence;
- ACA would inappropriately be skewed to goodwill; and
- Bad debts would be lost for "owned" (rather than acquired) debts.

Where a group has an entity that fits this category, these implications may be enough to deter the group from forming a tax consolidated group until the entity is wholly owned. This is because the group could then subsequently choose the formation "stick" option and avoid the above consequences.

We see this as a real impediment to forming a group early. It is submitted that the Board should recommend a solution to this problem. We request the Board consider whether an entity that subsequently joins an SME group, where it has been majority owned for the last five years, can join using a stick option/inherited history model for assets. This would alleviate the issues outlined above and would not create the impediment to form a group early. We understand that the Board is concerned with double taxation and double benefits that may occur on providing a stick option. Where this is the case, we highlight that alternative stick options may be available to alleviate this concern[17].

Roll-over problem

We also highlight the many issues that occur for SMEs where interests are rolled over. For example a Subdivision 122-A rollover on top of a consolidated group results in a complete group breakup. Furthermore, it results in the profits of the group failing to be Step 3 profits.

Furthermore, rollovers under Subdivision 124-M for SME groups cannot qualify for the compliance saving mechanisms in section 124-784B or Subdivision 715-W, as these mechanisms are only available to widely held groups (i.e. with reference to the requirement in paragraph 124-784(1)(a)(ii)). Accordingly, the lack of an appropriate Step 1 or Step 3 amount, coupled with an inability to use the consolidation compliance saving stick options in Subdivision 715-W is anomalous for SMEs.

The rollover issue for SMEs needs to be addressed. Without appropriate rollover opportunities, SME groups may be reluctant to consider forming a tax consolidated group where significant future ramifications could occur due to a rollover.

[17] Reference is made to the paper written by Alexis Kokkinos, TIA, "5th Consolidation Symposium SMEs and tax consolidation", 14 October 2010. Section 5.4 covers an alternative stick option that could be used to overcome issues with applying a push down calculation to a majority owned entity.

Losses and available fractions

We are concerned with simply providing a 1/3 method for COT losses and no other losses. This will not provide any compliance saving opportunity if there are SBT losses in existence, as the whole group would need to be valued on formation. The most significant advantage of the Board's proposals is the possible elimination of valuations. Accordingly, we believe that a shortcut approach should also be suggested by the Board for SBT losses. If the Board considers that a 1/3 method would be too generous for SBT losses that are transferred, then we request the Board consider an alternative utilisation rate, e.g. a 1/10 method.

We highlight that SBT losses are required to pass a very onerous transfer test and become in effect COT losses once transferred to a consolidated group.

Accordingly, we would support a 1/3 COT and 1/10 SBT shortcut for all losses transferred to a consolidated group, on formation and subsequent acquisition. We request the Board considers a significant simplification of this part of the consolidation provisions.

Interaction between stick and 1/3 loss method

The Board's paper suggests that an election to use the compliance cost saving measures would require both the stick and the 1/3 loss method to be utilised simultaneously. We do not see any reason why these two decisions should be so coupled.

We do not believe that making these two elections separate would give rise to any additional compliance costs. In many cases it will be appropriate to provide a choice, e.g. an existing group with all value in one subsidiary entity that has all losses in that entity. In that example, there would be minimal compliance costs in establishing an available fraction of 1, while providing the opportunity to use a stick method.

Recommendations

In our view the Board should consider and, if considered appropriate recommend that:

- the SME proposals be fast tracked, in a similar fashion to the capital account measures for managed investment trusts.
- corporate groups with less than five entities in total have the option to stick or spread on an entity by entity basis as this would attract minimal, if any, additional compliance costs. At a minimum, an option to stick or spread should be available for entities that have not been majority owned for the last five years.
- an entity that subsequently joins an SME group, where it has been majority owned for the last five years, be able to join using a stick option/inherited history model for assets.
- a 1/3 COT and 1/10 SBT shortcut apply for all losses transferred to a consolidated group, both on formation and subsequent acquisition.
- The choice to stick to existing asset values and the 1/3 loss method be decoupled.

There are a number of other impediments to a SME group forming a consolidated which the Board should consider in making its final recommendations to Government.

Position 5.2

The Board considers that, as a transitional rule, the formation concessions proposed in Position 5.1 should be available to all groups which are eligible to form a consolidated group at the date of announcement of the measure for a specified period time. The concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

Question 5.2

(a) Do stakeholders agree with the Board's Position 5.2? If not, why not?

(b) Are stakeholders concerned about the increased complexity and additional compliance costs caused by the adoption of Position 5.2?

We support extending to all groups which have not yet consolidated the option of using the proposed SME formation concessions where the group is:

- eligible to consolidate at the time the Government announces such a concession should it accept the Board's proposed recommendation; and
- chooses to consolidate within a specified period after that time.

However, we note groups have remained outside the consolidation regime for various reasons. A decision to enter the regime utilising the proposed transitional concessions will entail a review of the tax consequences of such a choice. Accordingly we would recommend that the time period within which such groups may choose to consolidate utilising the proposed SME formation concessions be 24 months from the date of announcement of such a measure. In our view, the 12 month period mooted in paragraph 5.47 of the Position Paper is too short.

Recommendation

We agree with Position 5.2 and recommend that the period within which qualifying groups may choose to consolidate utilising the SME formation concessions be approximately 24 months from the date of any Government announcement of such a measure.