PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers
ABN 52 780 433 757

Darling Park Tower 2
201 Sussex Street
GPO BOX 2650
SYDNEY NSW 1171
DX 77 Sydney
Australia
Telephone +61 2 8266 0000
Facsimile +61 2 8266 9999
Direct Phone +61 2 8266 7939
Direct Fax +61 2 8286 7939
www.pwc.com/au

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

12 March 2010

Dear Sir or Madam

Submission in relation to the Board of Taxation's Post-implementation Review into Certain Aspects of the Consolidation Regime

We appreciate the opportunity to make this submission in relation to the above Review and the Discussion Paper which was released by the Board of Taxation on 9 December 2009.

Our comments and observations raised in this submission are based on our experience in dealing with consolidation issues that we have encountered together with our clients and are not presented on behalf of any individual client.

At the outset, we advise that we have contributed to the comments made in the joint submission made on behalf of the Institute of Chartered Accountants in Australia and Taxation Institute of Australia (dated 12 March 2010) and endorse those comments.

Our comments set out in the attached appendix cover off on additional matters and recommendations that are not reflected in that submission.

Yours sincerely

Wayne Plummer
Partner
Tax and Legal Services

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Appendix

(All section references are to the Income Tax Assessment Act 1997, unless otherwise specified. References to the ITAA 1936 are to the Income Tax Assessment Act 1936.)

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

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?

It has been our experience that the consolidation regime has on the whole increased business efficiency and reduced ongoing tax compliance costs (typically due to less income tax reporting).

However, delays in having specific consolidation issues addressed by legislative amendment or through guidance from the Australian Taxation Office (ATO) has been a concern.

Although it is commendable that an extensive consultative process was undertaken by Treasury to have proposed consolidation amendments developed and refined in the most practical and accurate manner[1], the delays for corporate groups ultimately contribute to additional compliance costs.

In this respect, we strongly recommend that any legislative outcomes arising from the Board of Taxation review be announced by Government and legislated promptly and in a manner that gives due regard to an appropriate consultative process.

Relevance of accounting

In relation to aspects of implementation of consolidation regime, we see merits in having accounting standards and principles applied in the manner that is currently applicable in

[1] As applicable for measures included in Tax Laws Amendment (2010 Measures No 1) Bill 2010

working out the relevant tax costs of assets on entry and exit (as part of the Allocable Cost Amount (ACA) calculations) as this goes some way to reducing compliance costs associated with implementing the consolidation regime.

However, we recommend that there needs to be a broader policy statement about making a commitment to adherence to accounting standards, and accept that accounting standards may change and those changes consequently should be applied for tax purposes. In particular, changes in accounting standards should not on their own result in a rethink as to whether the relevant ACA rules are achieving the intended outcomes.

We also recommend that a legislative remedy be worked through to address matters relating to the treatment of deferred tax balances as these issues have created much uncertainty for taxpayers, advisers and the ATO. These issues and options have been raised in a comprehensive ATO discussion paper released as part of the National Tax Liaison Group Consolidation subcommittee meeting held in February 2009.

Question 2.1

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?

In our view, the general reluctance of small business entities to enter into the consolidation regime is likely due to the complexity of the consolidation regime, particularly in respect of formation, where the costs of applying the regime are likely to be inappropriately high having regard to benefits that such entities would enjoy if they were to consolidate.

Our recommendations in relation to small business entities are discussed under Question 6.

In our experience, some of the other reasons that a group (not just small business groups) choose to remain outside of the consolidation regime include:

- the impact for the group on its ability to utilise carry forward losses, and
- the impact for the group on the tax cost of its assets.

In relation to losses, the available fraction limitation tends to be the main reason why some consolidatable groups have chosen not to consolidate in the short-term. Although it may be the case that such groups at some later stage ultimately decide to consolidate, their reasons for delaying the entry into consolidation is often because they would be able to recoup losses at a much faster rate than had they formed a consolidated group. This is typically the case for groups which have long-term projects which typically have a long lead time before they generate profits (such as infrastructure or resources companies).

However, it is disappointing that such groups which have or will continue to delay their choice to consolidate are not able to avail themselves of the transitional concessions which applied in the first two years of the consolidation regime[2].

Accordingly, it is our recommendation that consolidated groups that formed after 30 June 2004 should be given the option to apply the transitional concessions at least in relation to the ability to choose to retain the tax costs of assets ("stick") and the residual loss utilisation concessions (including value and loss donor concessions).

Furthermore, the application of the modifications in relation to losses of MEC groups is often problematic. In this respect, we affirm the comments made in the joint submission by the (professional bodies) in the context of:

- the limitations imposed on MEC group losses when a MEC group expands, and
- the deemed failure of the continuity of ownership test for MEC groups in certain circumstances where there is in fact no ultimate change in majority beneficial ownership.

In relation to the possible detrimental impact on the tax cost of assets for a group which consolidates, we make specific reference to cases in which the tax cost of assets of a joining entity is reset downwards. In this respect we are aware of instances where this has occurred simply due to an increase in the market value of the entity's goodwill, relative to the market values of other assets in the entity. One asset commonly affected in this way is trading stock.

Short of allowing groups the option to either "stick" with existing tax costs or "spread" its resulting ACA for any entity that joins a group (as recommended earlier), one alternative means by which this issue could be ameliorated in relation to trading stock is to amend the law to allow taxpayers the choice to treat trading stock as a retained cost base asset.

[2] Refer Subdivisions 707-A and 707-C of the *Income Tax (Transitional Provisions) Act 1997*

We envisage that such an amendment would have few (if any) detrimental implications for taxpayers.

In addition, the process by which the ACA is allocated between retained cost base assets which represent a right to receive a specified amount of Australian currency[3] and other assets creates inequities in cases where those Australian currency denominated rights are impaired (including, for example, a receivable for which there is a provision for a doubtful debt or which in fact has actually been written off for accounting purposes as a bad debt[4]).

Specifically, such retained cost base assets will have their tax cost reset at an amount equal to the amount of Australian currency concerned, notwithstanding that the debt may be impaired. That is, the ACA that is allocated to the debt will be inappropriately high having regard to the debt's market value. The allocation of ACA equal to the full face value of the impaired debt has the consequential effect of "robbing" ACA from the joining entity's reset cost base assets.

The amendments in Part 13 of the *Tax Laws Amendment (2010 Measures No 1) Bill 2010*, which propose to reduce the tax cost setting amount that exceeds the market value of retained cost base assets that are impaired debts, do not address the problem identified above. The proposed measures apply only in circumstances where CGT event L3 would otherwise apply, that is, only in respect of entities which have retained cost base assets and no reset cost base assets at the joining time (eg debt factoring companies).

It is our submission that further amendments are necessary to ensure that the law operates appropriately, and in particular, that consideration be given to allowing an impaired debt that is a retained cost base asset to be given a tax cost setting amount equal to its market value.

Operation of the single entity rule (SER)

We support the comments made in the joint submission made by the Institute of Chartered Accountants in Australia and Taxation Institute of Australia (professional bodies) in relation to the SER. In particular, we support any recommendations to address any inappropriate application of the SER on a case by case basis and, to the extent possible, by way of specific legislative amendment.

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[3] Section 705-25

[4] In the case of a bad debt, the debt arguably will have its tax cost reset at its face value where it is not yet statute barred (ie there is still a legally enforceable right to recover the outstanding amount), unless a view is able to formed that the debt is not an "asset" for consolidation purposes because it has no economic value – refer *TR 2004/13*.

Perhaps one of the easier matters involving third parties being affected by an intra-group transaction that can be dealt with by legislative means is the commercial debt forgiveness problem as raised in the Board's Paper[5].

It is our recommendation that this matter can be rectified by simply repealing the grouping provisions[6] within Schedule 2F of the *ITAA 1936*.

It is currently proposed as part of the rewrite of those provisions (see *Exposure Draft of Tax Laws Amendment (Transfer of Provisions) Bill 2009*) to remove any notion of grouping so that grouping will have no application to commercial debts forgiven in the 2010-11 income year and later years.

The Explanatory Material to the Exposure Draft indicates that the Subdivision 245-G provisions are not being rewritten as this is broadly consistent with the policy behind the consolidation provisions, that is,

> "The availability of a consolidation taxation regime removes the need to retain the current grouping provisions ... In particular, the current tax treatment is unsound whereby, on the one hand, each group entity is treated as a separate taxpayer and, on the other, grouping provisions operate to break down that separation in a partial fashion." (A Platform for Consultation, Review of Business Taxation)

On this basis, it would seem there are strong grounds to repeal the grouping provisions in the *ITAA 1936* with effect from from 1 July 2003, subject to transitional rules for substituted accounting period (SAP) groups that elected to consolidate, or form a MEC group, as from the start of the head company's first SAP income year after 1 July 2003. Also the grouping provisions should cease to apply for an entity when it has joined a consolidated group or MEC group before 1 July 2003.

However, having regard to compliance costs, it is recommended that any retrospective repeal be at a taxpayer's choice (in line with many of the retrospective amendments as set out in *Tax Laws Amendment (2010 Measures No 1) Bill 2010).*

[5] Page 28
[6] Subdivision 245-G of Schedule 2F of the *ITAA 1936*

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

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?

Difficulties for public trading trusts and corporate unit trusts

A unit trust may qualify to become the head company of a consolidated group if it is a "corporate unit trust" (CUT) or a "public trading trust" (PTT)[7].

It would seem that a number of practical issues are emerging for such group structures which we consider should be reviewed against principles of simplicity, equity and efficiency.

Some of these difficulties include:

- once the unit trust becomes the head company of a consolidated group it will continue to be treated as a company under income tax and related rules[8], even if it ceases to be a CUT or PTT and even if the group subsequently ceases to have subsidiary members – it is our recommendation that this should not be the case
- a PTT or CUT cannot choose to form a consolidated group on the day it acquires its first wholly-owned subsidiaries during its income year, where that day is not the first day of that income year[9] - it is our recommendation that the group be able to be formed from the time that it has wholly-owned subsidiaries
- where a CUT or a PTT owns a number of wholly-owned subsidiaries and it decides that it does not wish to be treated like a head company of a consolidated group, it may be possible for the CUT's or PTT's wholly-owned subsidiaries to form a consolidated group of which the CUT or PTT is not a member – it is our recommendation that this remain an option that is open to the group, and

[7] Section 713-125(2)
[8] Section 713-135(1)(b)
[9] ATO Interpretative Decision 2009/206

- the s23AJ exemption can apply in the case of a foreign dividend that is received by a trust in its capacity as a subsidiary member of the group (due to the SER), but not for a CUT or PTT that has chosen to be the head company of a consolidated group[10] - we recommend that the exemption be able to be applied to a group which has a CUT or PTT as its head company.

We recommend that the practicalities of these issues be reviewed in the context of possible legislative reform. It may be the case that some of these issues are affected by the Board of Taxation's review of the tax arrangements applying to managed investment trusts (MITs).

Review of the inherited history rules

Whilst with the benefit of hindsight it might have been appropriate for a "clean slate" rule to have been introduced from 1 July 2002 in respect of acquisition cases, and for the inherited history rules to operate only in cases of group formation, it is our submission that a clean slate approach should not be introduced at this stage.

One key reason for this is that the amendments proposed in *Tax Laws Amendment (2010 Measures No 1) Bill 2010,* which is currently before Parliament, adequately addresses many of the problems that arise under current law with respect to acquisition cases. Furthermore, any decision to adopt a clean slate approach for acquisition cases would present serious challenges in terms of the transitional arrangements for the introduction of such a rule.

Accordingly, it is our submission that the inherited history rules should remain in place, and that any inappropriate outcomes for acquisition cases should be dealt with by way of targeted legislative amendment.

In the interests of equity and simplicity, we do not support the outstanding proposal[11] relating to the deemed date of acquisition of depreciating assets. In effect, the proposed amendment would apply the entry history rule for depreciating assets to ensure that the head company is taken to acquire the depreciating assets of a joining entity at the time those assets were acquired by the joining entity (rather than at the joining time) for the

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[10] Paragraphs 17 and 20 of TD 2008/25 and also refer to PricewaterhouseCoopers submission lodged with Treasury in relation to the discussion paper on the reforms to the controlled foreign company rules (dated 5 March 2010)
[11] Announced on 8 May 2007 by the former Government

purpose of qualifying for changes in depreciation rates (eg for the purposes of qualifying for the 200% diminishing value method).

It is our submission that it has been long accepted that the effect of section 701-55(2) is to treat a depreciating asset as being acquired by the head company at the joining time, that is, the history in respect of the time the asset is first held is not inherited.

If the inherited history rule were now to apply in respect of depreciating assets (which if it did, should only apply on a prospective basis), there would be disparity for consolidated groups which are contemplating the acquisition of an entity (which will join the group) which has substantial value in its depreciating assets where differences in tax depreciation claims will arise depending upon whether the entity or the depreciating assets are acquired. In particular, it would be inequitable that a group could only access the 200% diminishing value factor in respect of depreciating assets that were only acquired directly rather than indirectly through the acquisition of the entity in cases where the joining entity first held those assets prior to 10 May 2006. In the current economic climate, enhanced depreciation entitlements promote economic investment and stimulus to business and any proposal to limit those entitlements would create an unnecessary impediment to business efficiency.

Operation of the consolidation regime for small businesses

In our view, the general reluctance of small business entities to enter into the consolidation regime is likely due to the complexity of the consolidation regime, particularly in respect of formation.

For such businesses, the costs associated with engaging a suitably experienced tax adviser and valuation experts to assist with the formation, and ongoing operation of, a consolidated group, are likely to be inappropriately high having regard to benefits that such entities would enjoy if they were to consolidate.

Other complexities also emerge in relation to reliance on accounting standards for purposes of applying certain provisions within the consolidation law in respect of entry and exit. In particular, many small business entities do not (and are not often required to) prepare financial statements in accordance with all applicable accounting standards.

It is our recommendation that to develop a simplified consolidation regime for small business may itself be problematic. Rather, it may be more appropriate to allow grouping relief for small business entities (as defined within the *ITAA 1997*) which would enable

assets and losses to be transferred or dividends paid within wholly-owned groups of such entities without tax impediments.