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5 March 2010

Dear Sir/Madam

Submission on Post-implementation Review into Certain Aspects of the Consolidation Regime - Discussion Paper

Please find below our submission in relation to the Discussion Paper "*Post-implementation Review into Certain Aspects of the Consolidation Regime*" (**"the Discussion Paper"**).

General comments

Before proceeding with our responses to the specific questions raised in the Discussion Paper, we take this opportunity to make some broad comments on the drivers of compliance costs, risks and uncertainty that are relevant to corporate groups that elect to consolidate, especially for those in the small to medium enterprise (**"SME"**) sector.

Compliance costs

It appears to us that Treasury and other government bodies believe that the lodgement of a single tax return covering all the members of a tax consolidated group should, in itself, deliver substantial compliance cost savings. However, the perception that the consolidation regime decreases compliance costs just because it results in the lodgement of a single tax return for all of the members of the consolidated group is inaccurate.

In practice, we have observed that the consolidation regime often increases compliance costs, as additional (and often complex) work is required to produce the consolidated group's tax return.

Notwithstanding that only one tax return is lodged for the group, the need to perform a separate taxable income calculation for all the members of the consolidated group remains. Furthermore, these individual tax calculations must then be consolidated into a single head company tax return, a process that is often complex and time consuming.

It is often not feasible to base the consolidated group's income tax return on the consolidated financial statements of the reporting entity, as for most groups the consolidated entity for financial reporting purposes is very different to the tax consolidated group. For example, consolidated accounts can include subsidiaries that are controlled, but not wholly owned, by the head company, foreign subsidiaries and branches, and may also include certain equity accounting recognition of significant interests (i.e. 20% to 50% shareholdings). This means that consolidated accounts are seldom suitable to form the basis of the consolidated tax return.

Where this is the case, the tax consolidation regime effectively requires a further accounting consolidation exercise to be undertaken in order to produce the consolidated tax return.

Risks and costs associated with the ACA process

The determination of the Allocable Cost Amount ("**ACA**") and the preparation of the associated spread calculations is often a complex, labour intensive and extremely expensive exercise, especially for capital intensive groups that have an extensive fixed asset register, as well as for those groups that have intangible assets that are difficult to identify and/or value.

Furthermore, the consolidation entry process invariably exposes groups to the expense and inherent uncertainty associated with obtaining market valuations for all of the assets of the joining subsidiaries. Market valuations are, for most assets, a matter of judgement and in our experience independent valuations conducted by different valuers for the same assets often differ significantly. As a result, the tax cost of the subsidiary members' assets is always an area of uncertainty for many corporate groups that choose to form a consolidated group.

Perception of integrity issues associated with "step ups" in tax cost overlooks anomalies where there may be a "step down"

At certain points in the Discussion Paper, issues are raised as to the appropriateness of groups obtaining a step up in tax cost for their assets when an entity joins a consolidated group or when a consolidated group is formed, especially where there has been no change in the ultimate beneficial ownership.

However, in our experience, entering into the consolidation regime often results in an adverse (and inappropriate) ***step-down*** in the tax cost of assets. We have often observed situations where the choice to consolidate will result in a reduction in the tax cost of all of a subsidiary's reset cost base assets. In other situations, tax cost is drawn away from the revenue assets and reallocated to the assets that are taxable under the Capital Gains Tax (**"CGT")** regime due to the market value of goodwill or intangible assets relative to that of certain revenue assets (e.g. trading stock or plant and equipment).

Furthermore, the election to consolidate a wholly-owned group which includes subsidiaries that may have been in a loss-making position whilst they were part of that wholly owned group often results in a taxable capital gain under CGT event L5 (and sometimes CGT event L3) – hardly an appropriate outcome in situations where there has been no change in the ultimate beneficial ownership of the wholly owned group.

If the Treasury, the Board of Taxation or the ATO are concerned about inappropriate "step-ups" on consolidation when there has been no change of ownership, the same (if not a greater) level of concern needs to be directed towards the inappropriate step-downs or CGT events that also may occur in the same circumstances.

In our experience, taxpayers are most concerned about the exposure to step-downs in tax cost and/or CGT events L3 and L5 in circumstances where an election to consolidate is made with no change in the ultimate beneficial ownership of the group.

Appendix – responses to specific questions

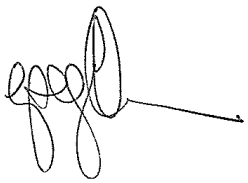
We provide, in the appendix attached, our specific comments in relation to the following Discussion Paper questions:

- Question 4.3;
- Question 4.4;
- Question 4.6;
- Question 5.1; and
- Question 6.1.

We thank you for the opportunity to provide our comments in this regard. Should you have any queries about this submission, please do not hesitate to contact us on (03) 8320 2102 (Greg Thompson) or (03) 8320 2329 (Aldrin De Zilva).

Yours sincerely

BDO (Australia) Limited



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APPENDIX – BDO RESPONSE TO SPECIFIC QUESTIONS IN THE DISUSSION PAPER

Chapter 4: Interaction between the Consolidation Regime and Other Parts of the Income Tax Law

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

At a policy level, we do not consider there to be a significant need for the trustee to be a member of the same consolidated group as the trust.

Inter alia, for a trust to be a subsidiary member of a consolidated group, all its membership interests must be beneficially owned, directly or indirectly, by the head company.

A membership interest, as defined in section 960-135 of the *Income Tax Assessment Act 1997* (**"ITAA97"**), essentially refers to each interest or right (or set of interests or rights) held in the entity by virtue of which the holder is a member of the entity. Item 3 of subsection 960-130 of the ITAA97 provides that a member of a trust, other than a corporate unit trust or a public trading trust, is a beneficiary, unit holder or object of the trust (collectively referred to as "beneficiary" throughout the remainder of this question).

A trust will therefore be a subsidiary member of a consolidated group where all its beneficiaries are members of the same consolidated group. Accordingly, we submit that it is not inconsistent with the wholly-owned group concept if a trustee is not a member of the same consolidated group as the trust.

The single entity rule (**"SER"**) should treat the trust as being part of the head company of the consolidated group and therefore the taxable income of the head company should essentially include all of the net income of the trust. Any distributions from the trust to the beneficiaries (i.e. other members of the consolidated group) should be viewed as intra-group transactions which are ignored.

Question 4.3(b) If a trustee is not a member of the same consolidated group as the trust, do the core rules and other tax rules operate appropriately to deem the income and expenditure of the trust to be that of the head company?

We acknowledge that there may be some ambiguity regarding the interaction of the consolidation provisions and other tax law provisions in relation to trusts that requires clarification. The Board of Taxation has noted that if the trust, but not the trustee, is a member of the consolidated group, the ambiguity generally arises due to the concept of legal ownership contained in certain income tax law provisions and their interaction with the SER in the consolidation provisions.

For example, the capital allowances provisions in Division 40 of the ITAA97 broadly provide a deduction for the decline in value of depreciating assets to the holder of the asset. Under item 10 of section 40-40 of the ITAA97, a depreciating asset is held by the owner or the legal owner (if there is both a legal and equitable owner). Under trust law, the trustee is the legal owner of the trust's assets. Accordingly, if the trustee is not a member of the same

consolidated group as the trust, this may cause a technical issue as to whether the head company is entitled to claim depreciation deductions in respect of the trust's assets. Further ambiguity arises because the 'entity' referred to in the membership rules of the consolidation provisions is the trust and not the trustee.

However, we submit that the main cause of any ambiguity between the interaction of the consolidation provisions and other tax law provisions derives not from whether the trustee is (or should be) a member of the consolidated group, but rather the inconsistent terminology used by drafters throughout the provisions.

To provide certainty and ensure that the current provisions operate as intended, we recommend the inclusion of clarifying amendments that align the terminology used throughout the consolidation provisions with other tax law provisions.

Question 4.3(c) Should a trust be a member of a consolidated group if it has beneficiaries that are not members of the group? If yes, what other issues need to be resolved? If not, why not?

We submit that a trust should not be a member of a consolidated group if it has beneficiaries, other than debt beneficiaries, that are not members of the group. Allowing a trust to be a member of a consolidated group if it has beneficiaries that are not members of the group would be inconsistent with one of the fundamental concepts of tax consolidation. That is, that only eligible wholly-owned groups can become consolidated groups.

However, we acknowledge the possibility that a trust may have beneficiaries whose interests in the trust would be classified as debt interests (i.e. debt beneficiaries). Pursuant to subsection 960-130(3) of the ITAA97, any debt interests should not be classified as membership interests in the trust. This view is consistent with excluding debt interests in companies (i.e. finance shares) from the definition of a membership interest (refer to the note to section 960-135 of the ITAA97).

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

No comment.

Question 4.4(a) Should non-resident entities that satisfy the foreign hybrid rules be members of a consolidated group? If yes, how is this consistent with the Government's policy intent that limits the types of entities that become members of a consolidated group?

In our view, non-resident entities that satisfy the foreign hybrid rules should be eligible to be members of a consolidated group (with membership of course being subject to the proviso that all of the members of the foreign hybrid entity are members of the same consolidated group).

The Government's policy intent that limits the types of entities that may become members of a consolidated group should not be considered to be driven by the issue of whether an entity is a non-resident. Instead, the issue driving the policy is whether all of the income, assets and capital of the relevant entity is ultimately held by the head company ***and*** whether all of the income derived by the relevant entity (from both Australian and foreign sources) is effectively subject to Australian income tax at the normal Australian company tax rate at the time of derivation. This interpretation of the policy drivers is not inconsistent with the paragraph from the Explanatory Memorandum quoted at paragraph 4.31 of the Discussion Paper.

Where all of the membership interests in a foreign hybrid entity are held by members of a consolidated group, all income derived by the foreign hybrid entity should be subject to tax in the hands of the head company pursuant to section 92 of the *Income Tax Assessment Act 1936* (**"ITAA36"***)* in any event. Viewed in this light, we believe that it is appropriate for foreign hybrid entities to be eligible for membership of a consolidated group.

In contrast, restricting foreign hybrid entities from eligibility for membership of a consolidated group just because they are foreign residents would only serve to undermine the policy intent behind Division 830 of the ITAA97 (i.e. that foreign hybrid entities be treated for Australian income tax purposes as though they are partnerships).

Question 4.4(b) Would non-resident entities that satisfy the foreign hybrid rules effectively gain or be denied concessional treatment by becoming a member of a consolidated group?

In our view, this question is misplaced – because the foreign hybrid entity is fiscally transparent, it is the entity that holds the membership interests in the foreign hybrid that gains (or is denied) any concessional treatment that may be associated with consolidation, not the foreign hybrid entity itself.

In any event, we consider that the outcomes listed in paragraph 4.35 of the Discussion Paper are consistent with the policy objectives of both the consolidation regime and the foreign hybrid regime. As each of those outcomes would be expected to arise if the relevant income were derived by a partnership that is a member of a consolidated group, those outcomes should apply equally for foreign hybrids.

Question 4.4(c) If these entities can become members of a consolidated group, are there any integrity risks that need to be addressed? If so, what are they and what is the best way to resolve them?

For the reasons outlined above, we do not see any integrity risks associated with foreign hybrids being members of a tax consolidated group.

Question 4.4(d) If these entities cannot be members of a consolidated group, what is the most efficient way of preventing non-resident entities from being members of a consolidated group.

No comment.

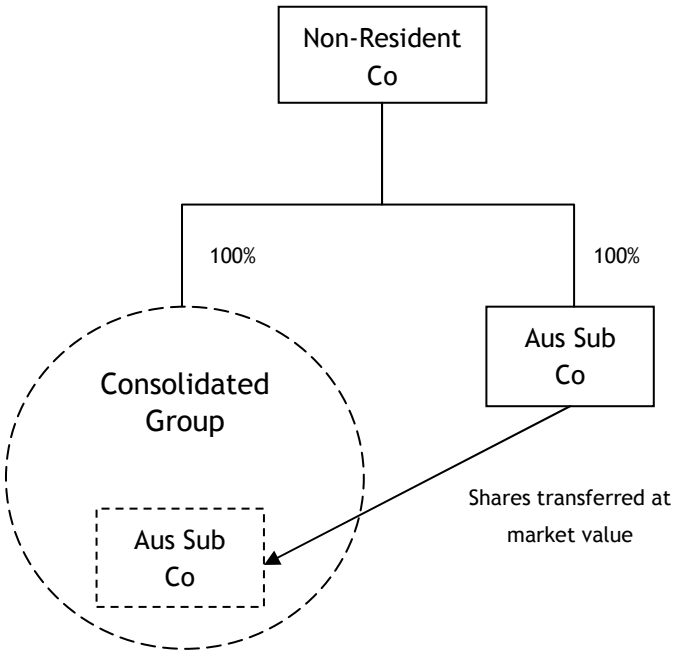
Question 4.6(a) Do integrity risks arise from a consolidated group being able to reset the cost base of its assets to market value where there has not been a change in ultimate beneficial ownership of the assets before and after the transaction? If so, what is the most effective way to overcome those integrity risks?

The example from Chapter 4 (paragraphs 4.52-4.54) of the Discussion Paper provides:

- An entity or a group of entities in the group have predominantly non-taxable Australian real property assets;
- The non-resident owner of the group incorporates a new consolidated group that it wholly owns; and
- The non-resident entity disposes of all the shares it owns in a member of the group that has predominantly non-taxable Australian real property assets to the newly formed consolidated group at market value.

The Board concludes at paragraphs 4.53 and 4.54:

> *"The foreign resident CGT rules allow the foreign owner of the group to disregard any capital gains it makes on the disposal of the membership interests in the Australian resident entity to the new group as the majority of the entity's assets are not taxable Australian real property assets.*
>
> *The consolidation tax cost setting rules then allow the newly formed consolidated group to reset the tax cost of the purchased group's assets to their market value."*



Integrity risks do arise in circumstances where consolidation is chosen, there is no change in the beneficial owner of the assets and the purpose of the transaction is to generate an uplift in the cost base of the assets transferred. However such structures are currently subject to Part IVA and other existing integrity measures.

Given the existing integrity measures, the application of any new integrity measures, outside of those already contained in the legislation (such as Part IVA), requires careful consideration. There may be a number of legitimate reasons for undertaking an internal restructure, which may result in a cost base uplift without a change in beneficial ownership of the assets. We refer to the example at paragraphs 4.52-4.54 of the Discussion Paper and note that there are several reasons why it may be practically and commercially important to undertake such a restructure. A "catch all" integrity measure that denies a cost base uplift in such circumstances may yield unfair outcomes.

We suggest that the current integrity rule in Part IVA should sufficiently apply to circumstances where the dominant purpose is to obtain a tax benefit (consistent with the ATO view provided in its paper *The Application of Part IVA to Elections to Consolidate* dated 9 October 2003).

Chapter 5: Review of the Inherited History Rules

Questions 5.1(a) to (f)

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

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

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

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

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

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

The main issues with the entry history rule (**"EHR"**) and the exit history rule (**"XHR"**) seem to arise where the objects of the tax consolidation legislation do not align with tax laws which are unaffected by the 'entity core purposes'. This is because the head company core purposes relate solely to the determination of the tax position of the head company (and not of shareholders of the head company).

Several of the 'misalignment' issues have been specifically addressed, including the following examples:

- How long a head company is taken to have held an asset for the purpose of determining if a sale of the shares of the head company is subject to the small business CGT concessions (refer TD 2004/44);
- The timing of a CGT event where an entity which is a party to a contract enters a consolidated group before the contract is settled (refer proposed section 716-860 contained in Item 153 of the Tax Laws Amendment (2010 (Measures No. 1) Bill 2010) as well as TD 2008/29 and TD 2008/31; and
- When a unit trust is deemed to have acquired the asset if it exits a consolidated group and disposes of the asset for the purpose of determining whether the CGT discount rules apply (ATO ID 2006/130).

However, issues still arise in relation to these rules, such as the situation where:

- One consolidated group (**"Purchaser Group"**) acquires another (**"Target Group"**) under a scrip for scrip arrangement;
- All assets in the Target Group are transferred to the Purchaser Group head company; and
- Target Co is liquidated.

Where an individual obtains scrip for scrip roll-over in relation to their receipt of Purchaser shares, they will be deemed to have acquired their Purchaser shares when they acquired their Target shares (refer subdivision 112-C, item 8C of section 109-55 and section 115-30 of the ITAA97). However, in order for the CGT discount to apply, it must be the case that, broadly, the majority of the CGT assets of the Purchaser head company have been held for 12 months (refer section 115-45 of the ITAA97). Where assets are transferred to the head company, this requirement may not be satisfied because the EHR in relation to these assets will not be relevant for the purpose of satisfying section 115-45 of the ITAA97. The proposed changes in sections 115-32 and 115-34 seem to only apply to membership interests and not other assets (refer Schedule 6, Part 11, items 142, 143, 144, 145 and 146 of the *Tax Laws Amendment (2010 Measures No. 1) Bill 2010*).

Clean Slate Rules

Adopting the deemed acquisition and clean slate rules as described in Appendix 3 of the Discussion Paper would represent a large shift from the current rules, which itself would result in complexity and uncertainty in relation to joining or exiting a consolidated group. If the clean slate rules do not offer continuity in relation to the activities of the subsidiary prior to joining a consolidated group, this could cause inefficiencies where, for example, a head company would have to re-apply for a private binding ruling obtained by a subsidiary.

Where tax attributes such as losses and franking credits are at risk, it would be necessary to modify the rules such that these attributes can continue to be utilised. Otherwise the choice to consolidate would be less palatable.

The compliance cost in moving to a new system could be significant, given the current regime has been in place since 2002.

In our view, although a number of difficulties arise under the inherited history rules, they should not be materially amended. This is because changing the method of dealing with an entry or an exit will likely cause significant complication which may be counterproductive. As an alternative, specific issues with these rules should be specifically dealt with. Also, where it is determined that a different method to facilitate an entry or exit is appropriate (e.g. the clean slate rules), taxpayers should have the ability to choose which method best suits their situation.

Chapter 6: Operation of the Consolidation Regime for Small Businesses

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

The Board has noted that many eligible small business groups have not elected into the tax consolidation regime and seeks comment on whether there are any aspects of the consolidation regime that are causing particular difficulties for small businesses. Paragraph 6.5 of the Discussion Paper notes that, despite the intended advantages of the consolidation regime, only a relatively small proportion of small business corporate groups have formed a consolidated group.

The Board also noted two key factors that that may discourage small business corporate groups from forming consolidated groups, namely:

- The complexity of the consolidation legislation and cost of keeping up-to-date with the provisions makes access to the consolidation regime very difficult for many accounting and tax professionals that advise small business corporate groups and therefore impose a significant compliance burden on taxpayers; and
- If the membership interests in an entity that joins a consolidated group are pre-CGT assets, the provisions that currently apply when the entity leaves the group can result in an erosion of the pre-CGT status of those membership interests. Relevant amendments are expected to be introduced into Parliament in the first half of 2010 to address these.

We concur with the above identified impediments, and also add that the issues outlined on pages 1 and 2 of this submission are especially relevant to small business. We take this opportunity to emphasise that the following issues are of particular concern for small business:

- The available fraction mechanism often limits the ability to utilise tax losses more so than the existing structures;
- Where structures have been in place for some time, tax consolidation may result in a decrease in the tax cost of assets. Obviously, the transitional provisions were aimed at addressing these difficulties; and

The perception that the tax consolidation provisions decrease compliance costs is misplaced. For example, generally additional work is required to produce the financial accounts for tax purposes as the accounting definition of a consolidated group differs considerably from the tax definition. Small businesses would therefore be increasing their compliance burden by consolidating.

In addition to the above, we would note the following:

- Two of the most compelling reasons as to why larger groups elect to consolidate are:
    - The ability to ignore intra-group transactions (such as asset transfers) and to pool losses, franking credits and foreign tax credits. Many small business groups are structured in a manner which does not require frequent access to these benefits. For example, assets are often held in separate entities for asset protection and succession planning purposes. The requirement to transfer assets between entities arises infrequently, if at all; and
    - In relation to tax losses, subject to the satisfaction of certain tax loss and anti-avoidance rules, small business groups are able to utilise the benefits of discretionary trusts to distribute profits among the group.

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

Prior to moving towards introducing a "simplified" consolidation regime for small business, we would recommend a review be undertaken of the need for a tax consolidation regime targeted at the small business community. Based on our experience and observations above, it would appear that there is no compelling reason for a separate, simplified consolidation regime. We would also be concerned that a simplified consolidation regime would not result in any real simplification in any event (just as the "simplified tax system" does nothing to simplify business taxation for small businesses).

However, we recommend that consideration be given to reintroducing certain wholly-owned corporate group concessions for small business groups (e.g. those with a group turnover of up to $250 million) as they existed before the introduction of the consolidation regime. That is, the reintroduction of the Subdivision 126-B rollover (as it existed before the introduction of the consolidation regime), the loss transfer provisions and an inter-corporate rebate for unfranked dividends within a wholly owned group should be considered.

Alternatively, or in addition to the above recommendation, a reintroduction of a "stick" election for small business groups could also be considered.

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