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

Dear Sir

Submission on the Post-Implementation Review into Certain Aspects of the Consolidation Regime

We welcome the opportunity to make submissions in relation to certain issues raised in the Discussion Paper for the Post-Implementation Review into Certain Aspects of the Consolidation Regime (**Discussion Paper**).

In this submission, references to the "ITAA 1997" will refer to the *Income Tax Assessment Act 1997* (Cth) and references to the "ITAA 1936" will refer to the *Income Tax Assessment Act 1936* (Cth). Section references that do not include the name of an Act are references to sections of the Discussion Paper.

1. Single entity rule

1.1 Question 3.2(c)

Does section 701-85 of the ITAA 1997, which sets out the approach to the interpretation of the core consolidation provisions, increase uncertainty in the application of the single entity rule? If so, how can this uncertainty be alleviated?

In our submission, section 701-85 of the ITAA 1997 does not increase uncertainty in the application of the single entity rule (**SER**), although its operation appears to be somewhat otiose given that its intended role would already be achieved by express provisions and the existing common law rules of statutory interpretation.

In Taxation Ruling 2004/11 the Australian Taxation Office (**ATO**) note that section 701-85 provides for the modification of the SER,[1] that is, that while the intention is for consolidated groups to be treated as one entity, the SER may give way to other provisions within the Act and related acts[2]

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[1] Taxation Ruling TR 2004/11, Available: <http://law.ato.gov.au/atolaw/view.htm?locid=txr/tr200411/nat/ato>; *Income Tax Assessment Act 1997* (Cth) section 708-85.

[2] *Income Tax Assessment Act 1997* (Cth), see e.g., section 995-1, Definitions, 'this act' includes such acts as the *Income Tax Assessment Act 1936*, Part IVC of the *Taxation Administration Act 1953*.

if there are express or implied provisions which are contrary to the SER.[3] The ATO ruling suggests that the application of section 701-85 will depend upon the specific provisions being considered.[4]

In our submission, it is clear that section 701-85 has the effect that a provision, whether express or implied, may override the SER. If express, the overriding provision should be clear as to when section 701-85 is applied. Where uncertainly may arise is where it is unclear as to whether a specific provision is overriding the SER if the provision does not explicitly state this and such an effect is to be implied.

The normal common law rules of statutory interpretation would still need to be employed, regardless of whether or not section 701-85 existed, to determine in what circumstances the SER should be overridden by another provision.

In our submission, any uncertainty in this area should generally be addressed by expressly stating when the SER does not apply, whenever possible. This could be facilitated, for example, by including a regulation making power to specify provisions which override the SER, rather than amending the legislation each time a conflict between the SER and a particular provision is identified.

1.2 Question 3.3(b)

In what circumstances, if any, do you consider the taxation outcomes that arise when intra-group assets are acquired or disposed of to be inappropriate? What do you consider the appropriate outcome to be?

The single entity rule can result in inappropriate outcomes when an intra-group asset is transferred to a third party outside the tax consolidated group.

As noted in Chapter 3 of the Discussion Paper, an option granted by one member of a tax consolidated group to another member of the group is not recognised for tax purposes under the single entity rule (eg no tax cost base to the grantor, even if there was a cost of granting the option). As such, when this option is transferred to a third party outside the tax consolidated group, there is no mechanism for setting the tax cost base of the option to the tax consolidated group except for incidental transfer costs (TD 2004/35). This is an inappropriate outcome as it does not reflect the true cost of granting the option to the tax consolidated group.

To avoid such inappropriate outcomes, there should be a special rule to set the tax cost of assets which cease to be intra-group assets when they are transferred to a third party outside the tax consolidated group. A more appropriate outcome would reflect, in the asset's tax cost base, the true cost to the group of holding the intra-group asset.

Such a rule could be implemented by adding a subsection to section 110-35 of the ITAA 1997 along the following lines:

The *tenth* is expenditure that:

(a) is incurred by one member of a consolidated group to an entity that is not a member of the same consolidated group; and

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[3] Taxation Ruling TR 2004/11, paragraph 42. Available: <http://law.ato.gov.au/atolaw/view.htm?locid=txr/tr200411/nat/ato>; *Income Tax Assessment Act 1997* (Cth).

[4] Taxation Ruling TR 2004/11 at paragraph 23 and 42.

Available: <http://law.ato.gov.au/atolaw/view.htm?locid=txr/tr200411/nat/ato>.

(b) reasonably relates to the intra-group asset,

in circumstances where the intra-group asset is transferred to an entity that is not a member of the consolidated group.

1.3 **Question 3.5**

The Board seeks stakeholder comment on:

(a) Are there other situations which are not identified in Chapter 3 where a third party may be required to reconstruct intra-group transactions?

(b) Should the single entity rule be extended to all third parties who have dealings with a consolidated group? If so, would any exceptions be required?

(c) Alternatively, should the single entity rule be extended to third parties who are directly related to a consolidated group (such as shareholders)? If so, would any exceptions be required?

(d) As a further alternative, should the operation of the single entity rule outside the consolidation provisions be considered on a case by case basis?

The single entity rule should not be extended to all third parties who have dealings with a tax consolidated group.

There are a number of examples where such an extension would be inappropriate, as well as examples where it might be appropriate. Accordingly, the single entity rule should be extended to interactions with third parties on a case-by-case basis. In addition to those situations identified in Chapter 3 of the Discussion Paper, the single entity rule also has ramifications for third parties under the debt / equity rules in Division 974 of the ITAA 1997 and the TOFA rules.

(a) **Application of debt/equity rules to intra-group assets - "issue" of a debt on transfer out of group**

As noted in Chapter 3, if a loan exists between two members of a tax consolidated group, which is later assigned to a third party outside a tax consolidated group, it is treated as an issue by the head company of the tax consolidated group of a security (TD 2004/84). This raises the question of whether the debt/equity tests should be applied to the security at the time it was legally created or when it ceases to be an intra-group asset.

For example, consider an intra-group convertible note which carries an interest rate of 3%, and requiring the principal amount of the loan to be repaid in 12 years. Under the debt test in Division 974 of the ITAA 1997, the financial benefits to be provided and received are valued in present value terms using a discount rate of 75% of the benchmark rate of return. If at the time the instrument is issued, the benchmark interest rate is 2.75%, then all other tests being satisfied, it would be substantially more likely than not that the value of financial benefits provided will be at least equal to the value of financial benefits received. As such, the interest would be treated as a "debt interest" by the issuing entity for the purposes of Division 974 of the ITAA 1997.

If however, a third party acquires the instrument after 1 year, and the benchmark interest rate has increased to 4.5%, then (tested at the time the interest is acquired by the third party) it would not be "substantially more likely than not" that the present value of financial benefits provided, using 75% of the benchmark interest rate, would be at least equal to those received. The instrument would satisfy the test for an equity interest in Division 974 of the ITAA 97 as it is an interest that may convert into an equity interest in the issuer.

Therefore, if the transfer of the interest outside the consolidated group is treated as an "issue" of the interest, the interest could effectively change characterisation from a debt interest to an equity interest, simply by reason that it is transferred outside the group. This would then have flow-on effects for deductibility of interest payments on the instrument and the tax treatment of returns in the hands of the third party acquirer. In particular, if the third party acquiring the interest is a non-resident, and the issuer of the instrument has no franking credits, then the acquiring company would need to pay dividend withholding tax at 30% rather than interest withholding tax at 10% on any amounts received in relation to the instrument.

In contrast, if the instrument had been issued between two members of a non-consolidated group, the instrument would continue to be a debt interest in the hands of the third party acquirer. We submit that such disparity in tax consequences between acquiring a loan from a tax consolidated group and from a non-tax consolidated group is inappropriate and therefore the debt/equity tests should be applied at the time an intra-group asset is legally created and not when is ceases to be an intra-group asset.

We submit that the single entity rule should not change the legal characterisation of transfer of an intra-group debt to a third party. The transaction should retain its character as a transfer. As this could give rise a gain or loss, there should be a specific rule which states that where a member of a tax consolidated group assigns a right that is an intra-group asset (such intra-group asset arising from the borrowing of money or obtaining of credit) to an entity that is not a member of the group, this does not give rise to any assessable income or capital gains, or allowable deductions or capital losses to the group (eg under sections 26BB or 70B of the ITAA 1936 or sections 6-5 or 8-1 of the ITAA 1997).

Flowing on from this recommendation, there should also be a specific rule that ensures that time for testing the debt / equity character of an intra-group financial instrument is at the time the instrument is legally issued, rather than at the time when the instrument is transferred or assigned out of the group. This will ensure that such an instrument would not change character simply by reason of it being assigned or transferred to a third party that is not a member of the group.

Notwithstanding the above, we submit there should not be a blanket rule that the single entity rule does not apply to all dealings with third parties where Division 974 applies, as there may be some provisions in relation to which the application of the single entity rule would be appropriate in the context of the debt / equity rules.

(b) **TOFA test for financial arrangement**

It is unclear how the single entity rule operates in relation to the test for a "financial arrangement" under the TOFA rules. Under section 230-45 of the ITAA 1997, a "financial arrangement" is an arrangement under which you have a "cash settlable" legal or equitable right to receive or obligation to provide one or more financial benefits.

Whether something is "cash settlable" depends on satisfying one of a number of tests, including whether "you have a practice of satisfying or settling similar rights or obligations" or whether "you deal with the right or obligation, or with similar rights or obligations, in order to generate a profit from short-term fluctuations in price, from a dealer's margin, or from both."

There is uncertainty as to whether these requirements (ie. whether you have a "practice" or deal with "similar rights or obligations") should be tested only from the perspective of the legal entity which has the arrangement, or from the perspective of the tax consolidated group of which it is a member.

We submit that these tests should be applied on a legal entity basis rather than applying the single entity rule, as this would achieve more commercially accurate outcomes.

(c) Conclusion

In relation to some provisions, the single entity rule should be extended to third parties who have dealings with a consolidated group, and in other situations such an extension would be inappropriate. Accordingly, we submit that the extension of the rule should be made on a case by case basis as is proposed to occur with certain CGT integrity provisions as outlined in Chapter 3 of the Discussion Paper. The single entity rule should not be extended in all circumstances to third parties who have dealings with a consolidated group generally.

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

2.1 Question 4.1

The Board seeks stakeholder comment on:

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

(b) *Do the current rules need to be amended to achieve an appropriate outcome? For example, are specific provisions needed in the consolidation rules to align the calculation of the income of a trust with the method used for calculating the net income for the trust's non-membership period? If so, is there a simple approach that can be used that produces an appropriate outcome?*

(c) *Should a single set of rules apply to assess all beneficiaries on a share of the trust's net income for a non-membership period? If so, what should the rules be?*

(d) *Are there any other issues which are not identified in this Chapter that arise when a trust joins or leaves a consolidated group part way through an income year? What is the best way of resolving these issues?*

In our experience, most trust deeds provide for entitlements to trust income to be determined at the end of an income year (generally 30 June), with some trust deeds also providing for interim distributions of trust income. Accordingly, any amendments to deal with the assessment of beneficiaries and trustees for a trust's non-membership period should recognise that income entitlements for an income year will generally only be determined at the end of the income year.

To address this, we consider that the following options should be considered:

(a) The single entity rule should not apply for the purpose of determining whether the beneficiary of a trust estate is presently entitled to a share of the income of the trust estate.

(b) To avoid any doubt and in order to reduce compliance costs, it should be specifically stated that Division 6 of Part III of the ITAA 1936 does not apply where a trust has been a member of a tax consolidated group at all times during an income year.

(c) Where a trust has a non-membership period during an income year, a notional net income of the trust for the non-membership period should be determined. An exception should apply if the beneficiary or beneficiaries who were (collectively) presently entitled to all of the income of trust were members of the same tax consolidated group as the trust at the end of the income year. The existing sections 716-75 to 716-100 of the ITAA 1997 should ensure that that the head company and beneficiary are taxed appropriately if a beneficiary has a non-membership period.

(d) The net income should be apportioned using similar principles as sections 716-75 to 716-100 of the ITAA 1997. These sections apply where a *beneficiary* is a subsidiary member of consolidated group or a MEC group for some but not all of the income year. We have set out below, in broad terms, the principles that should apply.

(e) In all cases where a trust has been a subsidiary member of a consolidated group or MEC group at any time during an income year (including a whole income year), Division 6 of Part III of the ITAA 1936 should not apply to the trust. Instead, specific provisions should be included in Part 3-90 to deal with the taxation of the head company of the group, the trustee of the trust and the beneficiaries. Unfortunately, we submit that to achieve an appropriate and fair outcome, a number of rules are required to effectively reconstruct how a trustee and its beneficiaries would be taxed if the trust's income year was confined to the non-membership period of the trust.

(f) The net income for the non-membership period of the trust should be calculated as follows:

(i) the total assessable income of the trust for the non-membership period is the sum of:

(A) the total assessable income of the trust for the whole income year so far as it is reasonably attributable to the non membership period;

(B) a proportion (worked out as the number of days that are in the non membership period divided by the number of days that the trust was in existence during the income year) of the total assessable income of the trust for the whole income year so far as it is not reasonably attributable to a particular period within the income year.

(ii) the total allowable deductions of the trust for the non-membership period is equal to the sum of:

(A) the total deductions of the trust for the income year so far as they are reasonably attributable to the non membership period;

(B) a proportion (worked out as the number of days that are in the non membership period divided by the number of days that the trust was in existence during the income year) of the total deductions of the trust for the income year so far as they are not reasonably attributable to a particular period within the income year.

(g) The "income of the trust estate" for the non-membership period of the trust should be calculated as the sum of the following:

(i) the total "income of the trust estate" for the whole income year so far as it is reasonably attributable to the non-membership period;

(ii) a proportion (worked out as the number of days that are in the non membership period divided by the number of days that the trust was in existence during the income year) of the "income of the trust estate" for the whole income year so far as it is not reasonably attributable to a particular period within the income year.

(h) A beneficiary's "share of the income of the trust estate" for the non-membership period should be worked out by dividing:

- the share of the income of the trust estate for the non-membership period to which the beneficiary is taken to be presently entitled as worked out under paragraph (i) below;

by

- the income of the trust estate for the non-membership period;

and expressing the result as a percentage.

(i) For the purposes of paragraphs (h) and (k), a beneficiary is taken to be presently entitled to the sum of the following amounts:

(i) the "income of the trust estate" for the whole income year to which the beneficiary is presently entitled so far as it is reasonably attributable to the non-membership period; and

(ii) a proportion (worked out under paragraph (j) below) of the "income of the trust estate" for the whole income year to which the beneficiary is presently entitled so far as it is not reasonably attributable to a particular period within the income year.

(j) The proportion is worked out by dividing:

- the share of the income of the trust estate for the whole income year to which the beneficiary is presently entitled *less* the amount of income to which the beneficiary is taken to be presently entitled so far as it is reasonably attributable to the non-membership period (refer to subparagraph (i)(i) above);

by

- the income of the trust estate for the whole income year *less* the amount of income of the trust estate reasonably attributable to the non-membership period (refer to subparagraph (g)(i) above);

and expressing the result as a percentage.

(k) Where a beneficiary is taken to be presently entitled to a share of the income of the trust estate for the non-membership period, the assessable income of the beneficiary includes so much of that share of the net income of the trust estate for the non-membership period.

(l) Where there is no part or a part of the net income of the trust estate for the non-membership period to which no beneficiary is taken to be presently entitled under paragraph (i), the trustee of the trust estate would be assessed and is liable to pay tax on all or that relevant part of the net income of the trust estate for the non-membership period at a rate that would be specified in the *Income Tax Rates Act 1986*.

(m) Additional provisions may be required to deal with non-resident beneficiaries, non-Australian sourced income and beneficiaries who are under a legal disability.

(n) Consequential amendments may be required to ensure that the rules interact appropriately with other provisions in Part 3-90 of the ITAA 1997, including the existing sections 716-75 to 716-100.

2.2 Questions 4.5 and 4.6

Question 4.5 Does the interaction of the consolidation regime and non-resident CGT rules give rise to integrity risks? If so, what are they and what is the most effective way to overcome those risks?

Question 4.6 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 the ultimate beneficial ownership of the assets before and after the transaction? If so, what is the most effective way to overcome those integrity risks.

Questions 4.5 and 4.6 of the Discussion Paper identify two specific transactions which are perceived as presenting integrity risks arising from the interaction of the consolidation regime and the non-resident CGT rules in Division 855 of the ITAA 1997. The fact scenarios covered by the two questions may be summarised as follows:

Question 4.5 deals with a situation where non-taxable Australian property assets owned by a subsidiary member of a MEC group are transferred to a newly formed eligible tier-one company (**ETOC**). The new ETOC is then sold by the non-resident top company without Australian capital gains tax.

Question 4.6 deals with a situation where non-taxable Australian property assets are owned by an ETOC or are transferred to an ETOC by another subsidiary member of the MEC group. The ETOC is transferred at market value to a new consolidated group incorporated by the non-resident top company. No Australian capital gains tax is paid by the top company on the transfer of the ETOC to the new consolidated group and the tax cost of the assets held by the transferred ETOC are reset to their market value under the consolidation tax cost setting rules. The assets are then sold at their market value without a tax gain.

In relation to Question 4.5, we note that there may be circumstances where a transaction which is structured in the manner described in Question 4.5 is consistent with the policy of the non-resident CGT rules, that non-residents should only be subject to Australian CGT on the disposal of taxable Australian property assets, and does not present an integrity risk. The example below illustrates a fact scenario where this may be the case.

Consider a company which is wholly-owned by a non-resident company and carries on 2 distinct businesses, business A and business B. Business A is comprised predominantly of taxable Australian property assets but business B is not. If company A disposes of business B, the sale is subject to Australian tax. Now consider a non-resident company which has instead set up two separate companies, one which carries on business A and one which carries on business B. In these circumstances, the non-resident company can sell the company carrying on business B without Australian CGT.

There is no reason in policy why these two fact patterns should result in such markedly different tax outcomes, simply because the second non-resident company structured its business operations in two separate companies while the first non-resident did not. This is particularly true given that the MEC group rules, which would allow the two companies to be consolidated as a MEC group, would effectively treat the two businesses of the second non-resident company, although carried out by separate companies, as divisions of the head company for tax purposes. In these circumstances, the transaction scenario outlined in Question 4.5 is arguably not inconsistent with the non-resident CGT rules and the consolidation rules, and does not present an integrity risk.

In any event, while the results outlined in Questions 4.5 and 4.6 are technically possible through the interaction of the consolidation regime and the non-resident CGT rules, it is likely that transactions structured in this way would be caught by Part IVA of the ITAA 1936

if they are not motivated by dominant commercial reasons. The impact of Part IVA applying to these transactions is that the tax benefits obtained are liable to be cancelled.

Part IVA of the ITAA 1936 is the general anti-avoidance provision of the Australian income tax law. Very broadly, Part IVA can apply to a transaction where the dominant purpose of any participant in the transaction is to obtain a tax benefit (either for itself or for another participant in the transaction). In enacting Part IVA, the Government has drawn the line between legitimate transaction structuring and illegitimate transaction structuring - transaction structuring is legitimate where it is supported by dominant commercial reasons and is illegitimate where it is not supported by dominant commercial reasons but is only explicable for dominant tax reasons. We submit that this an appropriate and commercially realistic place at which to draw the line between legitimate and illegitimate transaction structuring and that it is not necessary or desirable to introduce additional new legislation to target specific perceived integrity risks.

Introducing new narrowly targeted legislation will undoubtedly increase the complexity of the tax legislation for no gain where Part IVA would otherwise apply to an impugned transaction. Recent cases show that Part IVA is more than adequate to capture transactions in which steps have been inserted for dominant tax, and not commercial, reasons (a good recent example is the decision of the Federal Court in *British American Tobacco Australia Services Limited v Commissioner of Taxation* [2009] FCA 1550 (21 December 2009)). Moreover, any new legislation could apply more broadly than intended and could stultify legitimate, predominantly commercially motivated transactions. One of the key benefits of relying on Part IVA to deal with integrity risks is that it should not apply to discourage legitimate commercial transactions of this type.

Accordingly, we submit that Part IVA is the preferred tool to deal with integrity risks rather than introducing complex new rules. Part IVA is a well known provision with a long history of judicial and administrative consideration. It is a provision which practitioners and the ATO are familiar and comfortable with. From a policy perspective, it draws a flexible and commercially realistic line between legitimate and illegitimate transaction structuring and has proven to be more than effective to capture tax abusive transactions. As such, we submit that Part IVA should be relied on to address integrity risks arising out of the consolidation regime and that specific legislative provisions are not required.

2.3 Question 4.7

(a) *Are there circumstances in which CGT event J1 produces undesirable outcomes? If so, how can the income tax law be amended to overcome these concerns?*

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

CGT event J1 is set out in section 104-175 of the ITAA 1997. CGT event J1 happens, in general, where a company ceases to be a member of a wholly-owned group after a roll-over has taken place. As noted by the Discussion Paper at 4.60, CGT event J1 is modified such that it does not apply in respect of a company in receipt of a roll-over asset which leaves a consolidated group[5]. However, the modification does not apply to MEC groups as only consolidated groups are referred to. The definition of a consolidated group in section 995-1(1) has the effect that the reference to a consolidated group in section 104-182 does not include MEC groups. The effect of the modification of CGT event J1 in section 104-182 appears to be that CGT event J1 will occur for subsidiary members of MEC groups, but not for subsidiary members of consolidated groups.

[5]By the operation of section 104-175(6) and section 104-182.

We question whether there is a reason for applying CGT event J1 to a subsidiary leaving a MEC group. The rationale for the exclusion of CGT event J1 when a subsidiary member of a consolidated group leaves the group is because the historic cost base of the roll-over asset is reflected in the cost base of membership interests of the leaving subsidiary (Explanatory Memorandum, *New Business Tax System (Consolidation) Act (No. 1) 2002* at paragraph 13.29). In the absence of an exception from CGT event J1, the gain on the roll-over asset is effectively double-counted. We note that the Discussion Paper has already acknowledged the resulting possibility for double counting of a capital gain or loss on a rolled over asset for a subsidiary member leaving a MEC group. Double counting arises because a provisional head company of a MEC group is also required to determine whether a capital gain or loss has occurred under the cost setting rules when a subsidiary member leaves the group.

We submit that as the cost setting rules already operate to capture the deferred capital gain or loss targeted by CGT event J1 when membership interests in a subsidiary are disposed of, it is inappropriate for CGT event J1 to operate cumulatively such that the capital gain or loss is recorded twice. We submit that the exception should be extended to subsidiary members of MEC groups.

2.4 Question 4.9

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

Application of CGT event L5 to subsidiary members that are deregistered

TD 2007/13 expresses the ATO's view that the head company of a consolidated group can be taken to have made a capital gain, under CGT event L5, when a subsidiary member of the group is deregistered after liquidation. We submit that the Board should consider whether it is appropriate for CGT event L5 to operate in the absence of any realisable asset which could be used to fund a resulting tax liability and, instead, submit that the deregistration of a subsidiary member with unsatisfied "commercial debts" should be treated as a commercial debt forgiveness.

TD 2007/13 states that where a subsidiary member has unsatisfied debts at the time of deregistration that would result in a negative allocable cost amount as calculated under section 711-20(1) of the ITAA 1997, the head company will make a capital gain under CGT L5 when the subsidiary ceases to be a subsidiary member of the consolidated group as a result of deregistration.

We suggest that a distinction should be made between:

(i) the tax consequences for a head company of a subsidiary taking a liability with it upon leaving the consolidated group; and

(ii) the tax consequences for a head company when a subsidiary with an outstanding liability is deregistered.

In the first case, the liabilities will continue to exist and therefore as those liabilities will no longer be attributed to the head company the head company is effectively receiving a form of consideration. However, in the second case, the outstanding liabilities cease to exist on deregistration and the creditors have, by operation of law, effectively released those outstanding debts. We submit that the elimination of a debt by deregistration of a subsidiary is economically akin to the forgiveness of commercial debts rather than to the realisation of an economic gain. Indeed, this result could be ensured simply by cancelling the outstanding debts some time before the deregistration of the subsidiary. However, as a matter of commercial and legal practice, once a company in liquidation has exhausted all

of its assets, it would generally not seek to enter into arrangement with individual creditors to have its unsatisfied liabilities released. Rather, this happens by operation of law when the company is deregistered. It is inappropriate for the income tax provisions to treat two economically identical transactions in a different way. As such, we submit that the commercial debt forgiveness rules in Schedule 2C of the ITAA 1936 are more appropriate to deal with this than CGT event L5 in the case of subsidiary members that are deregistered.

Interaction of proposed Division 275 (Australian managed investment trusts) and the consolidation regime

Schedule 3 to the *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* contains proposed measures that will enable a trust that is a "managed investment trust" (**MIT**) to make an election that would have the effect of eligible assets being subject to exclusive capital gains tax (**CGT**) treatment.

There are a number of cases where a trust that is a member of a consolidated group may qualify as a MIT. For example:

- an Australian trust that is operated or managed by a financial services licensee or authorised representative as set out in proposed subsection 275-5(1)(b) of the ITAA 1997 or a registered managed investment scheme which is wholly owned by a life insurance company that is a member of a consolidated group or a MEC group (refer section 12-400 of Schedule 1 to the *Taxation Administration Act 1953* and proposed subsection 275-5(2)(b) of the ITAA 1997);
- a sub-trust that is wholly-owned by a trust of the kind referred to above that is operated or managed by a financial services licensee or authorised representative as set out in proposed subsection 275-5(1)(b) (refer proposed subsection 275-5(2)(a) of the ITAA 1997);
- a trust that is operated or managed by a financial services licensee or authorised representative as set out in proposed subsection 275-5(1)(b) of the ITAA 1997 and is at least 75% owned by a life insurance company that is a member of a consolidated group or a MEC group and the remainder of the interests in the trust are owned by other members of the consolidated group or MEC group (refer proposed subsection 275-5(3) of the ITAA 1997).

However, because of the single entity rule which treats such trusts as being part of the head company, rather than a separate entity, it is not clear whether any election made by trustee of the trust under proposed subsection 275-115 of the ITAA 1997 will enable the head company to access exclusive CGT treatment for covered assets. In addition, there may be uncertainty about whether a failure by a trustee of such a trust to make an election under proposed subsection 275-115 of the ITAA 1997 will result in deemed revenue account treatment for relevant assets under proposed subsection 275-120 of the ITAA 1997.

We note that there are already rules in Part 3-90 that result in relevant complying superannuation/FHSA assets of a life insurance company that is a member of a consolidated group or a MEC group to be taxed exclusively under the CGT provisions. This is because the head company is taken by section 713-505 of the ITAA 1997 to be a life insurance company so that section 320-45 of the ITAA 1997 can have operation. We submit therefore that is appropriate to extend proposed Division 275 of the ITAA 1997 to MITs that are members of a consolidated group or MEC group.

We submit that this could be achieved by including a provision in Part 3-90 that would provide that the ITAA 1997 applies to the head company of a consolidated group or a MEC group as if it were the trustee of a MIT for an income year if one or more MITs are subsidiary members of the group at any time during that year. This should have the effect that the covered assets (as defined in proposed section 275-105 of the ITAA 1997) of the MIT (and which are taken to be held by the head company by operation of the single entity rule) are subject to exclusive CGT treatment for the purpose of the head company of the group calculating its taxable income for an income year during which a MIT was a member of the group.

We also submit that the head company should be permitted to make a fresh election under proposed section 275-115 of the ITAA 1997 or to revoke any election made by the trustee of MIT under that MIT before the MIT became a member of the group. This can be achieved by adding proposed section 275-115 to the list of provisions in subsection 715-660 (which enables the head company to override the entry history rule in relation to certain choice which may have been made, or not made, by an entity joining a consolidated group or MEC group).

2.5 Question 6.1

The Board seeks stakeholder comment on:

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

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

We have relevant small business experience as an "adviser to the advisers". In our experience, the consolidation regime is generally unattractive to small business because its benefits are outweighed by the compliance costs of (for example) preparing entry and exit "allocable cost amount" calculations.

These costs are more than usually significant for small business because their usual accounting and tax advisers often need to call on the help of specialist advisers to handle consolidation issues. Such specialist advice is often considerably more expensive, per hour, than their usual adviser's fees. The client therefore finds it difficult to see the "value proposition".

Small business clients therefore, quite naturally, fear that if they elect into the consolidation regime, they will be "trapped" into requiring specialist advice far more frequently in relation to future acquisitions, divestments, and even just the ongoing tax compliance for the group (eg. the annual return). In essence, small business perceives that, by making the election to consolidate, they are also electing to increase their ongoing tax advisory and compliance costs to a level that would only represent "value for money" if their business was much larger, and much more tax was at stake.

In our view, the solution is not to simplify the consolidation regime; it is to introduce a separate regime that provides many of the same compliance and integrity benefits, but relies on concepts that are much more familiar to small business and their advisers. The obvious candidate for such a "consolidation-lite" regime would be an election that treats a closely-held company as a (fiscally transparent) partnership. This would be quite similar to the US "S Corporation" model.

The consolidation-lite regime would still need rules to deal with the change in status of a company, from fiscally opaque to transparent and *vice versa*, but it should be possible to make these rules far simpler than those in the full consolidation regime, having regard to the much smaller amounts of tax at stake.

Importantly, the election to treat a company as a fiscally transparent entity should terminate automatically if an administrator or liquidator is appointed to the company. Otherwise, taxable income of the company may be taxed in the hands of a shareholder who can no longer access the company's assets to fund the associated tax liability.

The above represents our attempt only to set out the most high-level features of a consolidation-lite regime. We imagine that a separate consultation exercise would be required to identify suitable international models for such a regime, together with aspects of the existing tax law (eg. the treatment of partnerships) that could be imported.

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Please call Duncan Baxter on (03) 9679 3014, Paul O'Donnell on (02) 9258 5734 or Vivian Chang on (02) 9258 5732 if you have any questions in relation to this submission.

Yours faithfully

Blake Dawson

Blake Dawson
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