CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006
Australia

GPO Box 2820
Melbourne VIC 3001
Australia

Phone +613 9606 9606
Freecall (Aust) 1300 737 373
Fax +613 9670 8901
Email vic@cpaaustralia.com.au
Website cpaaustralia.com.au

9 March 2010

The Board of Taxatiion
c/- The Treasury
Langton Crescent
PARKES, ACT 2600

By email: taxboard@treasury.gov.au

Dear Sir/Madam

Post-Implementation Review re Certain Aspects of the Consolidation Regime

We refer to the Board's press release No. 29 of 9 December 2009 inviting submissions to the abovementioned review and we hereby attach our submission for the Board's consideration.

CPA Australia represents the diverse interests of around 130,000 members in over 100 countries. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders. This submission is made not only on behalf of our members but also for the accounting profession and in the broader public interest.

Please contact me in the first instance if you have any queries in relation to the submission.

Yours faithfully,

G. G. Addison

Garry Addison
Senior Tax Counsel

Ph. +61 3 9606 9771
Fax +61 3 9642 0228
Em. garry.addison@cpaaustralia.com.au

CPA Australia Submission to the Board of Taxation

Post-Implementation Review Re Certain Aspects of the Consolidation Regime - Comments on questions raised in Discussion Paper

Question 2.l

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

These single entity rule (SER) and inherited history rules have increased business efficiency in that they have removed tax impediments to business reorganisations, and have reduced the need to consider the tax implications of group reorganisations and other transactions within groups. In relation to the integrity of the tax system, the treatment of consolidated groups as a single entity for certain purposes has removed opportunities to cascade losses in a chain of group companies, as well as the double taxation and loss duplication that previously occurred on the disposal of assets followed by a disposal of equity interests.

However, the rules have also given rise to uncertainty, particularly in the context of various issues identified in the discussion paper such as the application of the SER to intra-group assets, and the interaction between the SER and inherited history rules and other areas of the income tax laws. This uncertainty has reduced the overall business efficiency gains that would otherwise have resulted from the introduction of the consolidation rules.

(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?

Certain aspects of the consolidation rules have resulted in a reduction in compliance costs. In particular, the SER, as noted above, has increased business efficiency and removed the need for certain integrity measures in the income tax legislation.

However, as noted earlier, there are some aspects of the application of SER and the inherited history rules in particular circumstances (and, indeed, other parts of the consolidation rules) that have given rise to uncertainty which, even after consultation, remain unresolved. For example, the treatment of deferred tax assets and liabilities under the consolidation rules is still an area of significant uncertainty. Furthermore, many issues that were identified as requiring legislative amendment remain outstanding or have only recently been addressed through the introduction of *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* into Parliament. Importantly, some of the amendments in that bill have retrospective effect from 1 July 2002. Accordingly, the compliance cost savings arising from the treatment of consolidated groups as a single entity, and the removal of the need for certain integrity measures, have been reduced by the costs associated with addressing uncertain aspects of the consolidation rules and the additional costs that will be incurred by consolidated groups as they consider the implications of the amendments contained in *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* and, as a result, amend prior year tax returns.

(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?

The majority of corporate groups that have not elected to consolidate are small-to-medium (SME) enterprises. Our comments on why SMEs have chosen not to form consolidated groups are contained in our response to question 6.1. However, in brief, many SMEs do not operate through corporate structures and, where they do, the benefits of applying the consolidation rules have been outweighed by the complexity associated with those rules. In other words, there has been a perception that the consolidation rules would complicate rather than simplify the tax affairs of SMEs.

Outside of the SME market, we are aware of at least one instance where a new eligible tier-1 company did not join a MEC group because the required notifications were not made to the Commissioner within the stipulated timeframes. During the relevant income year, the foreign parent of a multinational group had made an acquisition. As a result of the acquisition, an Australian resident company became an eligible tier-1 company of an existing multiple entry consolidated (MEC) group. The existing MEC group was not involved in the restructure and was not aware of the acquisition of the new eligible tier-1 company. Furthermore, the complex global structure of the group and the lack of awareness of the election requirements of the executives of the foreign parent involved in the transaction, meant that there was no communication of the acquisition until after the existing MEC group had already lodged its tax return for the income year. The Commissioner was unable to defer the due date for lodgement of the choice to add the company to the MEC due to the decision in *McIntosh v FCT*[1]. It is noted that this outcome may need to be revisited in light of the amendments contained in *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* once that bill is passed. However, this example was intended to illustrate that some groups may have chosen to consolidate, or to bring new members into an existing MEC group, but those choices may have been invalid because they were not made in the approved form or simply not made within the requisite timeframes.

Another situation where corporate groups have stayed out of consolidation is where they have significant tax losses and the special trial year testing to bring the losses into consolidation has raised doubts as to the ability to bring losses into the group. However, this issue will diminish over time as these pre-consolidation losses are used up.

[1] [2008] FCA 1949

Question 3.1

(a) Is the operation of the single entity rule effectively meeting its stated policy intent of simplifying the tax system, reducing taxpayer compliance costs, and increasing the economic efficiency and integrity of the tax system?

Consistent with the comments made earlier, the SER has generally achieved this policy intent but its effectiveness has been hampered by uncertainty associated with the application of the rule in certain circumstances. Instances of where this uncertainty has arisen are discussed below.

(b) If not, in what circumstances is the single entity rule failing to meet its intended policy objectives, and what is the practical impact of this failure on consolidated groups?

The practical effect has been reduced business efficiency and increased compliance costs.

(c) How can the operation of the single entity rule be improved to ensure it achieves its intended outcomes?

Potential improvements to the SER are discussed later in this submission. In some cases, it is our view that legislative refinements will be required.

Question 3.2

(a) Are additional rules needed in the income tax law to support the operation of the single entity rule (section 701-1) to ensure the rule achieves its policy intent? If so, what supporting principles are needed?

The SER itself does not require amendment. However, consideration should be given to extending its application in certain circumstances, or to ensuring it operates appropriately, for example, where third parties are involved.

(b) Should the income tax law contain specific exceptions to the operation of the single entity rule? If so, what should those exceptions be?

No comments.

(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?

Section 701-85 effectively states that the SER (and the inherited history rules) are subject to any other provision that so requires, either expressly or impliedly. While the theoretical application of section 701-85 has been recognised by the ATO[2], there have been no examples of when the provision will be applied. It is referred to in several taxation determinations[3] but, in each case, the ATO has concluded that the SER 'does not operate to defeat a clearly intended outcome under provisions outside the consolidation rules'. Accordingly, at least in the circumstances set out in those taxation determinations, the ATO has relied on established approaches to statutory interpretation[4] without having recourse to section 701-85.

There is one private ruling[5] where the ATO has indicated that section 701-85 would not be applied to modify the application of the SER to capital restructuring transactions that occurred within a consolidated group. The taxpayer had specifically requested the ATO to rule upon the application of that provision. The facts of the ruling involved a member of a consolidated group (A Co) that obtained third party bridging finance to acquire all of the shares in another company (B Co). After joining the consolidated group, B Co entered into long term borrowings which it on lent to A Co as an unsecured interest bearing intercompany loan. A Co used the funds to repay the bridging finance. The ruling indicates that, under the SER, the transactions between A Co and B Co were intra-group dealings between members of the same consolidated group which have no income tax consequences. As to the application of section 701-85, the ruling states that 'having regard to the overall context in which

[2] TR 2004/11 Income tax: consolidation: the meaning and application of the single entity rule in Part 3-90 of the Income Tax Assessment Act 1997, paragraphs 41 and 42
[3] TD 2004/40, TD 2004/41, TD 2004/47, TD 2004/48 and TD 2004/81
[4] TR 2004/11, paragraphs 8(c), and 26 - 28
[5] Private Ruling Number 50749

the proposed capital re-structure is to take place, we consider that the application of the SER to the intra-group transactions that form the basis of the re-structure will not be modified as a result of the application of section 701-85 of the ITAA 1997.'

Extrinsic materials are also unhelpful with the explanatory memorandum to the *New Business Tax System (Consolidation) Bill (No. 1) 2002* providing one example – that the operation of the inherited history rules will be affected by the rules covering the treatment of losses and franking credits.

In summary, there is no guidance on the types of scenarios to which the drafters intended section 701-85 would apply and the ATO, in various taxation determinations it has released, seems to be of the view that it can reach an appropriate outcome through the application of general statutory interpretation principles. Accordingly, section 701-85 does increase the uncertainty in the application of the SER since it is a very broadly worded provision and it is not clear when it was intended to apply (or when the ATO would seek to apply it).

Our view is that the provision should be retained given some of the anomalous outcomes arising from the application of the SER. However, we strongly recommend that guidance be obtained by the ATO on when it would seek to apply section 701-85. This guidance should then be reconciled with the intention of the drafters in including that provision in the consolidation rules (it is acknowledged that the drafters may not have had specific scenarios in mind).

Question 3.3

(a) What concerns, if any, arise in relation to the announced changes to section 711-40 of the ITAA 1997?

No comments.

(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?

Intra-group debt

As noted in the discussion paper, the application of the SER using a divisional model has been adopted in practice. However, also as noted in the discussion paper, the ATO has recognised the need for some divergence from this model in particular circumstances, namely for debt like instruments. More specifically, TD 2004/33 and TD 2004/83 treat the assignment of an intra-group debt to a third party as the borrowing of money or the issue of an interest (i.e. the creation of a right). We note that the reverse transaction is outlined at example 3.1 of the discussion paper. The example states that the debt is assigned by Third Party Co to another member of the consolidated group for its market value of $25m. However, there is no guidance on how this transaction will be treated under the consolidation rules. Based on TD 2004/33 and TD 2004/83, the debt would arguably cease to exist. Given that the assignment of an intra-group debt outside of a group is treated by the ATO as the borrowing of money, one view would be that the assignment of such a debt to a group is the repayment of a loan. Further issues may arise where the debt is assigned for less than its face value. For example, if the face value of the loan was $26m, would there be a debt forgiveness of $1m? It is noted that the debt will not actually have been forgiven but would the SER allow the transaction to be recharacterised?

Other assets

As noted above, TD 2004/33 and TD 2004/83 treat the assignment of an intra group loan to a third party as a making of a loan (a creation case). In other situations the assignment of intra-group assets to a third party is treated as a situation of an assignment of an existing asset. For instance TD 2004/34 treats the assignment outside of the group of an intra-group option as a disposal case (CGT event A1). The different treatment of different intra-group assets introduces an element of uncertainty around the application of the SER.

Intra-group straddles

Issues with straddle contracts have been the subject of considerable consultation. We note that *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* will introduce amendments that will address double taxation issues concerns raised in respect of straddle contracts. However, the amendments will not address intra-group straddle contracts. Furthermore, the ATO has a series of taxation determinations that set out the ATO's views on the treatment of straddle contracts[6]. However, those determinations expressly provide that they do not apply if the entities entering into the contract are members of the same consolidated group at either the contract time or the time just after the contract is completed.

Question 3.4

(a) Are there any circumstances, in practice, where the history of an intra-group asset (other than its history as a divisional arrangement) is relevant to determine its tax treatment when it ceases to be owned by the group?

No comments.

(b) If any other history of an intra-group asset is relevant, are any modifications to the income tax law required to allow that history to be recognised?

Before the introduction of the consolidation rules, many corporate groups included 'in-house' finance companies which borrowed funds and on-lent those funds to other companies within the groups. Gains and losses such as foreign exchange gains and losses made by those finance companies on borrowings from outside of the group may have been on revenue account depending on the purpose of the borrowing[7]. Upon the formation of a consolidated group, the borrowings will be treated as having been entered into by the head company and the intra-group loans will be disregarded under the SER.

A question arises as to whether the formation of the consolidated group may change the character of the borrowings from third parties outside of the group. Assuming that the characterisation of any foreign exchange gains or losses depends on the purpose of the borrowing (as the authorities would tend to suggest), one view might be that the original purpose of a finance company in entering into a borrowing would be inherited by the head company as result of the entry history rule (i.e. a purpose of on-lending at a profit). However, the effect of the SER must also be taken into account. More specifically, does the SER require the recharacterisation of the transactions that were previously entered into by the finance company? That is, would the head company be treated as having entered into the borrowings not for the purpose of on-lending those funds (since the intra-group loans are disregarded under the SER) but instead for the purpose of whatever the funds were ultimately used for within the group (e.g. for working capital)? If the SER does result in this recharacterisation, the next question is whether the SER or the entry history rule takes precedence.

A similar issue arose in TD 2004/36, which considers whether the head company of a consolidated group can claim a deduction under section 8-1 for interest paid on funds borrowed before consolidation and on-lent interest-free to a subsidiary member of the consolidated group. Before consolidation, the head company would have been able to support the deductibility of the interest if there was a reasonable expectation that dividends would be received[8]. However, following the formation of the consolidated group, the prospect of future dividends can no longer be a basis for the deductibility of the interest because intra-group transactions are ignored under the SER. The taxation determination essentially requires the purpose of the borrowing and the use of the borrowed funds to be revisited in determining the ongoing deductibility of the interest under section 8-1.

In addition, it should be made clear that, despite the SER, different subsidiaries within the group can carry on businesses as a "division" within the consolidated group. For instance, a treasury subsidiary's loans to entities outside the group, such as foreign subsidiaries, should be treated as loans made as part of a money lending business even if the main activity of the consolidated group is, say, manufacturing or mining.

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[6] TD 2008/29, TD 2008/30 and TD 2008/31

[7] Refer to decisions such as that of the Full Federal Court in *Hunter Douglas Ltd v FCT* (1983) 78 FLR 182, the High Court in *Avco Financial Services Ltd v FCT* (1982) 150 CLR 510 and the High Court in *Commercial and General Acceptance Ltd v. Federal Commissioner of Taxation* 77 ATC 4375

[8] *FC of T v. Total Holdings (Aust.) Pty Ltd* (1979) 79 ATC 4279

Question 3.5

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

Division 974

Consider a member of a consolidated group that issues a convertible note that is an equity interest to another member of the group for $1m who then lends the funds at interest to an entity outside of the group. The loan would ordinarily be characterised as a debt interest (assuming all of the conditions for the debt test are satisfied). However, it must be queried whether section 974-80 could potentially apply to the entity given that interest is essentially funding returns on an equity interest. Although that equity interest would be ignored under the SER, the entity outside of the consolidated group arguably still 'sees' that interest.

Commercial debt forgiveness

As recognised in the discussion paper, a debt forgiveness within a consolidated group may still have implications for companies that are outside the group but which are under common ownership. Similar to the approach that will be adopted prospectively by the *Tax Laws Amendment (Transfer of Provisions) Bill 2009* exposure draft should it become law, we recommend that Subdivision 245-G should be repealed retrospectively from 1 July 2002.

Division 7A

The SER does not appear to apply in the context of Division 7A. The ATO takes the view that the SER does not apply to the calculation of the distributable surplus under section109Y when a private company that is a head company or subsidiary member of a consolidated group makes a payment or a loan, or forgives a debt to a shareholder (or shareholder's associate) outside of the consolidated group[9]. A further example would be the application of section 109T where one member of a consolidated group makes a loan to another member of the same group who then lends those funds to an associate of the head company or a shareholder in the head company. Another example might be the application of section 109XA where a trust that is a member of a consolidated group owes an unpaid present entitlement to another member of that group, and makes, say, a payment or loan to a shareholder (or shareholder's associate) outside of the group.

Division 152

The ATO has released a series of taxation determinations that address the application of the small business CGT concessions in Division 152 to consolidated groups[10]. In all of those determinations, the ATO applies the SER except for TD 2004/47. That determination considers whether the SER affects the application of the controlling individual test in paragraph 152-10(2)(a)[11] when a CGT event happens to a share or trust interest that is a membership interest in a subsidiary member (company or trust) of a consolidated group. The determination concludes that the SER does not prevent recognition of a subsidiary member or membership interests in the subsidiary member for the purposes of paragraph 152-10(2)(a). Accordingly, it was not possible for the head company to claim the small business 50% reduction in respect of a capital gain made on the disposal of shares in the subsidiary member.

Subdivision 705-C

The ATO has released two ATO Interpretative Decisions[12], which express the view that Subdivision 705-C will not apply where a single entity that is not a member of a consolidated group or a MEC group acquires a consolidated group or all of the eligible tier-1 companies of a MEC group, and immediately makes a choice to form a consolidated group. These interpretative decisions were

[9] TD 2004/68 Income tax: consolidation: Division 7A: if a private company that is a head company or subsidiary member of a consolidated group makes a payment or a loan, or forgives a debt to a shareholder (or shareholder's associate) external to the consolidated group, does the single entity rule apply to the calculation of the distributable surplus under section 109Y of the *Income Tax Assessment Act 1936* ?

[10] TD 2004/44, TD 2004/45, TD 2004/46 and TD 2004/47

[11] Note that this provision has been amended and now requires the taxpayer to be a CGT concession stakeholder in the object company of trust.

[12] ATO ID 2009/160 and ATO ID 2010/40

released following extensive consultation with the ATO during which views were expressed that that the SER should arguably cover these scenarios such that Subdivision 705-C can be applied. Other scenarios raised in the consultation include a non-resident company that owns all of the shares in the head company of a consolidated group where that non-resident company becomes a resident, or a consolidated group that becomes wholly owned by another Australian resident company due to the cancellation of minority interests. We consider that it should be possible to apply Subdivision 705-C in these scenarios.

(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?

It is difficult to unequivocally say that the SER should be extended to all third parties. It may need to be considered on a case-by-case basis.

(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?

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This would be the preferable option. For example, consideration should be given to extending the SER to Division 7A and Division 152.

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

It is difficult to make a generic statement as to whether the SER should operate outside the consolidation rules in all cases. Accordingly, we recommend that the application of the SER should be considered on a case by case basis.

Questions 4.1 and 4.2

Where a trust joins or leaves a consolidated group part way through an income year, the main issues seem to be the calculation of a trust's net income for the non-membership period and determining present entitlement while a trust is a member of a consolidated group. It seems that the simplest way of overcoming these issues is to either treat the trust as a member of the consolidated group for the entire year in which it joins the group, or to defer the joining time until the following income year. These options would remove the issues that currently arise from the interaction between Division 6 and the consolidation rules. However, it is noted that these options would need to be considered in further detail to ensure that they gave rise to appropriate outcomes.

We note that any position reached in respect of these questions is dependent on the outcome of the appeal to the High Court from *Bamford v FCT*[13].

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?

Our view is that a trustee does not need to be a member of the same consolidated group. Item 2 of subsection 703-15(2) clearly indicates that an entity that is a trust can be a subsidiary member. All that is required is that the trust be a wholly-owned subsidiary of the head company, that is, all the membership interests in the trust must be beneficially owned by members of the consolidated group. Membership interests are defined in section 960-135 and specifically include interests held by the members of a trust, which are beneficiaries, unitholders or objects of the trust. As noted at paragraph 4.24 of the discussion paper, under general law a trust is not a person that is distinct from that of the trustee. A trust represents the relationship between a trustee and a beneficiary where the trustee owns property for the benefit of others. On this basis, it may be arguable that the trustee automatically becomes a member of a consolidated group by virtue of the trust joining the group.

(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?

No comments.

(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?

Our view is that a trust should not be a member of a consolidated group if it has beneficiaries that are not members of the group. The clear policy behind the consolidation rules was that wholly-owned groups of entities could form a consolidated group and that trusts can only be members of a group if all of their membership interests are held by other members of that group.

However, we note that the Ralph Report[14] appears to have contemplated more 'relaxed' membership rules for discretionary or hybrid trusts[15]:

> *The 'wholly owned' principle can be applied where all the objects of a discretionary or hybrid trust are entities in a consolidated group. In this situation, it is clear that the 'wholly owned' principle has been satisfied and the trust should be included in that consolidated group. However, where this is not the situation, the Review considers 'ownership' of trusts with a discretionary component should be based on an 'objects' test. An 'objects' test will be easy to apply and to comply with. It will also provide certainty in its application.*

[13] [2009] FCAFC 66

[14] Review of Business Taxation 1999, *A Tax System Redesigned*, Ralph Report, AGPS, Canberra

[15] Ibid, pages 519-520

> *This will mean that a discretionary trust will be included in a consolidated group if a member of the group is an object of the trust. Similarly, a hybrid trust will be included in a consolidated group if all of the fixed interests in the trust are held by members of the consolidated group and at least one member of the group is a discretionary object of the trust.*
>
> *(Chapter 26 of A Platform for Consultation, pages 548 and 551). Such distributions will be subject to a final tax at the top marginal rate for individuals plus Medicare levy (in line with the family trust distributions tax in the existing trust loss measures).*
>
> *However, a trust will not have to be included in a consolidated group if it can be shown that the control of the trust and the group is exercised by different taxpayers. Control would be determined having regard to the potential influence of the relevant entities, individuals and associates of entities and individuals, either acting alone or together.*
>
> *Where a trust with discretionary objects is part of a consolidated group but is not the head entity of the group, any distributions made by that trust to objects outside the group will be subject to a final tax*

If a trust with beneficiaries that are not members of a consolidated group can still be a member of that group, various issues may arise. For example, the interaction of the consolidation rules and Division 6 would need to be considered. Arguably the trust would not have 'income' or 'net income' since it would be a division of the head company under the SER. A question may arise as to whether beneficiaries outside of the group still 'see' the trust (i.e. how far the SER extends).

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

Legislative refinements should be introduced which clarify that a trust can be a member notwithstanding that the trustee is not also a member of that group. In relation to issues around provisions that operate on the basis of legal ownership, the head company of the consolidated group could be deemed to be the holder or the owner for the purposes of those provisions.

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?

It is considered that it should be possible for foreign hybrids to be members of consolidated groups. The explanatory memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 stated[16]:

> *Consistent with Recommendation 15.1(i) of A Tax System Redesigned , certain groups of wholly-owned entities will be provided with a choice to be taxed as a single consolidated entity.*

That recommendation stated:

> *That consolidated income tax treatment for groups of entities ('consolidation') be introduced, based on the following six principles listed in A Platform for Consultation but subject to the modifications effected by Recommendations 15.2-15.6:*
>
> *(i) consolidation is optional, but if a group decides to consolidate, all its wholly owned Australian resident group entities must consolidate*

Although this recommendation appears to have only contemplated the consolidation of Australian resident group entities, the explanatory memorandum clearly indicated that there would be no residence requirements for partnerships to be members of consolidated groups[17]:

> *No residency test applies to partnerships (other than corporate limited partnerships)* [Schedule 1, item 2, subsection 703-15(2), column 3 of item 2 in the table] *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*

[16] Paragraph 3.2
[17] Paragraph 3.62

be a resident partnership for most income tax purposes. It is therefore unnecessary to impose a further residency test on partnerships.

The clear intention of the foreign hybrid rules was to treat foreign hybrids as partnerships for all purposes of the income tax laws. The consequential treatment of foreign hybrids as members of consolidated groups is not inconsistent with the original policy intent of the consolidation rules which, as noted above, simply required the partners in a partnership to be members of a consolidated group for the partnership to also be a member of that group.

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

This question would need to be further considered in the context of the issues highlighted at question 4.4(c) below.

(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?

It is noted that an issues paper was previously submitted to the ATO, which requests guidance on various aspects of the interaction between the consolidation rules and the foreign hybrid rules. In addition to the question of membership, which has since been addressed by the ATO in ATO ID 209/149, the paper raises the following issues:

- where the joining entity was not a foreign hybrid in the income year prior to joining, whether the tax cost setting rules contained in section 830-90 or section 830-95 would apply to set the costs of the assets of the joining entity
- where the joining entity was a foreign hybrid in the income year prior to joining, whether the tax cost setting rules contained in Division 713 or the general partnership rules would apply to set the costs of the assets of the joining entity
- where the joining entity joins the consolidated group after the start of the "hybrid year", whether the tax cost setting rules contained in Division 713 or the general partnership rules would apply to set the costs of the assets of the joining entity
- where the joining entity was partly-owned prior to joining but subsequently became a foreign hybrid (when wholly-owned), whether the tax cost setting rules contained in Division 830 or Division 713 would apply to set the costs of the assets of the joining entity.

Other issues also identified include whether the foreign hybrid is a branch of the consolidated group, and whether distributions made by the foreign hybrid to the consolidated group can be ignored.

Further consideration needs to be given to the interaction between Division 830 and the consolidation rules in order to identify any integrity risks.

(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 comments.

Question 4.5

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

It is acknowledged that the interaction between the consolidation rules and Division 855 can give rise to integrity risks as illustrated by the example at paragraph 4.50 of the discussion paper. However, the undertaking of such a contrived series of steps with a view to having a capital gain ignored under Division 855 would fall squarely within the ambit of Part IVA. Accordingly, we consider that any integrity risks can be addressed through this general anti-avoidance rule.

Question 4.6

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

The example given at paragraph 4.52 again involves a series of steps that are implemented with the sole purpose of resetting the tax cost of the purchased group's assets to their market value. Potential tax benefits would be a reduction in any capital gain if the purchased group is subsequently disposed of, increased capital allowance deductions or, once *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* is passed, the ability to claim deductions under proposed subsection 701-55(6) or section 716-405. In our view, Part IVA would be sufficient to address these integrity risks.

Question 4.7

No comments.

Question 4.8

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

No comments.

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

We note that issues with the application of the consolidation rules to joining entities that hold hedging financial arrangements are still to be resolved.

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?

Interaction with the R&D provisions

We have highlighted under our response to question 5.1 the uncertainty that arises in relation to the interaction of the SER and inherited history rules with the R&D provisions.

Earnouts

We understand that Treasury is currently considering specific provisions for the taxation of earnout arrangements. It is not clear whether those provisions will be prospective or retrospective. In any event, there needs to be a mechanism to ensure that, since the introduction of TR 2007/D10, consolidated groups are able to take into account amounts paid under earnout arrangements at step 1 of the allocable cost amount calculation. The provision originally introduced to allow this, subsection 705-65(5B), was effectively rendered obsolete as a result of the views expressed in this draft ruling.

Intangible assets

The application of the consolidation rules to non-CGT assets such as customer relationships, know how and similar assets is currently unclear. A key issue is whether such assets can be treated as assets for the purposes of the consolidation rules. We recommend that consideration be given to the introduction of amendments to specifically treat these assets as assets under the consolidation rules.

Question 5.1

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

As with the SER, the inherited history rules have given rise to uncertainty in some circumstances. The interaction of those rules with the research and development (R&D) rules in section 73B is one such example. For example, a company that is a member of a consolidated group (Group A) may have incurred expenditure for which deductions were claimed by the head company of that group under section 73B. That expenditure may have resulted in the development of an asset, say, intellectual property with a market value of $1m. If that company leaves Group A because all of its shares are acquired by another consolidated group (Group B), a number of issues arise including:

- Does the exit history rule in subsection 701-40 treat the company as having incurred R&D expenditure and claimed R&D deductions? In this regard, section 73BAD treats a leaving entity as having actually incurred expenditure and claimed R&D deductions in relation to that expenditure for the purposes of sections 73P to 73Z (incremental R&D deductions). However, this is no similar provision for R&D expenditure and deductions claimed under section 73B. If the exit history rule applies to attribute the history of R&D expenditure and deductions under section 73B, why was section 73BAD considered necessary?

- Assuming the exit history rule does pick up the history of R&D expenditure and deductions under section 73B, does the entry history rule bring that history into Group B? This may depend on the nature of the asset being transferred. For example, if the intellectual property was a depreciating asset under Division 40, subsection 701-55(2) would deem it to have been acquired by the head company of Group B at the joining time. There may be an argument to that the entry history rule is overridden in such a case. However, it is not clear if the deemed acquisition under subsection 701-55(2) would operate to 'sever' the link between the asset held by Group B and the history of R&D expenditure incurred and deducted by Group A.
- The consequences of the inherited history rules are relevant to the application of provisions such as subsection 73B(27A), which include in assessable income amounts received from the disposal of, or the granting of licences in respect of, the results of R&D activities. However, that provision only applies where a deduction has been allowed or is allowable to the company under section 73B, which raises the question of whether the inherited history rules would treat the head company of Group B as having previously claimed such deductions.

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

To overcome such uncertainty, consideration should be given to the specific drafting of provisions such as section 73BAD.

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

No comments.

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

No comments.

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

No comments.

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

No comments.

Question 6.1

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

The consolidation rules have not been relevant for many SMEs simply because they do not operate through corporate groups. For those that do, there are a number of reasons why they have chosen not to form consolidated groups.

The complexity of, and uncertainty associated with, the rules has, in many instances, outweighed the benefits. The need to perform complex entry and exit calculations, uncertainty around the interaction between the consolidation rules and other areas of the law such as Division 152, anomalous outcomes that arose under the rules designed to preserve the pre-CGT status of membership interests are some examples of reasons why SMEs chose not to form consolidated groups. Although this meant the loss of the ability to transfer intra-group losses, SMEs have, to an extent, overcome this through management services arrangements. Furthermore, ongoing amendments to the provisions some of which apply retrospectively from 1 July 2002 have also reduced the attractiveness of the consolidation rules.

Many SMEs have very small corporate groups (as few as 2 or 3 entities) with limited intra-group transactions. The compliance cost savings that might be achieved through the treatment of those groups as a single entity for tax purposes often have not outweighed the additional compliance costs involved in considering the consolidation rules, performing entry and exit calculations, calculating available fractions, etc.

Accordingly, many SMEs that were eligible to consolidate chose not to for the above reasons. Some were simply adopting a ‘wait and see’ approach but, in doing so, lost the opportunity to access the transitional concessions that accompanied the introduction of the consolidation rules.

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

As noted earlier, many SMEs adopted a ‘wait and see’ approach and, therefore, missed out on the transitional concessions that were initially available. One possible incentive for SMEs to enter the consolidation regime is to reintroduce a transitional period.

When the consolidation rules were introduced, a significant disincentive for SMEs was the need to understand a lengthy and complicated set of new rules, the application of which was uncertain in many instances. Eight years on, the ATO has provided substantial guidance on the application of the rules and amendments have also been made to ensure that the rules operate appropriately. Once *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* receives Royal Assent, a number of significant issues arising from the consolidation rules will be addressed. Furthermore, the outcome of this post-implementation review may also result in legislative refinements to the SER and inherited history rules that clarify their operation. In summary, SMEs have now had time to gain a better understanding of the consolidation rules, how they interact with other areas of the law that are typically relevant to SMEs such as Division 7A and Division 152, and a large part of the uncertainty that is associated with any new law has been dissipated.

In summary, the reintroduction of a transitional period for SMEs from, say, 1 July 2011, might provide them with an incentive to form consolidated groups. The concessions would be the same as those originally offered (e.g. stick and spread, COT concessional loss treatment, value and loss donor rules, etc.). It would not seem that considerable drafting resources would be required since the existing provisions in the *Income Tax (Transitional Provisions) Act 1997* could be used.

Alternatively, it would be worthwhile considering a simplified version of the consolidation rules for SMEs that allows, for example, simplified entry and exit calculations, the ability to use the ‘stick’ method on all acquisitions, or the ability to claim losses brought into a consolidated group over a fixed period of time, say, 3 years (removing the need for complex available fraction calculations).