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Board of Taxation
C/- Treasury
Langton Crescent
CANBERRA ACT 2600

3 December 2010

Our Ref: JC

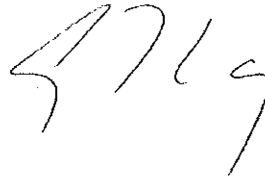
Dear Sir/Madam

Re: Post-implementation review

Deloitte welcomes the opportunity to provide comments on the Board of Taxation's position paper under its post-implementation review into certain aspects of the consolidation regime.

Please find our comments on the Board's positions in the attachment to this letter. We welcome the opportunity to discuss any aspect of our response in further detail.

Yours sincerely



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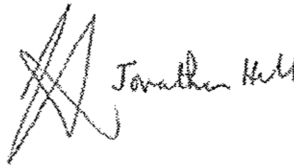

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Contents

Glossary 3

1 Executive summary 4

1.1 Background 4

1.2 Policy framework 4

1.3 Single entity rule 4

1.4 Interactions 5

1.5 Small corporate groups 5

2 Policy framework 6

2.1 Further issues for consideration 6

2.2 Formation case modifications 7

2.3 Other modifications 8

2.4 Compliance and complexity 9

3 Single entity rule 10

3.1 Intra-group assets 10

3.2 Intra-group liabilities 11

3.3 Integrity issues 12

3.4 Extension of single entity rule to third parties 12

4 Interaction with other parts 15

4.1 Taxation of trusts 15

4.2 Consolidation membership rules 21

4.3 International tax issues 24

4.4 Capital gains tax 26

4.5 Other issues 30

5 Small corporate groups 35

5.1 Formation concessions for eligible groups 35

5.2 Extension of concessions for limited period 40

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Glossary

ATO	Australian Taxation Office
Board	Board of Taxation
CGT	Capital gains tax
Discussion Paper	Board of Taxation's Discussion Paper on its Post-Implementation Review into Certain Aspects of the Consolidation Regime
DP submission	Deloitte submission dated 12 March 2010 on the Board of Taxation's discussion paper
DTA	Deferred tax assets
DTL	Deferred tax liabilities
ET-1	Eligible tier-1
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
NMP	Non-membership period
Position Paper	Board of Taxation's Position Paper on its Post-Implementation Review into Certain Aspects of the Consolidation Regime
SER	Single entity rule
SME	Small-to-medium sized enterprise
TARP	Taxable Australian Real Property
TCSA	Tax cost setting amount

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1 Executive summary

1.1 Background

The consolidation regime is based on a series of principles in respect of which complex mechanical provisions were required in order to ensure an appropriate interaction between those principles as well as between the regime and other parts of the income tax laws. Despite ongoing refinements over the years since its inception, we believe there is scope to further simply the regime, thereby reducing compliance costs and increasing accessibility to the regime.

As such, we welcome the opportunity to assist in the consultation on the Board's Position Paper and have endeavoured to provide comments on each aspect of the Board's review. A summary of our comments is set out below.

1.2 Policy framework

Due to the increasing number of acquisition cases compared with formation cases, we agree in principle with the Board's proposal for the adoption of an asset acquisition model, as opposed to a wholesale acquisition model.

Under such a model, the inherited history rule would continue to apply to everything except for assets, which should minimise the changes that are required to the current law and the implications such a change.

Notwithstanding our support for such an approach, we do not consider that an asset acquisition model is appropriate for formation cases and that the inherited history rules should be retained for such cases. We also consider that care will need to be taken in determining formation cases and have set out some possible criteria for distinguishing such cases from acquisition cases.

1.3 Single entity rule

The SER is a fundamental provision within the consolidation rules. As we outlined in the DP submission, while it is our view that the SER operates appropriately in the majority of cases, a number of issues affecting its operation exist. The Board considered a number of the issues raised in our DP submission on its operation.

The first issue concerns intra-group assets. We agree with the Board's position that the tax cost of intra-group assets that do not have corresponding liabilities (or similar obligations) should be recognised. We consider that the Board's position of deferring the time of this recognition is not appropriate, or consistent with an asset acquisition model and as such, submit that a concessional timing principle be considered. We note that although the history of an intra-group asset would be irrelevant in most cases under an asset acquisition approach, consideration should be given to retaining the history of an intra-group asset in limited circumstances.

The second issue considers the treatment of intra-group liabilities. We agree with the Board that an intra-group liability adjustment should be triggered, for both accounting and non-accounting liabilities/obligations, where a member leaves the consolidated group and takes an intra-group asset with it that does not have a corresponding intra-group accounting liability.

The third issue queries whether additional integrity measures are required where intra-group transactions may result in value shifts. While we agree with the position, we note that one of the

rationales for the consolidation rules was to reduce the need for integrity measures such as the value shifting rules and, therefore, recommend that any proposed amendments be approached with caution.

The final issue considered the extension of the SER to third parties. We agree in principle that the SER be extended to shareholders. We have considered a number of provisions that may apply not only to shareholders but other related third parties. We note that any extension of the SER be given further consideration and addition consultation undertaken.

1.4 Interactions

We provide our view on a number of areas that interact with the tax consolidation provisions that the Board has considered. We have considered the Board's position with respect to the taxation of trusts, the consolidation membership rules, international tax issues (non-resident capital gains tax rules), capital gains tax rules, the interaction with double tax agreements, and deferred tax assets and liabilities.

While we broadly agree with a number of the Board's positions, we have provided our comments and proposals/recommendations where appropriate.

1.5 Small corporate groups

We agree in principle with the Board's position that on-going formation concessions should be available for wholly owned corporate groups that qualify under specified asset and turnover tests.

We have highlighted concerns with the proposed turnover test taking into account the turnover of entities that will not be part of the consolidated group and the compliance burden that will potentially be imposed on SMEs under the asset test (due to the potential need to obtain independent valuations of assets on an annual basis).

Finally, we are generally supportive of the extension of the formation concessions to all eligible consolidatable groups for a limited period/on a transitional basis. We note, however, that this may create an unfair advantage over groups that did consolidate and have highlighted some alternatives in this regard.

2 Policy framework

> ***Position 2.1***
> ***The Board considers that the asset acquisition approach should be adopted.***

> ***Question 2.1(a)***
> ***Do you agree with the Board's view to adopt the asset acquisition approach? If not, why not?***

In the DP submission[1], we expressed the view that changing to an acquisition model may result in significant compliance costs for corporate taxpayers but with little or no change arising from the outcomes of the current inherited history model. Accordingly, we concluded that but for the theoretical advantage of adopting an acquisition model, it was difficult for us to conclude that the Board should recommend wholesale change to the way in which the consolidation regime deals with the allocation of tax costs to assets.

The Board, however, is proposing to adopt an asset acquisition model rather than an acquisition model where the inherited history rule continues to apply to everything except for assets, which should minimise the changes that are required to the current law and the implications of those changes. We support the adoption of an asset acquisition model. Our specific comments are set out below.

2.1 Further issues for consideration

We note that many of the uncertainties with the inherited history rule have been removed. For example, *Tax Laws Amendment (2010 Measures No. 1) Act 2010* introduced a number of amendments intended to clarify the way in which the TCSA allocated to assets under subsection 701-55(6) is to be used. In the DP submission, we indicated that these amendments appeared to reduce the need for change from an inherited history model to an acquisition model but this was subject to the proviso that the ATO view on how these amendments applied would allow for an appropriate treatment of tax costs allocated to assets. In this regard, we note that an issues pro-forma has recently been submitted to the ATO requesting guidance on the following questions:

- To what extent is the "entry history" of an asset overridden by subsection 701-55(6) and to what impact in relation to section 8-1? In particular, is the deemed "amount incurred or paid to acquire [the asset]" under subsection 701-55(6) then characterised (for the purposes of applying section 8-1) with reference to the [historic] circumstances of the actual amounts incurred to acquire that asset? Or is the characterisation of the reset tax cost setting amount to be determined based on a notional acquisition of the underlying asset at the joining time (albeit with all other asset "history" remaining in place)?
- Is the reset tax cost setting amount to be characterised, for the purposes of section 8-1, in relation to each asset in isolation; or does that characterisation need to have regard to the context of the total assets joining a tax consolidated group under the same transaction?

While an asset acquisition model would eliminate uncertainty under the first question by making it clear that the entry history rule does not apply, the guidance ultimately provided by the ATO on this question may achieve the same outcome. Accordingly, the uncertainty

[1] Paragraph 5.3

previously associated with subsection 701-55(6) may no longer justify moving from an inherited history model to an acquisition model or an asset acquisition model given that it may be addressed by guidance provided by the ATO. We note, however, that the ATO is currently examining this question and is not yet clear what views it will adopt.

Turning to the second question raised in the issue pro-forma, it would appear that this issue may still be relevant even under an asset acquisition model. That is, even if a consolidated group were taken to have directly acquired an asset at the joining time, it would appear that the characterisation of the reset TCSA would also depend on whether section 8-1 is applied to each asset in isolation, in which case the reset TCSA should be deductible as expenditure from circulating capital, but if the characterisation was to be performed having regard to all of the assets that a joining entity or entities brought into a consolidated group, then any TCSA may be considered to be on capital account. Accordingly, an asset acquisition model would not appear to remove all of the uncertainties associated with the current inherited history model. This issue would need to be addressed if an asset acquisition model is introduced.

Another issue that we highlight is the inconsistency in treatment of pre-1 July 2001 mining rights depending on whether they are acquired by way of an asset or share acquisition. If a consolidated group acquires the rights directly, they will be able to claim capital allowance deductions under Division 40 in respect of expenditure incurred on the acquisition. In the case of a share acquisition, however, where the joining entity holds such mining rights, the CGT rules will continue to apply to the TCSA of such assets. Despite submissions lodged by various professional and industry bodies, this anomalous treatment remains. An asset acquisition model would presumably overcome this issue as the mining rights would be treated as having been directly acquired by the consolidated group. We recommend that this issue be addressed under any consultation on a proposed asset acquisition model.

2.2 Formation case modifications

Question 2.1(b)

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

We consider that the asset acquisition approach should be modified for such cases. For the same reasons as why a clean slate model was not adopted when the consolidation rules were introduced, namely that significant compliance costs would arise due to certain assets and expenditure changing character from being on revenue account to capital account merely as a result of formation, an asset acquisition model would not be appropriate for formation cases that occur going forward. The inherited history rules should be retained for such cases.

It will also be important to develop a rule to determine what constitutes an acquisition case or a formation case. The simplest approach would be to define an acquisition case as one where an entity joined a consolidated group by virtue of the acquisition of interests in that entity. A formation case would, by default, only arise where an entity was already wholly owned by another entity and a decision was made by the latter entity to form a consolidated group. This may, however, give rise to inappropriate outcomes in certain circumstances. Consider, for example, a consolidated group that owns 99% of the membership interests in a company, Bco, and has held those interests for some time. Bco holds assets that are pre-CGT and there has been no change in the majority underlying ownership of the interests in Bco that would result in the loss of that status under Division 149. If the consolidated group acquires the remaining 1% in Bco, and this is considered to be an acquisition case that attracts the application of the asset acquisition approach, this would result in the loss of the pre-CGT status attaching to the assets that Bco holds. This would appear to be an

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inappropriate outcome. Other examples of status that would be inappropriately lost would include the period that an asset has been held for the purposes of the 15-year exemption under Division 152 or the participation exemption in Division 768.

Having regard to the above, there needs to be some mechanism to ensure that history is appropriately taken into account under what would otherwise be conventionally considered an acquisition case. This mechanism would need to take into account the ownership of the joining entity leading up to the joining time. For example, it might be appropriate to allow the history of an asset held by the joining entity to be retained insofar as that history relates to a period during which the joining entity was at least 50% owned by members of the consolidated group. Continuing with the above example, consider the following ownership profile of Bco by the consolidated group:

Year	1995 – 2000	2001 – 2004	2005 – 2009	2010
Percentage ownership	40%	75%	99%	100%

If the consolidated group sold an asset immediately after Bco joined the group and was attempting to determine the availability of the 15-year exemption, it would be treated as holding the asset from 2001, which was the first year in which it held a majority ownership interest in Bco. The period before 2001 would be disregarded even though Bco may have held the asset before that year.

An alternative to this approach might be to introduce a minimum period of majority ownership for any history to be inherited. For example, if this period was 5 years, unless the joining entity had been majority owned by the consolidated group for at least that period, no history would be inherited.

2.3 Other modifications

Question 2.1(c)

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

We would recommend that the asset acquisition approach be modified when the entity being acquired is a previously exempt entity. That is, the application of Division 58 will need to be preserved in such cases.

It appears that modifications will also be required where the acquisition is of an associate. For example, when a depreciating asset is acquired from an associate, subsection 40-65(2) requires the continued use of the same method of working out the decline in value that the associate was using. Similarly, for a depreciating asset that you start to hold where the former holder is an associate of yours, subsection 40-95(4) specifies that the following effective lives must be used:

- If the associate was using the diminishing value method for the asset – the same effective life that the associate was using
- If the associate was using the prime cost method – an effective life equal to any period of the asset's effective life the associate was using that is yet to elapse at the time you started to hold it.

Accordingly, if the joining entity is an associate, it would seem that history in respect of the method of depreciation and the effective life should be inherited.

2.4 Compliance and complexity

Question 2.1(d)
What compliance cost implications would arise from the adoption of the asset acquisition approach?

In the DP submission, we highlighted that the inherited history rule has required the introduction of various complicated interaction rules to ensure appropriate outcomes for various types of assets and liabilities. There is no doubt that the inherited history rule has added an additional layer of complexity to the consolidation rules and, notwithstanding that the ATO may provide guidance on how the inherited history rule applies in the context of subsection 701-55(6), the application of that guidance may vary depending on the circumstances. Simply removing the inherited history rules for assets will remove the compliance and complexity currently associated with having to consider those rules.

As noted in the Board's Position Paper, the consolidated group would not be able to rely on private binding rulings issued to the joining entity to the extent that those rulings relate to assets of the joining entity. Accordingly, there may be compliance costs associated with re-applying for private binding rulings. However, on balance, we would expect that compliance costs should, ultimately, be lower given that the uncertainties associated with the inherited history rule would be eliminated. Furthermore, as noted in the DP submission[2], the current framework is already a hybrid model with significant elements of an acquisition model scattered throughout the provisions, which should further limit the amendments that are required to move to an asset acquisition model. In this regard, as highlighted in the DP submission, it may also be possible to move further towards an asset acquisition model through simple amendments to the current law. The example given was of subsection 701-55(2) (which deals with setting the tax costs of depreciating assets) and how it could be simplified by repealing paragraphs (b) to (e) such that only paragraph (a) remains, which simply deems depreciating assets to be acquired at the joining time. Making such simple adjustments to the current rules would, in our view, allow taxpayers to more readily adapt to any changes that are made, which should minimise any additional compliance costs.

Ultimately, it is expected that an asset acquisition approach should reduce compliance costs in the long run by simplifying the consolidation rules. The removal of the inherited history rule will reduce the need for guidance from the ATO on a number of areas and, in theory, it should be possible to apply principles in the existing tax law that apply to direct asset acquisitions.

[2] Section 5.1.2

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3 Single entity rule

3.1 Intra-group assets

Position 3.1

The Board considers that:

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

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

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

Question 3.1

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

3.1.1 Tax costs of intra-group assets

We broadly agree with Position 3.1(a) and outline below the expected outcome under some examples.

Example at section 3.7.2 of the DP submission – direct acquisition of debt

In the DP submission[3], we gave the example of a third party (Third Party Co) that loans $20 million to a member of a consolidated group (Sub A) at a fixed interest rate of 10% per annum. The market interest rate subsequently moves to 8% such that the debt has a market value to Third Party Co of $25 million. Third Party Co assigns the debt to the head company of the consolidated group (Head Co) for $25 million.

Under paragraph 3.27 of the Position Paper, the tax cost of the debt would be its actual cost, which is $25 million. Position 3.1 only allows recognition of a tax cost that does not have a corresponding accounting liability which is recognised elsewhere (for tax purposes) in the consolidated group. We assume that this requires the recognition of a liability at step 2 of the entry ACA calculation as paragraph 3.42 appears to suggest. If so, the tax cost of the debt would remain $25 million since the loan of $20 million was made to Sub A when it was already a member of the consolidated group. That is, the liability will not have been taken into account in working out the ACA of Sub A when it joined the consolidated group.

If the debt is subsequently transferred by Head Co, any gain or loss would be worked out by reference to the tax cost of $25 million. If, however, the debt is repaid by Sub A, the economic loss to the group would be $5 million so the tax cost of the debt should only be recognised to that extent.

Direct acquisition of debt where corresponding liability taken into account at step 2

[3] Section 3.7.2

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Consider a variation of the above example where Third Party Co loans $20 million to Sub A before Sub A is acquired by Head Co. As a result, the loan of $20 million is taken into account at step 2 of Sub A's ACA calculation. The market interest rate subsequently moves to 8% such that the debt has a market value to Third Party Co of $25 million. Third Party Co assigns the debt to Head Co for $25 million.

Under paragraph 3.27 of the Position Paper, the tax cost of the debt would only be $5 million since $20 million was recognised at step 2 of Sub A's ACA calculation. That is, the tax cost of an intra-group asset **to the extent** that it does not have a corresponding accounting liability which is recognised elsewhere in the consolidated group **for tax purposes** should be recognised for income tax purposes.

Example – indirect acquisition of debt

Consider a variation on the first example where, instead of assigning the debt to Head Co, Third Party Co is acquired by Head Co. As a retained cost base asset, the TCSA of the debt will be its face value of $20 million. The purchase price of Third Party Co will, however, have reflected the market value of the debt of $25 million. This excess of $5 million will be allocated to any other assets that Third Party Co held at the joining time. Accordingly, under Position 3.1, the tax cost of the debt would be $20 million.

3.1.2 Tax costs of intra-group assets

While we understand the Board's revenue concerns with bringing forward the point of recognition of the tax costs of intra-group assets, particularly where such assets remain in the consolidated group indefinitely, we note that the blanket deferral proposed by the Board is inconsistent with the proposed asset acquisition model and will impose additional compliance costs due to the need to track intra-group assets notwithstanding that they cease to be recognised within the consolidated group. Accordingly, consideration should be given to the introduction of a concessional principle that allows tax cost of intra-group assets to be recognised at the time when they are brought into the group where the remaining term of those assets is under a threshold of, say, 5 years.

3.1.3 Relevance of income tax history of intra-group assets

We agree with the Board's position that income tax history of an intra-group asset prior to it coming into the consolidated group should be irrelevant when it is subsequently disposed of or lapses.

3.2 Intra-group liabilities

Position 3.2

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

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

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

Question 3.2

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

We agree with Position 3.2. We highlight that the amendments should also address the technical issue identified at section 3.7.5 of the DP submission.

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3.3 Integrity issues

Position 3.3
The Board considers that additional integrity provisions are required to address inappropriate outcomes that arise from the use of intra-group transactions to create value shifts.

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

While we agree in principle with the Board's position that additional integrity provisions may be required to address inappropriate outcomes, we note that a rationale of the consolidation rules was to reduce the need for integrity measures such the loss duplication or value shifting rules. Accordingly, any proposed amendments should be approached with caution and we strongly recommend that further consultation be undertaken to ensure that any such measures will not result in significant complexity or unintended outcomes.

3.4 Extension of single entity rule to third parties

Position 3.4
The Board considers that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who are:
(a) shareholders of the head company of a consolidated group; or
(b) liquidators appointed to the head company of a consolidated group.
Consideration should also be given to extending the single entity rule (together with other parts of the consolidation provisions) so that it applies to the dealings of a related third party with a consolidated group.

Question 3.4
(a) Do stakeholders agree with Position 3.4? If not, why not?
(b) Are there circumstances where an exception should be made to the principles proposed in Position 3.4?
(c) Do stakeholders agree with the proposal to extending the SER so that it applies to the dealings of a related third party with a consolidated group?

We agree with Position 3.4 subject to our comments below.

3.4.1 Other parts of the consolidation rules

Further clarification is required on the Board's reference to "other parts of the consolidation provisions". There is no discussion in the Position Paper on what these other parts might be, e.g. the entry or exit history rules, the entry and exit tax cost setting rules, etc.

3.4.2 Indirect shareholdings

A number of the provisions referred to in the Board's Discussion Paper and submissions can apply to indirect shareholdings.

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Consider, for, example, an individual that holds all of the shares in the head company of a consolidated group and has held them for at least 12 months. If the individual disposes of those shares, the CGT discount will not be available unless the integrity rule in section 115-45 is satisfied. That is, the discount will not be available on the disposal of shares in the head company if more than half the underlying assets of the head company were acquired within the 12 month period immediately before the CGT event. Under Position 3.4, the SER would be extended to the individual when applying the integrity rule in section 115-45. If, however, the individual holds the shares in the head company indirectly through an interposed entity such as a trust or a foreign company, the SER would not apply even if the interposed entity were a mere holding vehicle with no other assets other than the shares in the head company.

In such a scenario, although the individual would not be considered a shareholder, they should arguably be treated as a related third party to whom the SER should be extended.

Another example might be Division 855, which would be capable of applying where there is a chain of indirect interests held by non-residents in the head company of a consolidated group. If Position 3.4 only extends to shareholders, a different outcome would arise depending on whether the shareholder disposed of the shares in the head company or the disposal occurred further up the chain of ownership.

3.4.3 Parties other than shareholders

We note that some of the provisions identified in the Discussion Paper may apply not only to shareholders but to other related parties. Some of these are highlighted below.

3.4.3.1 Division 7A

In TD 2004/68, the ATO concludes that the SER does not apply if a private company, that is a member of a tax consolidated group, makes a payment or a loan, or forgives a debt to a shareholder (or shareholder's associate) external to the consolidated group. This is because the rules operate to treat the transaction as a dividend to the shareholder or associate and is therefore outside of core purposes. Accordingly, Division 7A applies not only to shareholders but to their associates. Although such associates may not be shareholders in their own right, this should also be a scenario in which they should be treated as related third parties to which the SER applies.

3.4.3.2 Division 974

As highlighted in Appendix A of the DP submission, there are a number of issues with the application of the SER issues under Division 974.

Subsection 974-75(6)

The turnover test contained in subsection 974-75(6) is used to determine whether related party at call loans are debt or equity. The provision only applies if the company's GST turnover is less than $20 million. There is uncertainty as to whether the SER can apply when calculating GST turnover because such related party at call loans can be interest free in which case they would not affect the calculation of taxable income or a tax loss of the head company. Accordingly, the application of subsection 974-75(6) would not affect any of the core purposes and the SER would not apply. We consider that the SER should apply when working out the GST turnover for the purposes of this provision.

Section 974-80

The application of section 974-80 requires an assessment of transactions between a number of entities including a company, a target entity and connected entities. For example, a company (Aco) issues a debt interest to a connected entity (Xco). Xco in turn issues an

equity interest to its parent company, Wco. Wco and Aco are members of the same consolidated group.

The ATO is likely to treat Wco as a target entity and Xco as a connected entity. If the SER is not extended to Aco, then section 974-80 is likely to apply to treat the interest issued by Aco as an equity interest. This would not appear to be an appropriate outcome given that the arrangement is simply the issue of debt by Aco to the consolidated group of which Wco is the head company.

We understand that Treasury is considering amendments to section 974-80. Any extension of the SER should be considered in the context of any amendments.

Non-share distributions

When a company issues a non-share equity interest, payments made in respect of the instrument do not affect core purposes. Accordingly, it is unlikely that the SER applies from the perspective of either the issuer or the holder. This means that the third party is taken to hold an equity interest in the subsidiary member of the tax consolidated group.

Under section 709-85, any non-share distribution is considered to be that of head company for franking purposes only. However, the extent to which the distribution is frankable can only be determined by reference to the profits of the subsidiary member under section 215-20 (as confirmed in ATO ID 2009/65).

Consideration should be given to extending the SER such that the equity interest would be taken to have been issued by the head company. This would overcome the above issues 85 and would allow the consolidated group to take into account all of its profits for the purposes of section 215-20. Furthermore, a single non-share capital account would be maintained by the head company rather than one by each subsidiary member that has issued non-share equity interests.

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4 Interaction with other parts

4.1 Taxation of trusts

4.1.1 Calculating net income and income for a non-membership period

Position 4.1

The Board considers that:

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

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

Question 4.1

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

We agree with these two principles. However, further details are required on how a reasonable attribution of a trust's income and expenses to a non-membership period will be determined.

We note that, at paragraph 4.10, the Board refers to the use of the principles in Subdivision 716-A. The application of these principles may not give rise to an allocation of income and expenses that equates to that determined under the trust deed. If so, this may affect the proportions of income that beneficiaries are presently entitled to.

In summary, an alternative approach might be to determine a reasonable attribution of a trust's income and expenses to a non-membership period by reference to the trust deed and any determinations made by the trustee as to how income and expenses should be attributed.

4.1.2 Calculating the beneficiaries and trustee's share of the net income

Position 4.2

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

Question 4.2

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

We agree with this position.

Although we agree with the above principles, they are quite broad and, in our view, do not remove some of the uncertainties that exist in the current legislation.

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We note that the Board states in the Position Paper[4] that it had considered the trust interaction issues using the existing framework in Division 6 of the ITAA 1936 whilst taking into account the following principles:

- Ensure that all the net income of the relevant trust is assessed to a party for the income year
- Provide a mechanism that allows the net income to be allocated on a fair and reasonable basis, having regard to the entitlements to the income of the trust during the relevant periods
- Ensure that the mechanism used to allocate the net income of the trust does not result in the occurrence of double taxation or duplication of losses
- Ensure the trustee and beneficiaries are not penalised inappropriately at the top-marginal rate in circumstances where they would not otherwise be penalised if the non-membership period were instead an income year.

We agree with the Board's position that these four overarching principles should govern the taxation outcomes when determining who bears the tax in respect of income derived by a trust during the NMP when a trust enters or exits a tax consolidated group part way through an income year.

It is in the context of those principles, which Positions 4.1 and 4.2 are designed to reflect, that we suggest the following framework to be used as the basis for determining who should pay the tax on the income of a trust that has a NMP at some point during an income year.

We would like to emphasise that the framework that we are proposing is still in a relatively embryonic state and is therefore not fully developed. However, we include it in our submission for the Board's consideration and we would be happy to discuss this model further with the Board if it so desires.

We propose three options for determining which entity should pay the tax attributable to the NMP. The appropriate option will depend on whether or not the trustee has made a distribution (or created a present entitlement) during (or in respect of) the NMP. In an entry scenario, the options and the circumstances in which they apply are summarised in the following table.

Option	Circumstances giving rise to application
1	The trustee makes an interim distribution (or creates a present entitlement) in respect of the whole of the income attributable to the NMP
2	The trustee does not make any distribution (or create a present entitlement) in respect of the income attributable to the NMP
3	The trustee makes an interim distribution (or creates a present entitlement) but it does not match the income of the trust that is attributable to the NMP

The following example illustrates how we propose that the three options should work. The facts of the example are:

- The AB unit trust (AB) has the following three unit holders – Big Co Pty Ltd (50%), Mr Medium (40%) and the Little Family Discretionary Trust (10%)
- The net income of AB for the entire income year ending 30 June 2011 is $12,000. There are no seasonal fluctuations with AB's business and, therefore, expenses are incurred,

[4] Paragraph 4.7

and income is derived, evenly throughout the year. For simplicity, assume that the net income under subsection 95(1) ITAA 1936 and the trust law income identical

- On 1 December 2010, AB unit trust becomes a 100% wholly-owned subsidiary of D Co, the head company of the D Co tax consolidated group.

Option 1. The trustee makes interim distribution or creates a present entitlement in respect of the whole of the income attributable to the NMP

Assume that on 30 November 2010, the trustee of AB resolved to make an interim distribution of all of the distributable income of AB as at that date. The amount of the interim distribution attributable to the NMP, being 1 July 2010 to 30 November 2010, was later determined to be $5,000.

The unit holders' present entitlement to AB's trust law income was as follows:

Unit holder	**Share of trust law income** **$**
Big Co Pty Ltd	2,500
Mr Medium	2,000
The Little Family Discretionary Trust	500
Total Distributable Income	5,000

In this example, the NMP is 5 months. Given that the income is derived evenly throughout the year, the income that is reasonably attributable to the NMP is $5,000 (i.e. 5/12 months X $12,000). Our earlier comments in response to Position 4.1 regarding how to determine if income or expenses are reasonably attributable to a NMP should be noted.

In this simple example, the unit holders should be assessed under section 97 of the ITAA 1936 on their share of the net income of the trust (which, as noted above, equals trust law income) as follows:

Unit holder	**Share of net income** **$**	**Rate**
Big Co Pty Ltd	2,500	30%
Mr Medium	2,000	Marginal tax rates
The Little Family Discretionary Trust	500	Top marginal tax rate unless beneficiaries presently entitled
Total Net Income	5,000	

Once AB becomes a member of the D Co tax consolidated group, the net income of AB for the remaining seven months (i.e. $7,000) will be taken to have been derived by D Co under the SER.

Under this option, the beneficiaries of AB pay the tax on their share of AB's net income that is attributable to the NMP. Therefore, the D Co is not inheriting a tax liability in respect of AB's NMP. Therefore there is no need to consider the any provision for tax when calculating step 2 of AB's ACA.

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Option 2. The trustee makes no distribution or creates no present entitlement in respect of the NMP

Assume now that the trustee of AB does not make a distribution of any of the income attributable to the NMP. No beneficiary is therefore presently entitled to the NMP income of AB.

In these circumstances, legislation could be introduced to deem AB to be a public trading trust in respect of the NMP. In this case, the net income of AB that is attributable to the NMP (i.e. $5,000) would be taxed at the corporate rate under section 102S of Division 6C of the ITAA 1936.

AB (or the trustee of AB) would effectively be accumulating the net income attributable to the NMP because the cash stays in the trust. Under this option, a liability for the provision of tax (i.e. $5,000 x 30%) would need to be brought to account in respect of the NMP.

The provision for tax should represent a liability for the purposes of determining the Step 2 amount when calculating the ACA for AB. It would also seem to be appropriate that the (after tax) accumulated income in AB, to the extent that it is fully taxable, should be considered when calculating the Step 3 amount for AB.

Once AB becomes a member of the D Co tax consolidated group, the net income of AB for the remaining seven months (i.e. $7,000) will be taken to have been derived by D Co under the SER.

The principle that AB's distributable income (and therefore AB's net income) for the NMP is to be allocated on a reasonable basis as per the Board's recommendation, is inherent in this option as well as in the other two options.

Option 3. The trustee makes a distribution or creates a present entitlement in respect of part of the NMP

The third option deals with the situation where the trustee makes an interim distribution in respect of the NMP but that distribution does not match the amount that would be reasonably allocated as recommended by the Board.

Assume that the trustee of AB distributed $3,000 out of $5,000 of distributable income to the unit holders in accordance with their unit holdings for the NMP. That is, Big Co - $1,500, Mr Medium - $1,200 and The Little Family Discretionary Trust - $300.

Effectively, AB will retain the balance of $2,000 of the trust's distributable income that is reasonably attributable to the NMP.

We suggest that in these circumstances the Board may consider a hybrid model which encompasses both options 1 and 2 as described above. For example, the unit holders could be liable to tax on their share of the distribution as per option 1. In respect of the balance, AB could be deemed to be a public trading trust in respect of the remaining NMP (i.e. $2,000) as per option 2. To give effect to this, the period that AB is deemed to be a public trading trust could be worked out on a number of days bases, (i.e. based on the share of the NMP income that is distributed). In this example, the number of days that AB would be deemed to be a public trading trust would be calculated as follows:

365 days x 2,000/12,000 = 61 days

The remaining days of the NMP would be assessed to the beneficiaries as per their share of the interim distribution. To illustrate this concept the following table shows the allocation of days per period, and the tax treatment of the share of trust income for each period:

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Period days	Liability for tax	Share of net income $	Rate
91days - NMP	Beneficiaries	Big Co - $1,500 Mr Medium - $1,200 TLFDT - $300 Total = $3000	Corporate rate Marginal rates Trustee or beneficiaries rates
61 days - NMP	Trustee, but deemed public trading trust	$2000	30%
213 days	D Co - Consolidated Group	Head Company $7,000	30% under SER

Referring to the table, the remaining NMP income of $3,000 to which the unit holders are presently entitled would be calculated as equating to 91 days of the NMP. This is calculated using, broadly, the same formula that is used to allocate the number of days that the trust would be deemed to be a public trading trust. The remaining 213 days is the period that AB was a member of the D Co consolidated group. During this time, D Co is taken to derive the trust's income by virtue of the SER.

Again, the provision for tax for the 61 days would be a liability in the accounts of the trust and therefore a liability for the purposes of step 2 of the ACA. Similarly, the after tax income, to the extent it is fully taxed should be included at Step 3 of the ACA.

If interim distribution exceeds the amount that is reasonably attributable to the NMP

In the event that the trustee makes an interim distribution which is in excess of the amount that is reasonably attributable to the NMP, we propose that the excess could be treated as a non-assessable payment to the unit holders and therefore subject to CGT event E4.

Exit from a consolidated group

A similar model to the entry model discussed above may be used where a trust exits a consolidated group part way through an income year.

NMP losses

Where AB made a loss in respect of the NMP, it would still have to satisfy the trust loss provisions in order to transfer that loss to D Co.

4.1.3 Calculating the beneficiaries and trustee's share of the net income

Position 4.3

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

Question 4.3

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

4.1.3.1 Current tax liabilities

In Appendix C of the DP submission[5], we gave the following example:

> *AB unit trust has one beneficiary (Cco). AB unit trust has one depreciable asset with an original cost base of $1000, a tax written down value of $400 and an accounting written down value of $400. Cco sells all of its units in AB unit trust to Hco halfway during the income year. Consequently the unit trust becomes part of Hco's consolidated group. At the time of joining, income and net income of the trust is equal to $10,000. The trust has retained the net income in a bank account ($10,000).*

We indicated that if the trustee was assessable on the net income of $10,000, then this would appear to be a liability of the trust (i.e. a liability of the trustee in its capacity as trustee of the trust). Accordingly, a liability of $4,650 would be included at step 2 of the entry ACA calculation. The purchase price paid by Hco is likely to be discounted for the inherited tax liability. This would seem to provide for an appropriate result.

However, if under any proposed changes to the allocation of the net income of the trust arising from Position 4.2, if Hco is assessable on the $10,000 (or part of that amount), then this would not be a liability of the trust, but rather a liability of the tax consolidated group. Accordingly, this liability would not be included at step 2 of the entry ACA calculation, as it is not a liability of the joining entity. This would not be an appropriate result. Accordingly, we agree with Position 4.3, which would overcome this issue.

4.1.3.2 Deferred tax liabilities in respect of assets

The Position Paper does not consider if inherited DTLs should also be taken into account at step 2 of the entry ACA calculation. Consider the following example from Appendix C of the DP submission:[6]

> *AB unit trust has one beneficiary (Cco). AB unit trust has one depreciable asset with an original cost base of $1000, a tax written down value of $400 and an accounting written down value of $500. Cco sells all of its units in AB unit trust to Hco and consequently the unit trust becomes part of Hco's consolidated group.*

As the trust does not pay tax, this amount is not recorded as a liability in the accounts of the trust. If Hco acquires the asset for $500 (assuming the market value equals the accounting written down value), there would be no inherited DTL. If Hco acquired the units, it is not clear if the purchase price would be discounted for the DTL of $30.

Currently, if the purchase price was not discounted, then the step 1 amount of the entry ACA would be $500, which would be pushed down to the asset giving it a TCSA of that amount. This would be an appropriate outcome.

If the purchase price was not discounted, but Position 4.3 applied, a DTL of $30 would be recognised at step 2, which would initially result in an ACA of $530. However, subsection 705-70(1A) would then apply to reduce any DTL to nil, resulting in an ACA of $500. This would be an appropriate outcome.

4.1.3.3 Deferred tax liabilities in respect of liabilities

Consider the following example:

> *AB unit trust has one beneficiary (Cco). AB unit trust has one depreciable asset with an original cost base of $1000, a tax written down value of $400 and an accounting written down value of $400. AB unit trust also has a foreign currency loan with a tax value of*

[5] Example 2

[6] Example 1

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$300 and an accounting value of $200. That is, there is an unrealised foreign exchange gain of $100 on the loan. Cco sells all of its units in AB unit trust to Hco and consequently the unit trust becomes part of Hco's consolidated group.

Hco is likely to discount its purchase price for the DTL on the foreign currency loan. Accordingly, it would pay $170 for Cco worked out as follows:

	$
Depreciable asset	400
Foreign currency loan	(200)
DTL on loan	(30)
	170

The ACA would be $370 consisting of a step 1 amount of $170 and a step 2 amount of $200. The DTL would not be taken into account at step 2. Section 705-80 would result in the recognition of a gain of $100. As to whether this gain would be taken into account at step 3, subsection 713-25(1) states that the step 3 amount is the sum of the trust's realised profits, to the extent that:

(a) they accrued to the joined group before the joining time (as defined in subsection 705-90(7)); and

(b) as at the joining time, they have not been distributed to members of the trust; and

(c) if each of them were distributed as mentioned in paragraphs 705-90(7)(a) and (b):

  (i) they would be distributed *otherwise* than in respect of a unit or an interest in the trust; or

  (ii) their non-assessable parts for the purposes of section 104-70 would be disregarded in working out whether or not a capital gain had been made because of CGT event E4;

except to the extent that they recouped losses of any sort that accrued to the joined group before the joining time (as defined in subsection 705-90(8)).

As the AB unit trust was not held previously held by Hco, paragraph 713-25(1)(a) would not be satisfied as the gain of $100 would not have accrued to the joined group before the joining time.

Accordingly, section 705-80 would not appear to result in any adjustment to the ACA. It appears, therefore, that Position 4.3 may need to cover DTLs arising from liabilities. Allowing the DTL to be taken into account at step 2 of the above example would result in an ACA of $400, which would be entirely pushed down the asset. This would be an appropriate outcome.

4.2 Consolidation membership rules

4.2.1 Applying the consolidation membership rules to trusts

Position 4.4

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

Question 4.4

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

We reiterate out comments in the DP submission[7] that it should not be necessary for a trustee to be a member of the same consolidated group as a trust. This is based on subsection 960-100(1), which specifically treats a trust as an entity for the purpose of applying the income tax laws, and subsection 960-100(2), which specifically treats the trustee of the trust as an entity. There is no specific provision in the consolidation rules that requires a trustee to be a member of a consolidated group. A trust can be a member of a group so long as all the membership interests of the trust are beneficially owned by the consolidated group.

Furthermore, jurisprudential analysis indicates that a trustee cannot be separated from the concept of a trust. Accordingly, where a trustee company is acting as trustee of a trust that is a member of a consolidated group, its activities will be those of the consolidated group. Where the trustee company is acting in its own capacity, its activities will be its own outside of the tax consolidated group.

For the above reasons, we do not agree that principle in Position 4.4 is required. However, we understand that this position will address issues that have been raised by other stakeholders. Although we do not have any objection to the position, we do anticipate a number of problems may arise if Position 4.4 is adopted.

A trust that has one or more natural persons acting as trustee, which may be the case in the SME market, would not qualify as a subsidiary. Most trust deeds permit a change of trustee, so this problem could usually be rectified.

Perhaps a more common problem might involve a timing issue. For example, Big Co (a member of a tax consolidated group) acquires all of the units in the Small Unit Trust on 1 July 2011. As a result of Big Co's acquisition, Large Co replaces Small Pty Ltd as trustee on 4 July 2011. Under the current rules, the Small Unit Trust would automatically join Big Co's consolidation group on 1 July 2011. Under Position 4.4, the Small Unit Trust may not be eligible to be a member until 4 July 2011.

Further complexities are likely to arise where a corporate entity acts as trustee for two or more trusts, (say) a unit trust and a discretionary trust. In this example, assume that the unit trust is eligible to be a member of a tax consolidated group (under the current rules), whilst the discretionary trust is not a wholly-owned subsidiary and therefore not eligible. This situation can be reasonably common in the SME market, although not limited to that market requiring the trustee to be a member of the tax consolidated group would, in our view, result in unnecessary complexities.

4.2.2 Membership of a consolidated group – beneficiaries

Position 4.5

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

Question 4.5

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

We do not necessarily disagree with the Board's position in 4.5, however, we note that this position will result in an inconsistency between the membership rules for companies and those for trusts. That is, the note in section 960-135 makes it clear that section 960-135 (in conjunction with section 960-130(3)) operates to ensure that a debt interest is *not* a

[7] Section 4.7.1

membership interest. It follows that the cost of acquiring the debt interest would not be included in the Step 1 amount when determining the ACA of the trust.

If such interests are taken into account to determine the membership of trusts, a trust that has a financing arrangement by way of an equity instrument that has debt characteristics, will not be eligible to be a member of a tax consolidated group. This would be inconsistent with the position for companies.

Notwithstanding the above, we note that the Board's position will overcome the potential issues highlighted at section 4.9 of the DP submission where beneficiaries that hold debt interests are presently entitled to income of the trust which is a member of consolidated group. However, we highlighted that should the Board consider such arrangements appropriate, modifications to section 97 would be required. The Position Paper does not recognise this in the discussion preceding position 4.5.

Our preference would be to allow a trust to be a member of a consolidated group even though debt interests may be held by beneficiaries outside of the group. We note that the Accounting Standards also take a substance over form approach regarding the presentation of financial instruments as liabilities or equity (i.e. refer to AASBs 132 and 139). Therefore, a debt interest may typically be recognised in the financial statements of the trust in a manner that is consistent with the tax treatment. The definition of the income of the trust might, in many cases, be determined in accordance with accounting principles and, therefore, no problems would arise under section 97 of the ITAA 1936.

Notwithstanding this, as previously highlighted, certain modifications to section 97 may be required in cases where the income of the trust is defined as something other than the amount calculated under subsection 95(1) of the ITAA 1936, or an amount calculated in accordance with accounting principles.

4.2.3 Application of the membership rules to foreign hybrids

Position 4.6

The Board considers that:

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

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

Question 4.6

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

We agree with Position 4.6. A foreign hybrid is already permitted to become a member of a tax consolidated group provided that all of the partners in the relevant non-resident partnership satisfy the residency requirements.

This policy intent is clear from the drafting of section 703-15. It is also supported by the fact that the income of the partnership and any CGT events flow through to the respective partners who are Australian tax residents. The non-resident status of the partnership is irrelevant when considering the tax consequences of the income derived by the partnership from the perspective of the Australian residents who are the partners.

We see no reason to deviate from the policy objective of treating a foreign hybrid that is a partnership as eligible to join a tax consolidated group for Australian tax purposes. The ATO's view in ATO ID 2009/149, which states that a US limited liability company which

satisfies the foreign hybrid provisions can join a tax consolidated group, produces a correct policy outcome.

We are not aware of any integrity risks associated with foreign hybrids forming part of a tax consolidated group. If the ATO has identified any such risks we would ask that they provide an outline of such risks to enable a better understanding of any issues it may have with foreign hybrids joining a tax consolidated group.

4.3 International tax issues

4.3.1 Moving Australian assets within a MEC group

Position 4.7

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

Question 4.7

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

We strongly believe it is not appropriate to take into account all of the assets of a consolidated or MEC group for the purpose of applying the principal asset test in Division 855. We consider that existing integrity measures would address the arrangements of concern to the Board. Further, we consider that the proposal would create considerable complexity in applying the provisions, add to compliance costs and would be contrary to the policy objective of Division 855 to encourage offshore investment.

Two integrity measures currently exist which counter arrangements that would otherwise pass the principal asset test in section 855-30. Subsection 855-30(5) contains an integrity rule which requires that the taxpayer ignores assets transferred to, or from, the test entity if those assets are used to circumvent the principal asset test. Secondly, the general anti-avoidance provisions in Part IVA can also apply where assets are transferred from a test entity to another entity, where the other entity would not be within the principal asset test. Providing that transfers are done for a commercial purpose other than to obtain a tax benefit, there should be no need to insert additional integrity provisions.

Adding additional complexity to the tax legislation should be avoided when the concern that such changes are intended to address is already covered by existing provisions. It would take considerably more time and cost to comply with a requirement to review and value all of the assets of a MEC group or a consolidated group rather than just the assets of a leaving entity for the purpose of applying the principal asset test in Division 855. This would be particularly onerous for large scale MEC groups or consolidated groups.

We would be concerned with integrity rules that could jeopardise international investment in Australia. When Division 855 was introduced, the Explanatory Memorandum for *Taxation Laws Amendment (2006 Measures No. 4) Bill 2006* stated that these measures were introduced to:

> *[F]urther enhance Australia's status as an attractive place for business and investment by addressing the deterrent effect for foreign investors of Australia's current broad foreign resident CGT tax base.*

> *4.6 More generally, the amendments will encourage investment in Australia by aligning Australian law more consistently with international practice. This results in greater certainty and generally lower compliance costs for investors.*

In our view, the proposed change would contradict the policy behind the introduction of Division 855.

4.3.2 Uplifting the cost base of assets without recognising a capital gain

Position 4.8
The Board considers that, where Division 855 applies to an asset, the consolidation tax cost setting rules should not apply to the asset unless there is a change in the underlying beneficial ownership of the asset.

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

We believe that such integrity risks are already adequately covered by the operation of Part IVA and that the general anti-avoidance provisions should deal with transactions of this nature where the sole or dominant purpose of the transaction is to obtain a tax benefit. The interposition of an entity for the sole or dominant purpose of obtaining a tax benefit under the tax cost setting process ACA pushdown is one of the examples in the ATO's consolidation Part IVA guide.

We would also be concerned that additional integrity provisions would complicate (and add to the compliance costs) of totally commercially driven restructures.

Our earlier submission noted that similar concerns regarding integrity risks were raised by the ATO in relation to the application of Subdivision 124-M rollovers to public companies and restructuring arrangements. This resulted in complicated provisions to deal with such restructures in Subdivision 124-M (see Subdivision 715-W and sections 124-784A to C). During and after the associated consultation it was acknowledged that it would be rare for a transaction to fall within such provisions where Part IVA would not otherwise apply. A considerable amount of consultation time was therefore devoted to provisions that practically have little or no effect.

We also do not agree that it is appropriate for a restructure involving a transfer within an existing group which is commercially driven to be treated differently and produce different tax outcomes to an identical commercially driven transaction involving a transfer to an unrelated Australian consolidated group. Where the transaction – whether to a related or unrelated party – is not commercially driven, and entered into for the sole or dominant purpose of obtaining a tax benefit, it is appropriate to rely on the provisions of Part IVA.

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4.4 Capital gains tax

4.4.1 Subsidiary members leaves a MEC group

Position 4.9

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

Question 4.9

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

We agree with Position 4.9. Section 104-182 should also apply where the recipient company that ceases to be subsidiary member of a MEC group.

4.4.2 Eligible tier-1 company leaves a MEC group

Position 4.10

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

Question 4.10(a)

Do stakeholders agree with Position 4.10? If not, why not?

We agree with Position 4.10 (this position is illustrated in the example below under question 4.10(b)). However, we note that the example provided in the DP submission at Appendix D (MEC group roll-downs) has not been considered in the Position Paper.

The example at Appendix D in the DP submission (Appendix D example) assumes that the Subdivision 126-B rollover occurs within a MEC tax consolidated group, rather than prior to an entity joining a consolidated group as provided in the CTA/MCA submission.

In the Appendix D example, double taxation arises because the Subdivision 126-B rollover triggers the application of the MEC pooling rules (subparagraph 719-555(1)(b)(ii)), even though no capital gain or loss arises on the rollover. That is, the MEC pooling rules apply even though the capital gain that arises from the CGT event is disregarded under Subdivision 126-B. On subsequent disposal of the shares in the rolled down ET-1 company, a proportion of the CGT event J1 gain is duplicated.

To address this issue, consideration could be given to an amendment to subparagraph 719-555(1)(b)(ii) to exclude a CGT event where a Subdivision 126-B rollover is chosen.

Question 4.10(b)

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

The solution to the problem which arises when an ET-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group is complicated because of the interaction of the consolidation rules with CGT event J1. Perhaps there needs to be some mechanism in Division 855 to reduce a capital gain where CGT event J1 and another CGT event applies, and the capital gain which arises under the other CGT event is calculated by applying the cost setting amount for the reset interest under

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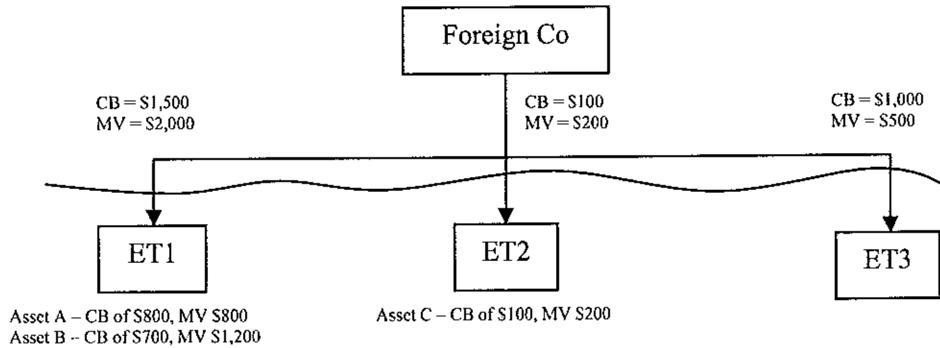
the MEC pooling rules. Alternatively, a new provision in the anti-overlap provisions in Division 118 could be inserted to reduce the duplicated gain. This will allow for the deferred gain or loss to be assessed under CGT event J1 at the appropriate time without duplication of the gain.

For example, assume the following group structure and details prior to consolidation on 1 July 2000:



Assume that Asset B, being real property, is transferred from ET1 to ET2 on 1 July 2000 (prior to ET1 and ET2 forming a MEC group) for market value consideration utilising Subdivision 126-B rollover relief. As a result, a debt is owed by ET2 to ET1 equal to the market value of the asset transferred ($1,200).

Assume that a MEC group is formed on 1 July 2002 and the shares in ET2 are disposed on 31 December 2002, at which time the market value of Asset B is $1,500 (assume all other market values have not changed).

Subdivision 719-K applies on the exit of ET2 from the MEC group. The pooling rules would act to reset the cost base of the shares in ET2 to $433 as follows (section 719-570):

$$\frac{\text{Market value of reset interest (ET2 = \$500)}}{\text{Market value of the group (\$3,000)}} \quad \text{x} \quad \text{Pooled cost amount (\$2,600)}$$

= $433

The sale of ET2 gives rise to a taxable event given that the shares in ET2 are TARP under section 855-25. Foreign Co derives a capital gain of $67 under CGT event A1, being equal to the difference between the market value of the shares of $500 ($200 plus the appreciation in the market value of Asset B of $300) and the pooled cost base of $433. CGT event J1 will apply to crystallise a capital gain of $800, being the market value of the asset ($1,500 and the cost base of Asset B ($700).

The total taxable gain in respect of the sale of ET2 is $867. In this example, the combined economic gain is only $400, being the combined market value of ET1, ET2 and ET3 separately ($3,000) less the combined original cost base of the shares in ET1, ET2 and ET3 of $2,600. This is ignoring the potential capital gain that may arise upon disposal of ET1 and ET3 in the future (if these shares are TARP).

Another provision could be inserted into Division 855 as follows:

Disregard that portion of a capital gain or capital loss from a CGT event if:

(a) the relevant CGT asset is shares in an eligible tier-1 company;

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(b) CGT event J1 happens at the same time; and

(c) A capital gain is made under CGT event J1.

The portion of the capital gain that is disregarded is calculated as follows:

Market value of roll-over asset to which CGT event J1 applies

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Total market value of all assets that are taxable Australian real property

In our example above the full $67 capital gain would be disregarded since the only TARP asset held by ET2 is the roll-over asset to which CGT event J1 applies. This draft provision would need to be considered in further detail to ensure that there are no unintended ramifications.

4.4.3 Head company leaves the wholly-owned group

Position 4.11

The Board considers that:

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

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

Question 4.11(a)

Do stakeholders agree with Position 4.11? If not, why not?

We agree with Position 4.11.

Question 4.11(b)

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

We believe that a number of amendments should be made in order to determine the cost base of the membership interests in the subsidiary member of the consolidated group:

- CGT event J1 could state that where a non-resident owner disposes of its interest in the head company of a consolidated group with a rolled over membership interest assume that the head company and its subsidiary members are not, and were never consolidated. Accordingly, this amendment would "switch off" the operation of the SER only for the purpose of determining the gain under CGT event J1. As such, if it is assumed that the consolidation rules never applied, the normal consequences of Subdivision 126-B would apply and the cost base of the membership interests in the relevant subsidiary member would be determined under the normal cost base rules, and any resulting CGT event J1 gain could be calculated.

- In order to ensure that the CGT event J1 gain is not duplicated upon subsequent disposal of shares in the rolled over membership interest, there needs to be some mechanism to pick up the market value of the rolled over membership interests at the time that CGT event J1 happens.

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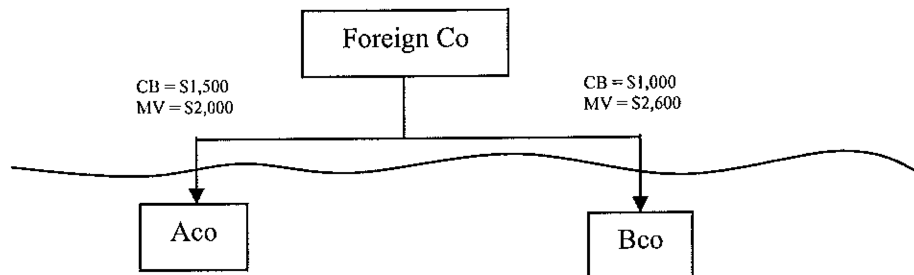
For example, assume the following structure:



Assume that the shares in Bco are transferred to Aco for market value ($2,600) utilising Subdivision 126-B rollover relief and Aco and Bco form a tax consolidated group. Foreign Co later sells the shares in Aco. At that time the market value of the shares in Bco is $3,000.

CGT event J1 should apply in this scenario, however, the membership interests in Bco (being the rolled over asset to which CGT event J1 should apply) are not recognised for tax purposes under the SER.

Applying our recommendations:

- The SER would be switched off for the purpose of determining the gain under CGT event J1. A capital gain of $2,000 would be crystallised by Foreign Co under CGT event J1, being the difference between the market value of the shares in Bco ($3,000) and the cost base of the shares in Bco as inherited by Aco under Subdivision 126-B ($1,000)
- When the shares in Bco are transferred to Aco and a tax consolidated group is formed the tax cost setting rules are applied. The step 1 amount on entry under section 705-65 would have been $2,600. This amount will be pushed down to the assets of Bco. However, since a CGT event J1 gain was crystallised upon disposal of Foreign Co's shares in Aco, the market value of the shares in Bco as at this date of $3,000 will be subject to tax. If Aco subsequently disposed of the shares in Bco and Division 711 was applied, double taxation would arise (since the tax costs of the assets of Bco would have initially been set on entry based on a step 1 amount of $2,600, which then becomes the step 1 amount on exit). Accordingly, in order to ensure that no double taxation arises, there needs to be some mechanism to a take into account the difference between the market value of the shares in Bco of $3,000 when Aco is sold and the initial tax cost setting amount for Bco of $2,600. For example, consideration could be given to allowing a Division 705 calculation to be performed at the time CGT event J1 occurs based on a revised step 1 amount of $3,000.

Question 4.11(c)

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

The amendments as proposed in our response to Question 4.11(b) should address the issue of a partial disposal of the membership interests.

4.4.4 Other changes to the operation of CGT event J1

Question 4.12

Do stakeholders consider that issues which currently arise because of CGT event J1 could be resolved if:

- ***a time limit applied to the provision;***
- ***minority interest divestments were exempted from the provision; and***
- ***the sub-group break-up exemption applied where less than 100 per cent of the interests in the sub-group is disposed of to non-group entities?***

The measures proposed in Position 4.12 would reduce the compliance costs for taxpayers. However, given the uncertainty that currently exists with the application of CGT event J1, we consider that the Board should undertake further consultation to determine if broader changes are required to CGT event J1.

4.5 Other issues

4.5.1 Interactions with double tax agreements

Position 4.13

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

Question 4.13

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

We are unsure of the specific circumstances that the Board considers creates uncertainties and which require clarification concerning how Australia's double tax agreements apply to a consolidated group. In the absence of further detail, we are unable to comment on whether a review by Treasury and the ATO is warranted.

4.5.2 Deferred tax assets and liabilities

Question 4.14(a)

The Board seeks stakeholder's comments on whether the inclusion of deferred tax assets and deferred tax liabilities in the tax cost setting process results in unnecessary complexity?

Although the inclusion of deferred tax balances in the tax cost setting process does result in complexity, it is recognised that this is sometimes required to achieve an appropriate outcome. Short of introducing amendments, some of this complexity would, therefore, based on the current provisions, appear to be necessary.

As highlighted throughout the NTLG discussion paper on this matter, the litany of unresolved issues surrounding the interaction of the relevant accounting standards and the tax cost setting process at the very least suggests that the current provisions inadequately provide for the inclusion of deferred tax balances in the consolidation regime.[8]

We agree with the assertion put forward in the NTLG's discussion paper that the interaction of AASB 112 with the other accounting standards has brought significant uncertainty and

[8] ATO Discussion paper – NTLG Subcommittee Meeting 26 February 2009

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complexity to the ascertainment of deferred taxes in relation to the application of the tax cost setting process.[9] However, we believe that the complexity surrounding the use of deferred tax balances in the tax cost setting process is not limited to that arising from the application of the accounting standards, and that additional confusion arises due to interpretational issues associated with the provisions.

These issues include, but are not limited to:

- The divergence between the measurement of DTLs between those used in the tax cost setting process and those presented in the financial statements as a result of recognition choices available within AASB 112
- The presence of anomalies in the tax cost setting process where the purchase price of the joining entity has not been adjusted for the value of any DTL or where the value of the joining entity's DTL is less than the same DTL post-entry into the consolidated group
- The complexity in the iteration process as established in the Consolidation Reference Manual and the compliance burden this creates, particularly upon small business corporate groups[10]
- Anomalies apparent in the tax cost setting process resulting from the exclusion of certain DTAs on unrealised losses where the vendor is taxed on consideration for the DTA and the consolidation provisions neutralise the deductibility of the consideration paid by the acquirer (see example in Appendix 1).

Question 4.14(b)

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

We do not consider that a universal rule can be introduced that will ensure the appropriate treatment of all DTAs and DTLs. This is because DTAs and DTLs can arise in a range of circumstances. DTAs can arise from losses, tax attributes or differences between the tax and accounting bases of assets or liabilities. DTLs can arise from differences between the tax and accounting bases of assets or liabilities. In relation to assets, DTAs and DTLs may arise from assets that are reset and those that are not reset. Furthermore, DTAs and DTLs need to be considered in entry and exit scenarios.

We consider that each of these permutations will need to be considered and potentially a rule developed for each one. We highlight below some examples of where DTLs give rise to appropriate and inappropriate outcomes under the consolidation rules.

DTL in respect of an asset on exit

Subco, is a subsidiary member of a consolidated group. Subco enters into a forward foreign exchange contract. The tax base of the contract is nil as nothing is paid to enter into the contract. The fair value of the contract subsequently increases to $100 resulting in the recognition of a DTL of $30. Subco is disposed of by the head company to a third party for $100. Although there is a DTL of $30 on the contract, the third party is a member of a consolidated group and, through the tax cost setting process, the contract will obtain a TCSA of $100 thereby eliminating any DTL.

The calculation of the exit ACA will give rise to a capital gain of $30 under CGT event L5. This is because the step 1 amount, which takes into account the tax costs of assets that the leaving entity takes with it, will be nil as the tax cost of the forward foreign exchange contract is nil (ignoring the potential application of Division 230). The step 4 amount, which takes into account liabilities of the leaving entity, would be $30 consisting of the DTL just before the leaving time. Subsection 711-45(5) would not apply here because it only applies to unrealised gains and losses on accounting liabilities. The unrealised gain here is on the

[9] Par 75, ATO Discussion paper – NTLG Subcommittee Meeting 26 February 2009

[10] Section C2-4-242, CRM (31 March 2008 edition)

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contract itself. Furthermore, the exit ACA would be nil, such that the head company of the consolidated group would make a gain of $100 on the disposal of Subco. Accordingly, tax of $39 (30% of $130) would be payable by the head company on an economic gain of $100.

If the consolidated group had simply sold the contract, there would have been a gain of $100 that would have been included in assessable income. Tax of $30 (30% of $100) would be payable on that gain.

DTL in respect of an asset on entry

Continuing with the above example, the purchaser of Subco is Xco, the head company of another consolidated group. As noted above, Xco paid $100 for Subco. The step 1 amount of the entry ACA calculation will be $100 and the step 2 amount will be Subco's DTL of $30. Accordingly, the entry ACA will initially be $130 and this would become the TCSA of the forward foreign exchange contract. Through the reiteration process required by subsection 705-70(1A), however, the step 2 amount would be reduced to nil such that the entry ACA would eventually equal $100. This is the appropriate outcome but there may be several reiterations required which can impose a significant compliance burden in practice.

DTL in respect of a liability on entry

Subco has cash of A$500 and has borrowed A$300 in a foreign currency. The loan decreases to the equivalent of A$200 due to foreign exchange movements. That is, there is an unrealised foreign exchange gain of A$100 on the loan. Subco is acquired by Headco, the head company of a consolidated group, for A$270, which is calculated as follows:

	$
Cash	500
Loan	(200)
DTL on unrealised foreign exchange gain	(30)
	270

The entry ACA for Subco is initially:

Step	$
1	270
2	230
	500

No reiterations are required under subsection 705-70(1A) as the DTL is not in respect of an asset. Section 705-80, however, requires the ACA to be calculated as if the unrealised foreign exchange gain had been realised for tax purposes.

Step	$
1	270
2	230
	500

Note that a liability of $30 is taken into account at step 2 under the notional ACA calculation required by section 705-80. Instead of a DTL, however, the amount is a provision for income

tax. Since the notional ACA calculation gives the same result as the initial ACA calculation, there will be no adjustment to the initial calculation. In this case, recognising the DTL would give rise to an appropriate outcome.

The ACA of $500 would be pushed down to the cash giving it a TCSA of the same amount.

DTL in respect of a liability on exit

Subco is a member of a consolidated group, the head company of which is Headco. Subco borrows the equivalent of A$500 in a foreign currency. The loan decreases to the equivalent of A$400 due to foreign exchange movements. That is, there is an unrealised foreign exchange gain of A$100 on the loan. Headco disposes of Subco. Subco's balance sheet at exit is as follows:

Asset/liability	Accounting value	Tax base	DTA/(DTL)
Plant and equipment	1,000	1,000	-
Loan	(400)	(500)	(30)
	600	500	(30)

Assume the market value of Subco equals its accounting value. Subco is, therefore, disposed of for $600. The exit ACA calculation would be:

Step	$
1	1,000
4	(530)
	470

In relation to the calculation of the step 4 amount, under subsection 711-45(5), where there a change in the amount of an accounting liability is taken into account at a later time for tax purposes than is the case under the accounting standards, the amount to be added for the accounting liability at step 4 is equal to the payment that would be necessary to discharge the liability just before the leaving time without an amount being included in the assessable income of, or allowable as a deduction to, the head company. The foreign currency loan would meet the description of a liability that falls within subsection 711-45(5). Since the tax value of the liability would be $500, this is the payment that would be necessary to discharge the loan without an amount without an amount being included in the assessable income of, or allowable as a deduction to, Headco.

If the DTL of $30 was ignored at step 4, the exit ACA would be $500, which would arguably be the correct outcome. As Subco is disposed of for $600, Headco would realise a gain of $100, which represents the unrealised foreign exchange gain on the loan.

However, it would appear that the DTL of $30 would need to be recognised at step 4 under the current law. Headco would effectively be required to pay tax on the tax liability in respect of the unrealised foreign exchange gain on the loan. This would not be an appropriate outcome.

In summary, it can be seen that there needs to be consideration of all of the various permutations of when DTLs can arise and how they affect entry and exit ACA calculations in order to determine if any rule or rules can be developed on when DTLs should or should not be taken into account. We have only considered above some examples in relation to

DTLs and a similar analysis would need to be performed for DTAs. We recommend that there be consultation to more comprehensively consider all possible scenarios.

Question 4.14(c) ***Should deferred taxes assets and deferred tax liabilities be removed from the tax cost setting process?***

This may be a potential solution. As noted in the examples above, however, it may be necessary to take into account DTAs and DTLs to achieve appropriate outcomes. Accordingly, if they are removed from the tax cost setting process, there needs to be a mechanism to take these into account where appropriate.

Question 4.14(d) ***If not, in what circumstances should deferred tax assets and liabilities be recognised in the tax cost setting process?***

Refer to our response to Question 4.1.4(c).

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5 Small corporate groups

5.1 Formation concessions for eligible groups

Position 5.1

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

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

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

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

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

Question 5.1(a)

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

Subject to our comments below, we agree with the proposal that on-going formation concessions should be available for wholly-owned corporate groups that fall below specified turnover and asset thresholds.

5.1.1 Eligible corporate groups

5.1.1.1 Wholly-owned corporate group

We note that many SME groups may include entities that are not companies such as trusts and, less frequently, partnerships. The Board may have loosely used the term 'wholly-owned corporate group' to refer to a consolidatable group which can include such entities. For certainty, we submit that that a group should be able to form a consolidated group and access the proposed formation concessions even if it includes entities other that companies.

5.1.1.2 Aggregated turnover threshold test

The Board proposes to adopt a turnover threshold of $100 million based on aggregated turnover. The term 'aggregated turnover' is defined in subsection 328-115(2) as the sum of the following relevant annual turnovers:

- The taxpayer's annual turnover
- The annual turnover of any entity (a relevant entity) that is connected with the taxpayer
- The annual turnover of any entity (a relevant entity) that is an affiliate of the taxpayer.

It does not, however, include:

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- Amounts derived in the income year by the taxpayer or a relevant entity from dealings between the taxpayer and the relevant entity while the relevant entity is connected with the taxpayer or is the taxpayer's affiliate
- Amounts derived in the income year by a relevant entity from dealings between the relevant entity and another relevant entity while each relevant entity is connected with the taxpayer or is the taxpayer's affiliate
- Amounts derived in the income year by a relevant entity while the relevant entity is not connected with the taxpayer or is the taxpayer's affiliate.

We do not consider that the concept of aggregated turnover is appropriate to determine eligibility for the formation concessions since it may take into account the turnover of entities that are not members of the relevant wholly-owned corporate group (and will not, therefore, be members of the consolidated group).

As noted above, aggregated turnover includes the annual turnover of any entity that is connected with you. Under subsection 328-125(1), an entity is connected with another entity if either entity controls the other entity or both entities are controlled by the same third entity. Whether one entity controls another entity depends on the nature of the other entity:

- An entity controls another entity other than a discretionary trust when that entity and/or its affiliates beneficially own, or have the right to acquire the beneficial ownership of, interests in the other entity that carry between them the right to receive at least 40% of:
  - Any distribution of income by the other entity
  - If the entity is a partnership – the net income of the partnership
  - Any distribution of capital by the other entity
- An entity controls a company, if it beneficially owns, or has the right to acquire the beneficial ownership of, equity interests in the company that carry between them the right to exercise, or control the exercise of, at least 40% of the voting power in the company
- An entity controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the first entity, its affiliates, or the first entity together with its affiliates. An entity also controls a discretionary trust for an income year if, for any of the 4 income years before that year the entity and/or its affiliates received distributions of at least 40% of the income or capital of the trust

It can be seen that aggregated turnover could take into account the annual turnover of, for example, a company that is only 40% owned by members of the wholly-owned corporate group or a discretionary trust that has beneficiaries who are not members of the wholly-owned corporate group.

Aggregated turnover also takes into account the turnover of affiliates of an entity. Subsection 328-130(1) states that an individual or a company is an affiliate of an entity if the individual or company acts, or could reasonably be expected to act, in accordance with the entity's directions or wishes, or in concert with the entity, in relation to the affairs of the business of the individual or company. An individual that is a majority shareholder of a wholly-owned corporate group might be considered to be an affiliate of the members of that group. We reiterate that it would not appear to be appropriate to take into account the annual turnover of entities that will not be members of the consolidatable group.

Given the above, an alternative turnover test would be required. For example, it may be possible to base turnover on the sum of the following relevant annual turnovers:

- The annual turnover of the entity that is the head company of the consolidatable group
- The annual turnover of entities that are subsidiary members of the consolidatable group.

That is, turnover could be based on the members of a consolidatable group as defined in subsection 703-10(1). It should not, however, include any amounts derived in the year of income from dealings between the members of a consolidatable group.

5.1.1.3 Assets threshold test

The Board states in the Position Paper[11] that the assets threshold of $300 million will be consistent with the threshold contained in the TOFA provisions. We note that subsection 230-455(5) provides that the value of an entity's assets is to be determined in accordance with:

(a) if the entity applies accounting standard AAS 25 in preparation of its financial reports – that accounting standard or another accounting standard prescribed by the regulations for the purposes of this paragraph

(b) if paragraph (a) does not apply and the entity prepares its financial reports in accordance with the accounting standards – the entity's financial reports

(c) if paragraphs (a) and (b) do not apply and the entity prepares its financial reports in accordance with an accounting standard comparable to accounting standard AAS 25 under a foreign law – that comparable standard

(d) if paragraphs (a), (b) and (c) do not apply – commercially accepted valuation principles.

If an entity does not prepare financial reports in accordance with accounting standards, it is not able to rely on those reports to determine the value of its assets. Instead, it will be required to value those assets using commercially accepted valuation principles. This may require independent valuations to be obtained. Furthermore, these valuations would need to be performed annually until such time as the assets threshold test is failed.

The Board's Position Paper[12] notes that many entities in smaller groups are not generally required to prepare financial statements in accordance with accounting standards. These entities would, therefore, be required to obtain annual independent valuations, which would increase the compliance burden and cost for those groups. Given that the proposed formation concession allowing eligible wholly-owned groups to retain the existing tax cost bases of assets appears to be intended to overcome the need for costly valuations that would otherwise be required if the tax cost setting rules applied, requiring such groups to undertake such valuations for the purposes of applying the assets threshold test of $300 million would appear to be counterintuitive.

In summary, adopting the assets threshold test in the TOFA rules would not be consistent with the Position Paper, which indicates that the formation concessions will provide eligible wholly-owned corporate groups with a relatively low-cost alternative on the formation of a consolidated group.[13] Consideration should be given to removing the assets threshold test such that only turnover needs to be tested. This is consistent with the DP submission in which an SME taxpayer was defined as one with turnover of between $10 million and $100 million.[14]

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[11] Paragraph 5.36
[12] Paragraph 5.15 – 5.17
[13] Paragraph 5.31
[14] Section 6.2.2

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5.1.2 Nature of formation concessions

Notwithstanding the formation concessions recommended, SME groups may still be cautious about entering a simplified consolidation regime for the following reasons:

- Specialist advice may be required where there are either acquisitions or divestments following the formation of a consolidated group as complex tax cost setting calculations will be required on entry of the acquired entity and upon the exit of a subsidiary member. Such specialist knowledge is often not the domain of small tier tax practitioners and as such is likely to be more expensive with the result that it would increase compliance costs
- Valuations will still need to be undertaken for acquisition and exit scenarios
- The additional work that may be required to produce financial accounts for a consolidated group. Many SMEs are not required to prepare financial statements in accordance with all applicable accounting standards
- Many SME groups include discretionary trusts in their structure so that assets can be held in these entities for asset protection or succession planning purposes. It is problematical whether a discretionary trust is capable of being included in a consolidated group. Further, the rules as they apply to trusts joining a consolidated group and the calculations of net income and the allocation of net income between non membership and membership periods are unclear (subject to any amendments that may be introduced as a result of Positions 4.1 and 4.2). As a result, this creates more complexity and raises practical issues as to whether consolidation is an appropriate regime for many small business groups.

In light of these issues, we highlighted in the DP submission[15] that consideration should be given to a simplified consolidation regime for SMEs and set out a number of shortcuts that could be introduced. We reiterate that such a regime could provide more certainty to, and reduced compliance costs for, SMEs and may, as a result, encourage more SMEs to form consolidated groups. Alternatively, we outlined, at section 6.2.3 of the DP submission, two alternatives to amending the consolidation rules – simplified grouping rules or an entity flow through regime – which would also allow SMEs to effectively consolidate for tax purposes.

These alternatives, which are set out in our DP submission, are summarised below:

Option 1 – simplified grouping rules for small and medium taxpayers

Under this option, small and medium business groups with a turnover of less than $100 million and assets of less than $300 million are allowed to:

- Group tax losses for wholly owned groups. The integrity rules contained in Subdivisions 165-CC and 165-CD would still be required to deal with issues such as the duplication of losses but such groups already need to consider those rules if they are outside of the consolidation rules
- Obtain tax roll-over relief for asset and liability transfers between wholly owned groups,

Option 2 – entity flow through taxation regime

For SME taxpayers with a turnover of less than $10 million, the Board should consider the adoption of a simpler flow through taxation model. An entity flow through model would enable an operating entity to flow through the taxation consequences of transactions to the owners of the entity, essentially being treated as a tax law partnership with the benefit of limited liability for such owners.

[15] Paragraph 6.2.2

Such a regime is likely to be significantly less complex than the consolidation rules. It also has the advantage of eliminating some of the current complexities for smaller groups such as Division 7A and unpaid present entitlement issues. Such a regime has previously been submitted to the government by the Institute of Chartered Accountants and Deloitte.[16] We also understand that such a regime is being considered in New Zealand.

If the decision is made to continue to apply the existing consolidation rules to SME groups, we note that several transitional concessions were made available when the rules were initially introduced, in addition to the two specifically referred to in the Position Paper. These included:

- The requirement that undistributed profits be frankable to be included in step 3 when working out the ACA was not applicable
- A head company could choose to add to the modified market value of a loss entity (the real loss-maker) the modified market value of another company (the value donor) when calculating the available fraction for the bundle of losses transferred from the real loss-maker.

The Board considers that many of these concessions would not be applicable to smaller, relatively simple group structures. However, there may be scope for groups at the higher end of the thresholds proposed by the Board (i.e. $100 million in turnover or $300 million in assets) to utilise these other concessions). Although there may be compliance costs associated with applying some of these concessions, these may be outweighed by the resulting benefits. Accordingly, we submit that consideration should be given to replicating some of those concessions.

5.1.3 Election to apply the formation concessions

Question 5.1(b)

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

An election to apply the original transitional consolidation concessions was made on an entity-by-entity basis whereby each subsidiary entity had a choice of adopting the existing tax values of assets (the 'stick' method) or applying the tax cost setting rules (the 'spread' method). However, the Board has proposed that this entity-by-entity election should not be available to eligible wholly-owned small business corporate groups because of concerns that this approach would result with additional complexity and cost.

Unlike the spread method, adopting the stick method does not require an allocation of the tax value of equity interests in the subsidiary entity to its assets and liabilities.

Paragraph 1.88 of the revised EM to the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* states:

> *Where a consolidated group is a transitional group, the head company may choose that the tax cost is not set for assets of chosen transitional entities. Instead, the head company will inherit the existing tax costs of the assets. This choice provides an option for groups to consolidate during the transitional period without having to undertake market valuations of all of the assets of subsidiary members of the group, or undertake allocable cost amount calculations for subsidiary members. Where the consolidated group elects that the tax cost of assets is not set, subsection 701-35(4) does not apply, and an entity is*

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[16] A joint report from the Institute of Chartered Accountants in Australia and Deloitte, "Entity flow-through (EFT) submission", April 2008

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able to revalue its trading stock in accordance with the trading stock provisions immediately prior to joining a consolidated group.

Accordingly, providing an entity-by-entity choice was still perceived to provide compliance cost savings. Furthermore, an entity-by-entity basis may be preferable where the election to adopt the stick method may not result in the most advantageous outcome for all members of the group. In this scenario, it may be preferable for the group to undertake tax cost setting calculations for some or all of the members of the group to determine the most desirable outcome.

In summary, we consider that an entity-by-entity election should be introduced. We note that many smaller SME groups may not consist of a significant number of entities and any additional compliance costs should be limited for those groups. Eligible corporate groups should still have the choice to simply stick for all entities in the group or, if they are prepared to incur additional costs and complexity, could choose to undertake additional analysis to determine for which entities the reset cost method could be adopted.

5.2 Extension of concessions for limited period

Position 5.2

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

Question 5.2(a)

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

We consider that making available the formation concessions for a limited period of time to all eligible consolidatable groups will result in some increase in the number of groups electing into the consolidation regime. The formation concessions should only be available for a period of 12 months from the date of introduction. Given that the consolidation regime has been operating for several years now and many of the identified problems have been legislatively resolved, we believe that a 12-month transitional period is sufficient.

While we are generally supportive of the above position, we question whether the extension of the formation concessions to those consolidatable groups that did not consolidate creates an unfair advantage over those groups that did. In particular, we are concerned that these groups would be able to utilise losses brought into the group over a three year period compared to those that were required to apply the available fraction method.

Further, it will not eliminate the complexities associated with applying the tax cost setting rules to acquisitions and divestments.

For these reasons, we would prefer the reinstatement of simplified grouping rules that are outlined under Option 1 in our response to Board Position 5.1 above.

5.2.1 Complexity and compliance

Question 5.2(b)

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

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Should Position 5.2 be adopted, we consider that stakeholders would not be concerned about increased complexity or compliance costs upon entering the consolidation regime under the formation concessions. In particular, if the original transitional rules are replicated for the purposes of extending the formation concessions to wholly-owned corporate groups that have not yet elected into the consolidation regime, we do not expect an increase in complexity and compliance costs caused by the adoption of Position 5.2.

However, there would be increased complexity and compliance costs in the event an entity is acquired by the group or is to exit the group on a go forward basis. For example, there would be additional complexity and compliance costs due to the need to obtain market valuations, the requirement to prepare financial accounts for the consolidated group and when calculating the tax costs of assets in respect of entities that join or exit the group.