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Post-implementation Review into
Certain Aspects of the Consolidation Regime
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600
By email: taxboard@treasury.gov.au

Dear Sir

Post-implementation Review into Certain Aspects of the Consolidation Regime
Position Paper

Ernst & Young welcomes the opportunity to provide comments to the Board of Taxation (Board) Position Paper on its Post-implementation Review into Certain Aspects of the Consolidation Regime.

Our submission, which responds to the questions in the Board's Position Paper, is attached as Appendix A.

The consolidation law is very intricate and complex, containing interactions with every other area of the tax law affecting companies, trusts and many other specific rules. So the amendments which might ultimately emerge from this review will also need detailed and extensive consideration, which takes time. We recommend that the Board should highlight the need for extensive consultation in relation to its final recommendations, before these are turned into exposure draft law.

If you would like to discuss this submission further or require any further information or assistance in respect of our submission, please contact any of Andrew Woollard on 03 8650 7511, Colin Jones on 02 9248 4724, Richard Czerwik on 03 9288 8408 or myself on 03 8650 7654.

Yours sincerely

Tony Stolarek
National Tax and Tax Policy Services

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Ernst & Young responses to Board of Tax positions

References in the Appendix are to the Income Tax Assessment Act 1997 unless otherwise indicated. References to a consolidated group are intended to apply to a MEC group in a corresponding way unless otherwise stated.

Consultation to implement eventual amending law

The consolidation law is very intricate and complex, containing interactions with every other area of the tax law affecting companies, trusts and many other specific rules. So the amendments which might ultimately emerge from this review will also need detailed and extensive consideration, which takes time. For this reason we recommend that the Board should highlight the need for extensive consultation in relation to its final recommendations, before these are turned into exposure draft law.

That consultation will need to involve the Australian Taxation Office and Treasury with the professional bodies in a transparent manner. We would be pleased to participate. Such consultation will be needed to ensure that the amendments achieve their intended purpose.

As well, any timetables or deadlines proposed by the Board (for example in relation to small business transitional concessions) should factor in the appropriate lead time for development of the law.

Policy framework for the consolidation regime

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

Question 2.1
The Board seeks stakeholder comment on:

- Do you agree with the Board's view to adopt the asset acquisition approach? If not, why not?
- 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?
- Do you consider that there are other circumstances in which the asset acquisition approach should be modified? If so, what are the issues?
- What compliance cost implications would arise from the adoption of the asset acquisition approach?

(a) Comments on adopting an asset acquisition approach

We understand that the Board proposes the adoption of an "asset acquisition" approach to replace the inherited history rule in relation to determining the tax attributes to be recognised for assets when a subsidiary joins or leaves a consolidated group. Assets would be excluded from the scope of the inherited history rules. The "asset acquisition" approach is in contrast to a pure "acquisition"

approach (which is akin to a clean slate rule): the asset acquisition approach would not impact non-asset tax attributes such as the treatment of liabilities.

A key reason for the input from various quarters for this change is to better align the tax outcomes for assets under the tax consolidation tax cost setting rules (as they interact with other provisions in the Act) with outcomes that would arise under a direct asset acquisition scenario. The clearest areas requiring legislative and policy improvement, and alignment, include:

- Division 40 limitations in respect of depreciating assets (choice of depreciation method, access to 200% diminishing value method gross-up and choice of effective life);
- Treatment of pre 1 July 2001 mining, quarrying or prospecting rights or information
- Restricted recognition of the tax cost of privatised assets;
- Potential application of subsection 73B(27A) of the ITAA 1936 to tax gross receipts from the sale of reset intangible assets held by a subsidiary member, where R&D deductions were claimed on expenditure relating to the creation of the asset;
- Ongoing application of the limited recourse debt rules in Division 243 of the ITAA 1997, where a subsidiary member that held a depreciating asset had triggered the application of Division 243 before the joining time.

While are cautious about the extent of drafting which might be required under an asset acquisition approach, and the administrative adjustment process this might require, we accept that the Board's proposal has the potential to alleviate some concerns with the abovementioned existing rules.

If an asset acquisition approach is adopted, in addition to any general "core" rule amendments, the Board should recommend that the amendments should unambiguously and specifically address the abovementioned issues. That may require the amendment or repeal of various specific problematic relevant provisions, such as Division 702 of the Income Tax (Transitional Provisions) Act 1997 in respect of pre 1 July 2001 mining, quarrying or prospecting rights or information.

Treatment of liabilities

A key implication of the Board's proposal is that the existing treatment of liabilities held by the joining entity would be retained (paragraph 2.65). We support this approach.

(b) Modification for formation cases or no change in ownership cases?

We would expect that the proposed reform would only apply prospectively. On that basis we see no pressing reason why the proposed reform should not apply to a formation case, subject to the following discussion on potential integrity issues.

We understand that there might be revenue integrity concerns in respect of existing consolidated groups and MEC groups seeking to avail themselves of the proposed reforms, in relation to joining entities that were members of a consolidated group before the commencement time of the proposed reforms and become members of the same or substantially the same consolidated group after the commencement time (refreshed membership scheme).

We understand that consideration may be given to a specific integrity rule that would require a change in the ownership of the joining entity for the proposed measures to apply. Consideration could be given to adopting similar capture tests as were used for the scrip for scrip "top-hat"

integrity rules that are contained in section 124-784A, which essentially require a 20% change of ownership.

However, any such integrity rule should be limited to ensure that it does not apply inappropriately, including the following requirements in our view:

- the joining entity was within the last 12 months a member of a consolidated group, where the head company of the previous consolidated group was also a member of the current consolidated group;
- a dominant, or significant and not incidental purpose of the arrangement was to benefit from the application of the tax consolidation tax cost setting rules including the asset acquisition rules.

We highlight that there should not be any integrity concerns regarding entities that join a consolidated group where the entity was not a member of that group at any previous time, for example, where an entity joins a consolidated group through the acquisition of say a 10% minority interest.

(c) Modifications to the asset acquisition approach

We have a number of observations, which may require clarification or modification to the proposed asset acquisition approach. These are outlined below:

Categorisation of assets on entry

Groups may potentially be disadvantaged by the proposed asset acquisition approach, if the result of that approach is that "the group would be taken to acquire **all** the assets of the joining entity at the joining time" (emphasis added)[1]. There is various case law authority that provides that outlays on assets acquired in the context of a purchase of a business would be characterised as being capital in nature (in the absence of the application of any specific provisions): *QCT Resources* 97 ATC 4432.

However, the Position Paper later provides (at paragraph 2.56) that the capital/revenue character of the amount received on the disposal of the asset (reset at the joining time) would be determined on the basis of the consolidated group's treatment of the asset (from the joining time). In our view, that characterisation should not be impacted by any deemed acquisition of the business of the subsidiary member at the joining time.

Consideration could be given to taking a similar approach as was adopted for recent amendments to s.701-55(6) regarding characterisation of assets. Section 701-55(6) is relevant for determining how the tax cost setting amount is to be recognised for the purposes of the Act for assets that are not dealt with under other subsections in section 701-55. The modified subsection 701-55(6) states the tax cost is set for the purpose of determining the amount of income or deduction as if the cost, outgoing, expenditure or other amount had been incurred or paid to <u>acquire the asset</u> at the joining time for the tax cost setting amount). The original section 701-55(6) did not have any reference to an acquisition.

[1] Paragraph 2.53

Note 1(a) to section 701-55(6) states that section 701-55(6) modifies the applicable assessing or deducting provision in the Act only for the purpose of determining the amount included in assessable income or allowing a deduction and the acquisition is only relevant for that purpose. Moreover Note 1(b) states the acquisition does not override the entry history rule other than those factors in section 701-56 (being the replacement of the cost and whether the joining entity had claimed a deduction).

The Explanatory Memorandum states at 5.13 and 14 (emphasis added):

> "The deemed acquisition in subsection 701-55(6) solely facilitates the application of a provision of the income tax law to the tax cost setting amount for the purposes of determining the amount included in assessable income or allowed as a deduction. In this regard, the deemed acquisition does not affect the operation of the entry history rule (section 701-5) where pre-joining time facts may be relevant in determining which provision of the income tax law is to apply to the tax cost setting amount of an asset.
>
> These facts may include, for example:
> - the original acquisition date of an asset;
> - whether an asset is held on revenue account or capital account; and
> - whether the tax cost setting amount for an asset that is a reset cost base asset has been reduced to the asset's market value or terminating value under section 705-40."

In our view the deemed acquisition in subsection 701-55(6) arguably provides a general context or setting for the tax cost setting amount, which should not impact the characterisation of the asset. Under the proposed "acquisition approach" characterisation of the asset should not be based on a notional whole of business acquisition of the joining entity.

Inherited history for receivables including bad debts

We are concerned by the Board's proposal that the pre-joining time history in respect of receivables held by a joining entity would be disregarded under an asset acquisition model.

The Board's paper notes that this may have adverse implications for bad debt deductions (paragraph 2.56) on the basis that any prior inclusion in assessable income would be disregarded for the purpose of applying section 25-35(1)(a).

However, we are concerned that if the modifications to the inherited history rule have that affect, this may have much broader potential application including:

- whether the consolidated group may be taxed on the gross receipt of reset trade receivables
- whether the right to future income rules (section 716-410) may apply to allow a deduction for a right in respect of previously taxed accrued income

We would recommend that consideration be given to retaining the inherited history regarding the inclusion of assessable income in respect of receivables. This may require a specific rule.

Characterisation of shares on exit

We understand the proposal is for the characterisation of intra-group membership interests in a leaving entity to be determined under existing principles (paragraph 2.58). We agree that membership interests would usually be held on capital account.

The alternative approach that would require characterisation of shares to be determined by reference to the character of each underlying asset of the leaving entity (as discussed in paragraphs 2.45 and 2.48) is not proposed to be adopted and we would agree with this approach.

Non-asset tax attributes for leaving entities

The Board has proposed that notwithstanding its more limited "asset acquisition" approach, non-asset tax attributes would **not** be transferred to the leaving entity (such as undeducted blackhole deductions, project pool deductions, borrowing costs etc). The justifications for this approach are exit ACA calculation simplification and consistency with the treatment of losses, franking credits and tax offsets (paragraph 2.59).

We are concerned that unless modifications are made, this proposal could result in forgone deductions future deductions, in circumstances where the critical elements for a deduction leave with the leaving entity. We would prefer the Board not proceed with this aspect of the proposal.

(d) Compliance costs

We are concerned that the proposed quite fundamental change in approach may impose a significant compliance burden on consolidated groups and their advisers. The tax cost setting rules have applied for nearly eight years, and have recently undergone significant refinement through various amendments contained in Tax laws Amendment (2010 Measures No 1) Act 2010. The Board's proposal will necessarily require consolidated groups and their advisers to learn a new set of rules, and potentially apply multiple approaches to assets held by the consolidated group (old tax cost setting vs new tax cost setting) in both an entry and exit scenario.

Tax asset registers and tax consolidation calculators and models would need to be modified to be able to appropriately implement an asset acquisition model. Tax asset registers would need to cater for a variety of different asset models applying to the tax consolidated group:

- Existing tax values for the head company's own assets and for any transitional chosen entities' assets
- Tax cost setting method for pre-commencement subsidiaries that were not transitional chosen entities; and
- Asset acquisition model for post-commencement subsidiaries
- Direct asset acquisitions

The proposed asset acquisition rules should only apply on a prospective basis, with effect once the relevant legislation is enacted. This would allow groups time to understand the rules, make system changes and also allow the rules to be reliably factored into acquisition and divestment deals.

Whilst we recognise that there are likely to be compliance costs associated with the proposal, apart from the modifications discussed above, we would seek to limit the use of options or shortcuts, which sometimes can contribute to complexity.

The proposals for small business corporate groups (considered in Chapter 5 of the Board's Position Paper) may alleviate any compliance issues for such groups.

Operation of the single entity rule

Position 3.1:

The Board considers that:

(a) the tax cost 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?

We understand that the Board's proposals for the treatment of intra-group assets **(excluding membership interests[2] and presumably debt interests[3])** in relation to joining and leaving entities are as follows:

- under the proposed "asset acquisition" model (considered above) intra-group assets would come to an end at the joining time for a payment equal to the tax cost setting amount of the asset (paragraph 2.53) but the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group;
- the entry history rule would be retained so that liabilities would be transferred to the group at the joining time based on their accounting value (query whether this would apply to intra-group liabilities);
- intra-group assets that emerge from the group would be taken to be created at the time they emerge (paragraph 2.56);
- when an entity leaves a consolidated group, the consolidated group would be taken to dispose of the membership interests held in the leaving entity.

[2] Paragraph 3.27 of the Board's paper outlines the tax costs of Intra-group assets.
interests (paragraph 3.9)

[3] Debt interests are identified as a separate category of intra-group asset in the Paper at paragraph 3.8. Although not expressly stated we have assumed that Chapter 3 also does not apply to intra-group debt interests.

Our comments in respect of Position 3.1 are based on an assumption that the proposals will not apply to intra-group assets that are debt interests. If this assumption is not correct then we would be pleased to provide the Board with our comments on the implications of the proposal in relation to debt interests.

Our comments in respect of the various questions raised by the Board are as follows:

a) Intra-group assets eligible for this proposal

-

We understand that the Board's proposed test for an eligible intra-group asset would cover situations where an undeducted "tax cost" arose for an intra-group asset (as outlined in paragraph 3.27) such as the following:

- direct acquisition of an asset that becomes an intra-group assets as a result of the acquisition of the asset from a third party during consolidation; and
- indirect acquisition of an intra-group asset which is brought into the group on formation or joining (and potentially reset in the hands of a joining subsidiary member).

Under either of those scenarios a tax cost would arise under existing provisions, such as the tax cost setting rules (ignoring the application of s.701-58) or under the operation of the relevant provision of the Act (e.g. Division 110 CGT cost base rules).

Generally, intra-group assets created whilst the relevant entities were members of the consolidated group do not currently generally give rise to tax cost under existing provisions and would therefore be outside the scope of this proposal, Third party incidental costs would generally be deductible under s.40-880. However, there should be an exception for the special category of intra-group assets that are severed from recognised assets during consolidation: these are considered in section (d) below.

The Board position is to then exclude from the scope of the proposal an intra-group asset that has a corresponding accounting liability which is recognised elsewhere in the consolidated group.

It is unclear as to how that proposed exclusion may apply. Presumably, this exclusion would require some form of income tax recognition of the corresponding accounting liability by the consolidated group, either before or around the time that the tax cost of the asset is to be recognised. As noted in the Board's paper (at paragraph 3.42) one form of potential recognition of the corresponding liability would be in the allocable cost amount (ACA) calculation of the other group member that holds the corresponding liability: specifically ACA Step 2 - if that entity was required to reset the tax cost of its assets. However, there will be various situations where asset tax cost setting does not apply when an entity becomes a member of a consolidated group, such as:

- a head company of a consolidated group
- an eligible tier-1 company of a MEC group
- a transitional foreign held subsidiary and
- chosen transitional entities.

This highlights that the identification of eligible intra-group assets will not be a straight forward exercise.

However, there is a more fundamental issue as to whether the tax treatment of intra-group assets should be based on the tax recognition of the corresponding liability which may differ not by reference to the type of asset/liability but by the status of the entity holding the corresponding liability.

It appears that the exclusion for intra-group assets with a tax recognised corresponding liability would apply even if the amount of the liability may change over time. This is desirable because otherwise complex liability tracking rules may need to be employed, such as those used in section 711-45(8) to deal with liabilities in a leaving entity in the exit ACA calculation that were also taken into account in the entry ACA calculation.

Recommendation:

- It is not clear to us why the eligibility for the recognition of an intra-group asset should differ depending on whether any corresponding accounting liability has been recognised for income tax purposes. We would prefer for this condition to be excluded.
- If there is to be an exclusion for intra-group assets with a tax-recognised corresponding liability, we expressly support the lack of any requirement to test subsequent events or changes in value of the liability; this is imperative to minimise compliance costs.

b)Recognition of intra-group asset tax cost on disposal or cessation

The Board's position is that the tax cost of an eligible intra-group asset should be recognised either when the consolidated group disposes of the asset or the asset lapses. The justification for this approach is a perceived adverse impact on revenue if the asset remains in the group indefinitely (paragraph 3.39).

Where the intra-group asset has a specified term, the tax cost of the asset should in our view be recognised over the term of the asset on a straight line basis: this would produce a better matching of the benefit of the asset and the recognition of the cost of the asset.

Where intra-group assets have an indefinite term, we submit that consideration could also be given to amortisation, rather than deferring recognition until disposal or lapse of the asset. Potential amortisation periods could be 5 years (based on the blackhole expenditure rule in s.40-880) or 10 years (based on the right to future income rules for contracts with no set term under section 716-405).

The position of eligible intra-group assets in respect of an indirect dealing is unclear. Where the intra-group asset leaves the consolidated group with a leaving entity, it appears to us that any undeducted tax cost should be recognised under exit ACA Step 3 and the tax cost of the asset for the leaving entity should be determined under section 701-45 and section 701-60 (table item 3)).

Recommendation:

- where the intra-group asset has a specified term, the tax cost of the asset should be recognised over the term of the asset on a straight line basis.
- for an indefinite term intra-group asset the tax cost of the asset should be amortised over 5/10 years.
- outcomes in respect of an indirect dealing with the intra-group asset should be confirmed.

c) What history, if any, is relevant for intra-group assets

If an asset acquisition model is adopted, and under that model intra-group assets that emerge from the group would be taken to be created at the time they emerge (paragraph 2.56), the Board's position is that the income tax history that an intra-group asset had prior to coming into the consolidated group would be irrelevant when it is subsequently disposed of or lapses (paragraph 3.43).

This then raises the issue of how the tax characterisation of the asset will be determined in respect of the intra-group asset. The Board's paper suggests that the capital/revenue treatment of any amount received on the disposal of the asset would be determined on the basis of the consolidated group's treatment of the asset (paragraph 3.43), in the context of a notional creation of the asset at that time. On that basis, taking into account our position in respect of the tax treatment of any costs associated with the asset discussed above, we would tend to agree that the income tax history that an intra-group asset had prior to coming into the consolidated group would be irrelevant when it is subsequently disposed of or lapses.

d) Treatment of intra-group assets severed from recognised assets during consolidation

As noted in section (a) above, a tax cost for the special category of intra-group assets that are severed from recognised assets during consolidation should be recognised under the Act.

If there is no recognition for the tax cost of such intra-group assets then inappropriate consequences might arise for the calculation of the exit ACA of the grantee of the asset. In relation to the sale / assignment of an intra-group asset by the subsidiary grantee of an asset to a non-group member, the operation of the single entity rule (SER) has consequences for the calculation of any balancing adjustment amount.

The deficiencies can be illustrated using the example of the granting of rights to use telecommunications infrastructure between group members. The granting of these rights is a common incident of the telecommunications industry, with the rights given recognition in the Act as depreciable assets (being Indefeasible Rights to Use (IRU) or Telecommunications Site Access Rights (TSAR)).

The Uniform Capital Allowances provisions contained in Division 40 provides (in section 40-115) that a single depreciating asset may be split into two or more assets. In that case, the holder is deemed to stop holding the original asset and start holding the two (or more) new assets. This applies where part of an asset is granted to a third party.

The application of this to IRUs and TSARs has given rise to some uncertainty (in part as a result of the removal of former Division 44 which specifically applied to the splitting of IRUs, which was repealed in the process of the introduction of the uniform capital allowance provisions). However, on the assumption that the asset splitting contemplated in Division 40 is taken to apply to IRUs and TSARs, it would operate as follows. The underlying asset, being the telecommunications system, would be deemed to have been "split" into two (or more) assets immediately before the grant of the rights. One asset will be that part of the telecommunications system that the grantor continues to hold and use; the other asset will be the IRU or TSAR that the grantee has acquired rights which provides it with rights to use the telecommunications system. The adjustable value of the original asset is then apportioned between the two new assets on a reasonable basis.

Under existing rules, there is a risk that the SER operates to disregard the intra-group transaction that would cause the splitting of the asset to be recognised during consolidation, with the result that the Division 40 asset splitting rules (sections 40-115 and 40-205) are not activated at that

time. Where such assets are held by a leaving entity, there is currently no mechanism to trigger the application of the Division 40 asset splitting rules at the leaving time, under the existing interpretation of the SER where such assets are taken to be pre-existing at the leaving time, rather than created at the leaving time (applying the principles in TD2004/34 and TD2004/35).

Recommendation:

- Division 40 could be amended to exclude the provisions relating to IRUs and TSARs from the SER. The effect would be to allow recognition of the tax cost of the asset at the time of grant, instead of at the time the subsidiary (or the asset) leaves the group. The granting of an IRU would result in two new assets being created, each being recognised as having a tax cost in the amount of the proportion of the value of the original single asset ascribed to it.
- Upon the subsidiary leaving the group, the terminating value for the IRU / TSAR is the amount of the proportion ascribed to it. The exit ACA for a subsidiary member of a consolidated group will include the value ascribed to the IRU / TSAR. The ACA will therefore be appropriately determined by recognising a split of the cost of the underlying asset over which the rights have been granted when that member (or the asset) exits the consolidated group.
- This 'splitting' treatment could be extended to other assets that can be split in a similar fashion. There seems no reasonable basis to restrict a consolidated group from being able to recognise two assets that would have otherwise been deemed to have been split by the relevant provision of the Act but for the operation of the SER.

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?

Position 3.2 relates to the situation involving an indirect disposal of intra-group assets held by a leaving entity. This is relevant for intra-group assets including debt interests but excluding membership interests.

We understand that the Board's position is effectively to amend exit ACA Step 3 (subsection 711-40(1)) so that it would apply to an intra-group asset (receivable) that has a liability owed by a member of the old group. The term 'liability' is not defined, which has created some uncertainty as to whether it applies to obligations of the leaving company. As well, the Government previously announced a proposal to limit the term to liabilities recognised in financial statements (accounting liabilities)

The proposal by the Board would mean that, when the asset leaves a consolidated group with a leaving entity, a corresponding liability or other similar obligation would be recognised more broadly than the existing subsection 711-40(1) and the Government announcement would not be implemented.

We support the Board's proposed approach, as there may be situations involving valuable intra-group assets where there is no corresponding accounting liability owed by members of the old group to the leaving entity (as noted in paragraph 3.47).

At paragraph 3.49 the Board notes that situations can arise where an amount is recognised under exit ACA Step 3, which could result in a gain not being recognised for tax purposes, "which would seem inappropriate". However no example is provided. It is difficult to comment on whether such outcomes may arise and the appropriateness of the outcome. We would welcome a worked example being provided to illustrate when such a situation could arise.

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?

We would generally agree that tax losses should not be recognised in respect of the direct or indirect disposal of assets, whose value has been reduced as a result of intra-group arrangements that place encumbrances on an asset, where a not incidental purpose of the arrangement was to create a tax loss or reduced gain on the disposal of the asset.

It would appear that a limited range of transactions may be of concern, and any proposed integrity measure should be specifically targeted and limited to such arrangements.

In respect of any indirect disposal of such an asset through a leaving entity, we query whether the existing loss integrity rules, specifically Subdivision 165-CD as modified by Subdivision 715-B, would suitably deal with such situations.

We caution against the application of the general value shifting rules to intra-group arrangements, as this would impose significant compliance burdens on consolidated groups, to address what would appear to be a relatively specific problem.

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

(c) Do stakeholders agree with Position 3.4? If not, why not?

(d) Are there circumstances where an exception should be made to the principles proposed in Position 3.4?

(e) Do stakeholders agree with the proposal to extending the single entity rule so that it applies to the dealings of a related third party with a consolidated group?

a) Extending the SER to certain third parties

We broadly support the proposal that the SER (together with other parts of the consolidation provisions) should be extended to third parties who are:

- shareholders of the head company of a consolidated group;
- liquidators appointed to the head company of a consolidated group; and
- a related third party with a consolidated group

on a case by case basis (in respect of specific provisions in the Act).

b) Potential approaches and exceptions to the principles

In our view a general rule to extend the single entity rule either to all third parties or to the three categories noted above is probably not warranted. Any extension of the SER should be implemented by specific rules relevant to the particular provisions concerned, in some central location in the Act for any such modifications: this could be in Division 701.

Consideration will need to be given to appropriately balance the information needs of third parties against the potential compliance burdens that may be imposed on consolidated groups, if information is to be required to be provided by the consolidated group.

Interaction between consolidation and other parts of the Act

Trust measures

Question 4.1

The Board considers that:

(f) 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

(g) 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?

The context of the proposals is where a fixed, discretionary or hybrid trust becomes a member, or ceases to be a member of a consolidated group during an income year.

The Position paper quite correctly observes that there are number of other trust tax reform developments that need to be taken into account in respect of proposed amendments in respect of tax consolidation interactions. We support the Board's proposed approach to attempt to use the existing framework to deal with the interaction issues (to deal with historical and current issues). However, interaction issues will need to be reviewed in respect of any further trust tax reforms, that is, the Boards approach may be an interim solution.

Recommendation:

- We support an approach that would allow for the allocation of an overall trust law income position (and net income position) between membership and non-membership periods, based on reasonable allocations of income, gains, expenses and losses to membership and non-membership periods.

- However, the proposed rules would need to recognise that in circumstances where any income or gains derived in a non-membership period are then eroded by expenses or deductions during a membership period, income tax should only be levied on the net overall position for the income year, **unless a beneficiary has actually received an income allocation referable to the non-membership period.**

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- We would support these proposed reforms applying from the date of the original announcement on 8 May 2007.

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?

The Board's example at paragraph 4.16 deals with a relatively straight forward situation of trust income being derived both in the non-membership period and the membership period: the issue in the example being different outcomes arising from a pro-rata allocation compared with specific allocation to the relevant periods. As noted above, the more challenging situation is one where losses may exist in one of the relevant periods.

Recommendation:

- The proposed rules should allow a trust the flexibility to choose which approach is most appropriate for the particular circumstances.

- In relation to the Board's comment on compliance impacts (paragraph 4.18), the proposed amendments could empower the trustee of the trust to make the relevant determination, which would then bind each beneficiary.

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?

This Position is relevant to the extent that Positions 4.1 and 4.2 are not adopted, or if adopted, may nonetheless result in the consolidated group bearing a tax liability referable to a non-membership period. Hence this proposal is expected to have limited residual application only.

We support the Position that a consolidated 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 for the joining trust.

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

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

We acknowledge the technical issues raised regarding the application of the entry tax cost setting rules to the assets of a joining trust that are legally owned by the trustee, if the trustee is not also an actual member of the consolidated group.

Recommendation:

- Any deemed membership for the trustee of a trust, in its capacity as trustee only, (where the trust is a member of the consolidated group) should be for all purposes of the Act. That deemed membership should apply for the purposes of any trustee assessment under section 99 or 99A of the Income Tax Assessment Act 1936 referable to a membership period. The practical effect of such a deeming would be that the head company of the consolidated group would assume the tax responsibilities (any tax liability and any tax administration responsibilities) of the trustee, through the application of the single entity rule.

- For the avoidance of doubt, any change in the identity of the trustee should not cause the trust to join or leave the consolidated group.

- We see merit in the deemed membership of the trustee extending beyond the leaving time of the trust, to ensure that any tax liability and any tax administration responsibilities of the trustee, referable to the membership period, can continue to be dealt with by the head company of the consolidated group.

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?

Under the existing membership rules, an entity is not taken to be a member of another entity just because the entity holds one or more interests or rights relating to the other entity that are debt interests (section 960-130).

We suggest that further consultation is required to clarify the potential scope of this Position, including whether the proposal should extend to entities other than trusts.

Position 4.6

The Board considers that:

- foreign hybrids should be eligible to become members of a consolidated group; and
- 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?

Foreign hybrids

In our view the tax consolidation provisions as currently drafted allow an entity that is a foreign hybrid pursuant to section 830-5, should be eligible to become a subsidiary member of a tax consolidated group provided that the entity is a wholly-owned subsidiary of the head company. This is on the basis that an entity that is a foreign hybrid is treated as a partnership for the purposes of the taxation law (subdivision 830-B) and the only eligibility requirement for a partnership to become a subsidiary member is that it be a wholly-owned subsidiary of the head company (section 703-15(2) item 2). We note that this view seems to be supported by the Commissioner of Taxation (refer ATO Interpretative Decision ATO ID 2009/149, which concluded that a US LLC was eligible to be a subsidiary member of a tax consolidated group).

While we believe the current law deals with this situation, we support a proposed amendment for the avoidance of doubt, to confirm that a foreign hybrid within the scope of section 830-5 is eligible to become a member of a consolidated group, and should be treated on a consistent basis as a partnership for Australian tax purposes.

Division 855 tax consolidation interactions

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 are concerned that this proposal may itself give rise to distortions and anomalous outcomes. For example, in circumstances where the assets of the leaving Eligible Tier One company are predominantly taxable Australian property assets, but the assets of the broader MEC group are not,

then the proposed rule may result in Division 855 not applying to a transaction where it clearly should.

Recommendation:

- We do not support a "one-way" integrity rule that would only expand the reach of Division 855, for example, integrity rule is triggered if the combined interests in each eligible tier one company in a MEC group would be taxable Australian property.
- This proposal has significant implications for existing foreign wholly owned group structures. Consequently, careful consideration will need to be given to developing appropriate transitional rules. It will not be sufficient for these rules to simply have prospective operation only.
- For existing foreign wholly owned groups, they should have the option of making, revoking or altering MEC group elections as a consequence of this proposal.

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 understand that this proposal is targeting restructures of foreign wholly-owned groups, whereby, Australian subsidiaries are acquired by a consolidated group or MEC group and the tax cost of assets held by those joining entities are otherwise reset (where the general anti-avoidance rule does not apply).

We understand that under this proposal, the tax cost setting rules will not apply, and the existing tax value of assets held by the joining entity/ies would be recognised by the acquiring consolidated group/MEC group.

An alternative approach would be to recognise the transferor's cost base, for the purpose of applying the tax cost setting rules. However, there are various integrity concerns and compliance burdens which would work against such an approach.

Recommendation:

- any integrity rule should be limited to joining entities where there is no change in the underlying beneficial ownership (restructure of wholly owned group).
- any integrity rule should be carefully constructed so that it does not apply in circumstances where Division 855 may otherwise have limited application. For example, if a joining entity was minority owned by a non-resident where Division 855 would apply, it would be inappropriate for this proposal to deny the tax cost setting rules applying. In such a case the integrity rule should not apply. We would not support a partial application of the integrity rule.

- the tax cost of the membership interests of the acquired entity should be quarantined and recognised in the event that the entity leaves the group.
- this proposal should only apply on a prospective basis.

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?

This has been a long outstanding issue for MEC groups. We support this proposal.

In respect of eligible tier-1 companies that leave a MEC group, please refer to our comments on Position 4.10 below.

Recommendation:

- Consideration should be given to allowing this proposal to apply on a retrospective basis.

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

- Do stakeholders agree with Position 4.10? If not, why not?
- What changes can be made to ensure deferred capital gains and losses are not taxed twice when an eligible tier-1 company leaves a consolidated group with assets that were rolled over?

We support the Position that appropriate measures should be considered to mitigate any double taxation that 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.

Recommendation:

- The pooling rules should be amended to factor in any capital gain that may arise under CGT event J1
- To the extent that Division 711 applies to the leaving eligible tier-1 company (where membership interests are held by other members of the MEC group), then any CGT event J1 capital gain should be reduced on a proportionate basis.
- These amendments should also apply to Subdivision 126-B rollovers that occur while the eligible tier-1 company was a member of the MEC group (that is, post joining time rollovers)
-

Position 4.11

The Board considers that:

- CGT event J1 should apply to rolled over membership interests when a non-resident owner disposes of its interests in the head company; and
- further work is needed to determine how the cost base of these membership interests in the subsidiary member should be calculated.

Question 4.11

- Do stakeholders agree with Position 4.11? If not, why not?
- How should the cost base of the membership interests in the subsidiary member of the consolidated group be determined?
- 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?

In the event that CGT event J1 applies to the (target) head company of a consolidated group in respect of rolled over membership interests in subsidiary members of the consolidated group, then we agree that appropriate compensating adjustments will be required, in circumstances where the tax cost of the assets of the target company are not reset following the divestment.

In circumstances where the target consolidated group is acquired by another consolidated group where Subdivision 705-C applies, and Subdivision 126-B rollover does not apply in relation to that transaction, then it would appear that the ordinary operation of the tax cost setting rules should provide appropriate outcomes in respect of the tax cost of assets for the target consolidated group (any tax liability arising from a CGT event J1 capital gain should be reflected in entry ACA Step 2).

In other cases, compensating adjustments for the target consolidated group would be required. We agree that further consultation is required to determine appropriate adjustments.

Question 4.12

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

- a time limit applied 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?

We would strongly support the reforms to CGT event J1 suggested by the Board. Each of the suggested reforms have merit, and such reforms are long overdue.

Recommendation:

- a time limit should be applied to CGT event J1. A possible approach would be to align the proposed time limit for CGT event L5 with the time limits that apply for stamp duty corporate reconstruction relief claw back (generally 3 years).
- minority interest divestments should be either exempted from the application of CGT event J1 , or CGT event J1 should only apply on a pro-rata basis. There is also merit in having a corresponding approach applied to CGT event L5 (when a subsidiary member leaves a consolidated group).
- the sub-group break-up exemption should be applied where less than 100 per cent of the interests in the sub-group is disposed of to non-group entities.

Tax Treaties and tax consolidation

Position 4.12

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 4.12? If not, why not?

We would support a broad ranging review of how Australia's double tax agreements apply to a consolidated group. This review should not be limited to the ATO and Treasury, so as to allow external stakeholders to provide relevant input.

Deferred tax balances and tax consolidation

Question 4.14

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?
- How can the tax treatment of deferred tax assets and deferred tax liabilities be simplified?
- Should deferred taxes assets and deferred tax liabilities be removed from the tax cost setting process?
- If not, in what circumstances should deferred tax assets and liabilities be recognised in the tax cost setting process?

We would support the Board further considering the treatment of deferred tax assets and liabilities as part of the entry and exit tax cost setting process.

Small business corporate groups

Position 5.1

The Board considers that on-going formation concessions should be available 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

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

(i) 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?

We strongly support the Board's position to provide permanent formation concessions to smaller eligible consolidatable groups. As we have outlined to the Board, small business consolidation formations arise in two scenarios:

a) A significant 'catch up' of smaller consolidated groups that were unable to enter into tax consolidation at its inception because governments had not rectified the inequitable features of the treatment of pre-capital-gains-tax assets until 2010. Such groups, denied entry into consolidation for 8 years previous, find no compliance concessions and as a result face significant costs to enter consolidation, and

b) With Australia's continued development, there is an ongoing supply of emerging corporate groups which have commenced or developed into potentially consolidatable groups, the likely perpetual supply of emerging businesses, which again have no simplified transitional mechanisms and must face significant compliance costs in a complex entry.

Transitional concessions are equitable and represent good policy to cover such situations.

We do not agree, however, with the position to deny the concessions to foreign owned corporate groups that elect to form MEC groups. Would the concessions apply if a foreign owned group chose to form a consolidated group? If the MEC rules are adjusted as contemplated in the Board of Taxation position paper, this should address concerns about integrity. In the light of those proposed MEC changes, we suggest that the proposed asset and turnover tests applied on a whole of group basis would be a sufficient determinant of merit and eligibility.

Each of the proposed concessions should be available on a whole of group basis.

The proposed removal of the 'entity by entity' elections for eligible wholly owned groups, in respect of both the treatment of assets and the treatment of losses, is less than optimal in situations where there is a group might have some acquired potential joining entities acquired for a price well in excess of the book value of their assets (and where those acquired entities would be potential candidates for 'push down' or 'spread' consolidation calculations).

We think that such outcomes might occur in more dynamic smaller groups which have made acquisitions.

We suggest the Board should consider whether there are any significant revenue impediments to offering a 12 month entity by entity option to smaller groups entering consolidation.

Without such an entity by entity option there will still be volatile or problematical outcomes for some smaller consolidating groups. Nevertheless, the Board's proposal may still be attractive for many eligible consolidating groups.

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 time. The concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

Question 5.2

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

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

We support the Board's position to provide a transitional formation concessions to all consolidatable groups (not subject to a turnover test or asset test).

We do not have a preferred set time period for such a transitional rule, but a 24 month election period after the date of enactment may be sufficient.