Tax Consolidation - Outstanding Issues as at 4 March 2010

Number	Issue	Comments
1	Treatment of Deferred Tax Liabilities (DTLs) in the Allocable Cost Amount (ACA) and tax cost setting process	The treatment of Deferred Tax Assets (DTAs) and Deferred Tax Liabilities (DTLs) in allocable cost amount (ACA) calculations is uncertain. For example, existing DTAs/DTLs are required to form part of the entry ACA calculation. These DTAs and DTLs may change as a result of the resetting of the tax cost of the assets of a joining entity. Currently, multiple iterations of the entry ACA calculation are required to ensure the correct DTA/DTL balance on entry is being recognised. We note that this process involves compliance costs and may not produce appropriate outcomes. Further, there is a requirement for the ACA calculated on the exit of a subsidiary member to be reduced by the amount of any DTL. In many instances, the amount of the DTL in the accounts of the subsidiary entity may not be reflected as a reduction in the price paid for the leaving entity (e.g. where the acquirer is a tax consolidated group). In these circumstances, this reduction of the ACA may result in effective double taxation of any gains on disposal.
2	Applicability of the Single Entity Rule (SER) to dealings with third parties	The extent to which third parties may have regard to the SER when dealing with entities that are members of a tax consolidated group is unclear. This creates considerable uncertainty and can result in inequitable outcomes. For example, it is unclear whether shareholders in the head company of a tax consolidated group should have regard to the SER in determining whether CGT event K6 happens, or whether they are eligible for the capital gains tax (CGT) discount, on disposal of their shares. - In determining whether shareholders in certain closely held companies are eligible for the CGT discount, it may be necessary for the shareholder to look through to the CGT assets of the company and determine whether the shareholder would be eligible for the CGT discount if the shareholder had held and disposed of the CGT assets of the company directly. In making this determination, it is currently unclear whether the shareholder should have regard only to the CGT assets of the head company itself or, due to the SER, not only to the CGT assets of the head company but also to the CGT assets of subsidiary members of the consolidated group that the head company is deemed to hold for tax purposes due to the SER. - CGT event K6 may occur in relation to shares in a company acquired prior to 20 September 1985 (such that the disposal/cancellation etc of the shares should, prima facie, not give rise to any CGT consequences) where, at the time the shares are disposed of/cancelled etc, the market value of property of the company that was acquired on or after 20 September 1985 is at least 75% of the net value of the company. If the SER does not apply, the shareholder in the head company should consider the assets held by the head company in its individual capacity in order to determine whether CGT event K6 has occurred. However, if the SER should apply, the shareholder must have regard not only to the assets of the head company but also to the assets of subsidiary members of the group that the head company is deemed to hold for tax purposes due to the SER.
3	SER and intra-group assets/liabilities	Clarification of the treatment of intra-group assets/liabilities that join and leave a tax consolidated group is required (for example, where there is a loan between two subsidiary members of the tax consolidated group, and the loan receivable is transferred to a third party). The reason this issue is problematic is that the ATO has issued guidance which provides a different outcome for debt instruments from all other types of intra-group assets (rights, options, leases etc). Furthermore, anomalous outcomes can arise where an asset is acquired and becomes an intra-group assets and subsequently is disposed of by the group (namely, the cost of acquisition may not be recognised for income tax purposes either at the time of acquisition or when the asset is subsequently disposed of).

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4	Potential application of Subdivision 705-C where a non-consolidated Australian resident company acquires a consolidated group	There is an issue in relation to whether Subdivision 705-C will apply where a single entity (a non-consolidated Australian resident company) acquires all the membership interests in the head company of a tax consolidated group. If Subdivision 705-C applies, then no exit ACA calculations would be required (i.e. there is not taken to be a deconsolidation of the acquired group) and formation ACA calculations may be performed as if the original tax consolidated group remained a consolidated group. In the event that Subdivision 705-C does not apply, exit ACA calculations must be performed in relation to the acquired group (potential immediate capital gain under CGT event L5) and then entry ACA calculations must be performed for each member of the acquired consolidated group (which can produce a different result to the calculation performed on a consolidated basis). In ATOID 2009/160 and in ATOID 2010/4, the ATO indicates that where a single entity, that is not a member of a tax consolidated group, acquires all of the membership interests in the head company of a tax consolidated group and immediately makes a choice to form a consolidated group, Subdivision 705-C has no application. The problematic outcomes include: - additional compliance costs; - potential capital gains on deconsolidation under CGT event L5; and - potentially different entry tax cost setting outcomes to those that can be achieved if Subdivision 705-C applies. There are also issues which require guidance, for example, whether Subdivision 705-C applies to a number of other scenarios such as special conversion events, where a consolidated group joins another consolidated group as a result of factors that do not involved the acquisition of shares (such as a conversion of an interposed entity to an Australian resident company and the buy-back of minority interests in a head company not owned by members of the acquiring group).
5	Treatment of Earnout Arrangements and Tax Consolidation	This issue is relevant to a consolidated group that acquires shares in a subsidiary member under an earnout arrangement. There is uncertainty in relation to earnout arrangements and how these are to be treated for the purposes of Step 1 of an entry ACA calculation. Currently, the ATO has indicated in TD 2007/D10 that the market value of earnout rights granted by a purchaser can be taken into account in Step 1 of the entry ACA process, but any actual payments in excess of that value are disregarded and appear to be otherwise unable to be taken into account for tax purposes. This may produce inequitable outcomes where the market value of the earnout right as determined at the joining date is lower that the amount that is ultimately required to be paid (as this excess may effectively be lost).
6	Interaction between the trust tax rules in Division 6 of the 1936 Act and Tax Consolidation	The tax treatment of beneficiaries' interests in trusts that join a tax consolidated group is uncertain. Where a trust becomes a subsidiary member of a tax consolidated group part way through an income year, there is no clear mechanism to establish that the consolidated group should only include in its taxable income that portion of the net income of the trust that corresponds to the part of the income year for which the trust was a subsidiary member. Consequently, there is potential for the consolidated group to be taxed on the entire net income of the trust for the relevant year of income.
7	Acquisition of entities holding depreciating assets originally acquired post-9 May 2006	On the basis of the law as presently enacted, a consolidated group is deemed to acquire the assets of a subsidiary member on the date the subsidiary member joins the tax consolidated group. Accordingly, where an entity holding depreciating assets becomes a member of a tax consolidated group subsequent to 9 May 2006, the consolidated group may be entitled to depreciate the relevant assets on the basis of the accelerated 200% rate under the diminishing value method of determining tax depreciation applicable to assets acquired subsequent to 9 May 2006. The Government has proposed to amend the law such that consolidated groups will only be entitled to access the above concession where the asset was originally acquired by the subsidiary member joining the consolidated group on or before 9 May. One of the aims of the consolidations regime was to remove inequality of tax treatment between the acquisition of an entity and the direct acquisition of assets. The introduction of this proposed amendment is inconsistent with this aim because it will result in a different outcome where depreciating assets are acquired directly (in which case the accelerated rate of diminishing value depreciation should be available) and where the entity holding the depreciating assets is acquired (in which case any entitlement will depend on the original date that the assets were acquired by that entity). We would like the rules in this area to be clarified

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8	Impact of the decision handed down in *MW McIntosh Pty Ltd & Anor v FC of T [2009] FCAFC 88 (McIntosh)*	The Full Federal Court ruled in *McIntosh* that *section 388-55 of the Taxation Administration Act* 1953 (the Admin Act) does not operate to allow the ATO to extend the due date for lodgement of the notification required by section 703-50 (i.e. the notification of formation of a consolidated group) beyond the lodgement date for the prospective head company's income tax return (as opposed to the date the return was actually lodged). There are certain amendments contained in Tax laws Amendment (2010 Measures No 1) Bill 2010, that impact the way that certain tax consolidation elections operate. These amendments may remedy some of the issues arising from the McIntosh case. However, there is the residual issue that the ATO still does not have a general power to specifically extend the time for making such elections.
9	Treatment of intra-group assets held by a subsidiary that leaves a consolidated group	It is unclear what amount should be recognised by a leaving subsidiary in respect of intra-group assets that it holds in step 3 of the exit ACA process, in particular, whether the intra-group asset is required to be recognised as an accounting liability in the hands of the other group member.
10	MEC group restructuring issues	The MEC group rules allow two or more "eligible tier 1" (ET1) companies - i.e. Australian resident companies that are owned by a non-resident group company (that is a top company or a wholly owned subsidiary thereof) - to consolidate for income tax purposes (along with all of their wholly owned Australian resident subsidiary entities). Where the ownership of a subsidiary of an ET1 company is transferred up to a non-resident group company, it is unclear whether the company will be deemed to leave, and potentially rejoin, the MEC group. Further, where an ET1 company becomes wholly owned by another member of the MEC group (i.e. it is "transferred down" from the top company and becomes a subsidiary of another ET1) it is unclear whether the entity will be deemed to exit and rejoin the MEC Group. The ATO issued two discussion papers on the above issues in 2006. The position adopted in both papers was that in both cases there was no exit or entry for the relevant subsidiary member (that is, the entity would be treated as a continuing member of the MEC group). In a transfer-down case, some groups may be disadvantaged by the non-application of the tax cost setting rules on entry . In a transfer-up case, the non-application of the exit tax cost setting rules can result in no cost base being recognised in respect of the shares in the relevant subsidiary member, with the result that the MEC group is fully taxed on the value of the shares in the subsidiary member it has disposed of. Certain MEC restructuring related amendments are contained in Tax Laws Amendment (2010 Measures No 1) Bill 2010, that impact a "transfer up" scenario which occurs in the context of a special conversion event. Under the proposed amendments such a "transfer up" will be recognised as an exit and entry case for the relevant subsidiary. However, the amendments do not deal with the "transfer up" scenario for an existing MEC group.
11	Treatment of incidental costs associated with the acquisition or divestment of a subsidiary member of a consolidated group	Where incidental costs are incurred in connection with the disposal of a subsidiary member, it is unclear whether these costs should be recognised as part of the CGT cost base of the shares in the subsidiary, or whether a blackhole deduction should be available under section 40-880 of the 1997 Act pursuant to which the consolidated group may deduct the relevant costs over a five year period. This uncertainty arises because, due to the current operation of the single entity rule, the asset that is disposed of (i.e. the shares in the subsidiary member) are disregarded until the subsidiary member leaves the tax consolidated group. In order to provide certainty, and to ensure that expenditure incurred in the above scenario is appropriately taken into account for tax purposes, further guidance should be provided in relation to incidental costs incurred in connection with the acquisition or disposal of subsidiary members of a tax consolidated group. The ATO has not provided comprehensive advice on acquisition and divestment scenarios. The ATO recently issued TD 2010/1 in which it determined that incidental costs incurred in respect of the divestment of a subsidiary member incurred before the leaving time are not included in the CGT cost base of the shares in the subsidiary but a s.40-880 deduction may be available. TD 2010/1 is silent in respect of costs incurred after the leaving time and the treatment of similar costs in an acquisition scenario.

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12	Commercial debt forgiveness (CDF) within a consolidated group and impacts on related entities outside the tax consolidated group	The extent to which the SER should be recognised by related entities outside the tax consolidated group in applying the commercial debt forgiveness (CDF) rules is unclear. While the forgiveness of a debt occurring between two members of a tax consolidated group should be disregarded under the SER, it appears that related parties of the debtor (that do not form part of the tax consolidated group) may have to recognise the forgiveness of the debt in applying the CDF related party rules (with potentially adverse outcomes). Draft legislation in respect of the proposed rewrite of the CDF rules released in 2009 indicates that the CDF grouping rules may be repealed, which if enacted, should remedy this issue but may not act retrospectively. The CDF rules apply to recognise the benefit obtained by a debtor in being released from its obligation to repay a debt by making adjustments to its tax attributes and, if it has insufficient tax attributes, the tax attributes of related entities. Arguably, a tax consolidated group would not obtain any benefit from a debt forgiveness in relation to a debt between two members of the consolidated group given the creditor is also part of the same tax consolidated group and is unable to reognise the tax loss/net capital loss arising from the forgiveness. As such, any impact on the tax attributes of related parties would be inappropriate. As a result, it would seem inappropriate for these proposed amendments not to apply retrospectively.
13	No cost base for service receivables held by a subsidiary when it leaves a consolidated group for the purpose of exit ACA Step 1	No cost base arises for an asset that is a receivable that arose from the provision of services (notwithstanding that those services may have been included in assessable income). Consequently, the tax value of assets under exit ACA Step 1 may be understated, and a gain ultimately realised due to this understatement. This may result in inappropriate double taxation.
14	Changes to the treatment of non-membership equity interests under tax cost setting rules - not previously announced, have an unfair commencement date.	Part 20 contains amendments that impact the treatment of non-membership equity interests issued by an entity that joins or leaves a consolidated group under the tax cost setting rules. These amendments were not previously announced, unlike most of the tax consolidation amendments in the Bill, and the immediate application may operates unfairly, particularly for widely held listed entities. This is an inappropriate commencement date and is a dangerous precedent for the application of tax consolidation amendments for any widely held or listed group and inconsistent with the manner in which amendments were made to the treatment of the scrip for scrip takeover rules. The proposed amendments to the treatment of non-membership equity interests that will apply from the date of its introduction into Parliament (10 February 2010), unless groups elect to apply the amendments from 1 July 2002 (refer clause 220 of the Bill). The proposed amendments may significantly disadvantage groups currently undertaking either an acquisition or a divestment of an entity with non-membership equity interests, where such arrangements were commenced before the date of introduction. The previously unannounced law could also disrupt some existing or committed funding arrangements where the consequential impacts of the proposed law change give rise to previously unanticipated tax costs. This may result in some funding arrangements becoming uneconomic. A similar problem arose when the previous Federal Government announced significant changes to the scrip for scrip rollover rules without prior consultation with effect from 12 October 2007. The current Government made a number of welcome changes to the to the scrip for scrip rollover changes including an effective exclusion for scrip takeovers that were sufficiently commenced prior to 13 May 2008, the date of the Government's final announcement in respect of the then proposed scrip rollover changes (see s.124-784A of the Income Tax Assessment Act 1997). The law protected an off market bid where the bidder lodged, with the Australian Securities and Investments Commission, a notice stating that the bidder's statement and offer document has been sent to the target, and an on-market bid where the bidder announced the bid to the relevant financial market (under step 2 in the table in subsection 635(1) of the Corporations Act 2001) after the specified time. The focus is thus on public announcement. The proposed amendments to the treatment of non-membership equity interests should not apply to arrangements that were in existence or sufficiently committed to before the date of Royal Assent of Tax Laws Amendment (2010 Measures No 1) Bill 2010 which should be allowed to run their course without the proposed amendments applying to them. The Government and Treasury should ensure that further measures, whether intended as design or integrity measures, do not prejudice listed and widely held entities, which have entered into commercial binding arrangements, by changing the law without notice and adequate consultation.