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7 December 2010

Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Email: taxboard@treasury.gov.au

Dear Sir/Madam

Post‑implementation review into certain aspects of the consolidation regime
Submission on October 2010 Position Paper

We welcome the opportunity to provide comments on the Board's position paper on the post‑implementation review into certain aspects of the consolidation regime.

Pitcher Partners comprises five independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is servicing and advising smaller public companies, large family businesses, small to medium enterprises and high wealth individuals (which we refer to as the "middle market" in this submission).

General comments

The review being undertaken by the Board is a once in a lifetime opportunity to address issues with the tax consolidation regime for taxpayers in the middle market.

In general, there are a number of positive positions contained in the Board's position paper. In relation to the majority of these positions, we have expressed our support for these positions contained in the position paper.

The attached document sets out our 31 recommendations in relation to Board's position paper. We highlight that each and every one of these recommendations is important for the middle market, to ensure that the tax consolidation provisions are both fair and reasonable when applied by those taxpayers in the middle market. Many of these recommendations could easily be catered for by making slight modifications to the positions contained in the Board's position paper.

However, in saying that, we would like to express our concern that we do not believe that the Board has appropriately addressed issues relating to the significant barriers to entry faced by taxpayers in the middle market. We highlight that the middle market would be somewhat disappointed if Position 5.1 was the one and only solution being proposed by the Board.

Given the nature of the review being conducted by the Board, there will likely be little opportunity in the future to revisit some of these issues. Accordingly, it is critical that the important issues identified by this submission are considered by the Board in its final position paper and final recommendations to Government.

Specific comments

We note that Position 5.1 addresses two very important formation issues. Accordingly, we provide our support for this position and recommend that this be fast tracked to Government ahead of the remaining positions in the Board's paper.

However, these two issues are only but a small part of a larger package of concerns with the tax consolidation provisions for non-consolidated groups in the middle market. Non-consolidated groups within this market space are unlikely to form a tax consolidated group unless some of these other residual concerns are also addressed as a complete package.

It is critical, therefore, that the Board recommends fundamental changes to correct interaction issues that are currently experienced between the rollover provisions and the tax consolidation provisions for privately owned groups in the middle market.

Furthermore, in our view, the Board must consider proposing amendments to the acquisition model to more appropriately deal with majority owned entities that subsequently form part of the tax consolidated group. This includes retaining an entry history model for certain assets (e.g. pre-CGT assets) and providing an alternative reset model with reduced compliance costs in such cases (as outlined in detail in this submission).

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We would welcome the opportunity to meet with you and discuss our recommendations contained in this submission in further detail. Should you have any queries, please contact Alexis Kokkinos on (03) 8610 5170 or Chris Birchall on (03) 8610 5586.

Yours sincerely

A M KOKKINOS
Executive Director

Attach:

Contents

1 GLOSSARY OF TERMS

Key Term	Description
1936 Act	*Income Tax Assessment Act 1936* (Cth)
1997 Act	*Income Tax Assessment Act 1997* (Cth)
ACA	Allocable cost amount
APFC	A Platform for Consultation
Board	Board of Taxation
Board position paper	The Board's Position Paper on the "Post-implementation review into certain aspects of the consolidation regime", dated October 2010
RBT	Review of Business Taxation
TCSA	Tax cost setting amount
Transitional Act	*Income Tax Assessment (Transitional Provisions) Act 1997* (Cth)

2 SUMMARY OF RECOMMENDATIONS

Recommendation 1

2.1.1 We request that the Board consider fast tracking a number of its positions to the Government. We believe that the Government could adopt the positions contained in Chapter 5 ahead of considering any other positions contained in the Board's report.

Recommendation 2

2.1.2 We request that the Board consider recommending a start date of 1 July 2010 for the concessions related to privately owned groups, in particular Position 5.1.

Recommendation 3

2.1.3 We request that the Board provide its view on Recommendation 15.6 of the RBT report in its final position paper to the Government. We highlight that Recommendation 15.6(a) and (b) can be implemented independently of each other. As these two recommendations have been lingering for 11 years, we believe the Board either needs to accept these recommendations or outline that these recommendations should not be considered any further. We do not believe it is appropriate to perform a review of the consolidation provisions for SME groups and leave these recommendations outstanding after such a period of time.

Recommendation 4

2.1.4 We fully support Recommendation 15.6(a) of the RBT report that would allow a family owned group to be taxed as a single entity. The family owned group would be determined by way of a family trust election, which carries with it significant integrity provisions. Furthermore, if there were multiple entities at the top level (i.e. more than one trust), the group would have a choice of head company or instead could form a MEC type group.

Recommendation 5

2.1.5 We fully support Recommendation 15.6(b) of the RBT report that would allow privately owned family groups an ability to properly restructure or apply rollover provisions. We refer to Recommendation 24, Recommendation 25, and Recommendation 26 that provide specific recommendations on the existing interaction issues that are currently encountered by SME groups with the rollover provisions. We highlight that these issues can be addressed independently of our Recommendation 4 above. We note that, in our view, it is critical for the Board to at least address these interaction issues.

Recommendation 6

2.1.6 As with our submission on Division 230, we do not support the definition of a SME entity as contained in section 230-455. The provisions require annual market valuations, which are contrary to the purpose of Position 5.1. As outlined in the RBT report, consolidation concessions should be targeted at "privately owned groups". Accordingly, we consider that a simple definition of a private group or a closely held group (e.g. similar to Division 7 of the 1936 Act) would be far more appropriate.

Recommendation 7

2.1.7 Should Recommendation 6 not be accepted, we submit that consideration should be given to adopting a simple annual turnover test (in line with the test used by the ATO in the relevant income year) for determining eligibility for on-going formation concessions.

Recommendation 8

2.1.8 It is critical that the Board adjusts its "acquisition model" to more appropriately deal with majority owned entities that subsequently join the tax consolidated group. In particular we refer to Recommendation 19 and Recommendation 20 of this submission for further specific details.

Recommendation 9

2.1.9 In our view, privately owned groups that have yet to consolidate are not as complex as those that originally formed consolidated groups in 2003. In many cases, a stick or spread option on an entity by entity basis is the only way to ensure an appropriate ACA result. Accordingly, we believe it is critical to allow such a choice to be made on an entity by entity basis on formation of the group.

Recommendation 10

2.1.10 While we strongly recommend that the Board consider our Recommendation 9 outlined above, if this is not accepted, we believe it is critical that a choice be given for non-majority owned subsidiary entities that were acquired within five years of the formation of a consolidated group.

Recommendation 11

2.1.11 We request that the Board accept that the stick and loss concessions can be made by taxpayers independently of each other.

Recommendation 12

2.1.12 We highlight that the transitional three year loss rule required losses to be incurred before 21 September 1999 ("the eligible time). We request that the Board ensure that an eligible time period is not recommended in the proposed loss concessions in Position 5.1. Furthermore, we believe it is critical to extend some form of available fraction concession for all types of losses transferred to the head company of an SME group, as compared to a requirement to value all entities. The available fraction calculation and requirement to value each entity creates a real impediment and barrier to entry for SME groups. Accordingly, a concessional available fraction calculation should also be available for SBT losses on formation and COT and SBT losses on subsequent acquisitions.

Recommendation 13

2.1.13 We request that the Board consider a recommendation to re-write and simplify the interaction of the loss integrity provisions for SME groups. Furthermore, the current exception for SME groups (i.e. groups with net assets under $6 million) is clearly not sufficient and needs to be reconsidered. It is noted that these provisions will likely apply if Position 5.1 is adopted.

Recommendation 14

2.1.14 We request that the Board consider a stick option for future acquisitions made by appropriate sized SME groups. We believe that this would significantly reduce ongoing compliance costs and would not result in integrity issues (given the current exceptions in Subdivision 165-CC and CD for SME groups).

Recommendation 15

2.1.15 While large public groups are provided various stick options on entity rollovers into a tax consolidated group (i.e. where the entity is commonly owned), no such options are provided for closely held groups. As identified by Recommendation 15.6(b) of the RBT report, fixing this issue is critical to ensuring that SME groups enter the tax consolidation regime. Please refer to Recommendation 24, Recommendation 25, and Recommendation 26 of this submission for our specific recommendations.

Recommendation 16

2.1.16 We recommend that the 12 month period in Position 5.2 be extended to 24 months, to allow appropriate time to consider all of the ramifications of entering into the tax consolidation regime.

Recommendation 17

2.1.17 We do not support the exclusion from Position 5.1 and 5.2 for foreign owned or MEC groups. There is no clear policy reason stated for this exception, especially where the group meets the relevant SME thresholds.

Recommendation 18

2.1.18 Subject to Recommendation 19 and Recommendation 20, we (in principal) support the proposition to move to an asset acquisition model. This is on the proviso that the Board recommends that certainty be provided by the Government on the treatment of "acquired profits" that are not part of the goodwill of the business acquired.

Recommendation 19

2.1.19 There must be exceptions to the asset acquisition model for certain assets held by a majority owned entity, where that entity subsequently joins a tax consolidated group. Due to the implications this modification has for pre-CGT assets, pre-13 May 1997 (Division 43) assets, Division 152 assets, bad debts, etc, that are otherwise "owned" assets of the group, we would not otherwise support a shift to the asset acquisition model without such an exception for these types of entities.

Recommendation 20

2.1.20 In addition to Recommendation 19, an alternative reset method should be provided for majority owned entities that subsequently join a tax consolidated group. We have provided details of this alternative method, which we believe addresses inappropriate skewing of ACA to goodwill that would otherwise occur for such entities, and the compliance costs in resetting the tax costs of majority owned entities (while being consistent with the objects of Part 3-90).

Recommendation 21

2.1.21 The proposed integrity provision contained in Position 3.3 is drafted quite broadly. As demonstrated by this submission, we are concerned that this may inappropriately require consideration of the provisions in unwarranted circumstances (e.g. a simple debt forgiveness of intra-group debts). If the Board or ATO have specific integrity issues in relation to specific provisions outside of Division 723, we recommend that the integrity provisions be more appropriately framed and targeted

Recommendation 22

2.1.22 Position 3.3 should be qualified so that it would only have application if the relevant liability of the encumbered asset is not otherwise taken into account in the exit calculation of the relevant subsidiary entity.

Recommendation 23

2.1.23 In principle, we support Position 3.4 of the Board's position paper. However, we believe that the position should allow for exceptions to be made for certain provisions as and when they are identified as being appropriate. Furthermore, the Board should consider an extension to the core rules for Division 152 and Division 6 purposes, which we believe would be unintentionally excluded from proposed Position 3.4 in some circumstances. We also believe that the Board should recommend that the extensions currently contained in Division 715 be reviewed in light of proposed Position 3.4. Finally, we do not support an extension of the core rules to related third parties that are mere "associates", as the ability for these entities to apply the core rules to transactions (let alone be certain that they are associates in relevant cases) would constitute a significant compliance burden.

Recommendation 24

2.1.24 A rollover under Subdivision 124-M will generally result in significantly adverse tax cost setting consequences for SME groups. We request that the Board recommend placing SME groups on par with publicly owned groups. This can be done by (a) where the common stakeholder or significant stakeholder test is satisfied, a privately owned group should be allowed to access the special cost base rules in section 124-784B instead of being required to apply the cost base rules in section 124-782, and (b) such rollovers be provided with the stick option and tax consolidation concessions contained in Subdivision 715-W that are currently only provided to widely held groups.

Recommendation 25

2.1.25 Consistent with Position 5.1, section 703-70 must be amended to allow for the interposition of a new head company under Subdivision 122-A rollover, without the need for complex exit and entry calculations.

Recommendation 26

2.1.26 If the Board does not accept our Recommendation 25, we request the Board to propose a recommendation that corrects the operation of section 705-90 (i.e. Step 3 profits) where Subdivision 122-A rollover is utilised.

Recommendation 27

2.1.27 Our testing of the Board's Positions 4.1 and 4.2 indicate that they do not provide an appropriate outcome in many circumstances. While we in principle support an allocation of net income on a reasonable basis, we believe the Board must conduct further testing of its positions before making a final recommendation to Government. We recommend that targeted consultation must occur on this issue. We have provided some worked examples that demonstrate the issue. However, we would also be happy to share our detailed testing of these two positions in the interest of trying to resolve this issue.

Recommendation 28

2.1.28 We provide our support for Position 4.3. However, we note that it is also appropriate to deal with certain DTLs in the same manner as current tax liabilities. We believe that one possible way of dealing with this issue would be to modify the operation of subsection 705-70(1A) in Subdivision 713-A, so that the head entity can recalculate these tax obligations where there is otherwise a nil amount in the accounts of the trust before the joining time. Alternatively, a specific Step 2 amount could be included for these liabilities (however, as these liabilities may change in the head company, the Board may still need to consider the subsection 705-70(1A) interaction issues).

Recommendation 29

2.1.29 In our view, Position 4.4 is a restatement of section 960-100. Accordingly, we support the position, in principle, however, we highlight that this position must only be framed as an “avoidance of doubt” provision. We believe the Board will create significant uncertainty as to the application of the term “entity” for all other purposes of the Act if this recommendation is ignored.

Recommendation 30

2.1.30 While we support Position 4.5, we highlight that the position will no longer be relevant if debt beneficiaries are not treated as a beneficiary of the trust for Division 6 purposes or for the purposes of other trust provisions of the Act. We recommend that the Board acknowledge this interaction issue (as it will be important if the Division 6 interaction issue is later dealt with). We also recommend the Board consider transitional issues for such trusts that are already part of a tax consolidated group.

Recommendation 31

2.1.31 While the removal of DTAs and DTLs may simplify the tax cost setting process, we are not sure that this will always provide for appropriate outcomes or simplification. We recommend that the Board consult and workshop this issue with ATO, industry and professional experts on this matter, before makings its final recommendation to Government.

3 OVERVIEW

3.1 Outline of submission

3.1.1 We welcome the opportunity to provide our comments on the positions reached by the Board, before the Board makes its final recommendations to the Government.

3.1.2 The tax consolidation provisions are an important and component of the taxation provisions for corporate groups in Australia. A review of this magnitude that is being conducted by the Board is unlikely to occur again for some time and accordingly it is critical that substantive changes to the regime are considered by the Board thoroughly and appropriately.

3.1.3 In general, there are a number of positive recommendations contained in the Board's position paper. In relation to the majority of these recommendations, we have expressed our support for these positions contained in the position paper.

3.1.4 However, we highlight that we do not believe that the Board has appropriately addressed issues relating to the significant barriers to entry faced by the middle market. The middle market would be somewhat disappointed if the Board's Position 5.1 was its one and only solution to this issue. Given the nature of the review conducted by the Board, there will be little future opportunity to revisit some of these issues. Accordingly, it is critical that the important issues identified by this submission are considered by the Board in its final position paper.

3.1.5 That is, Position 5.1 only addresses certain formation issues. However, we highlight that this is only one of the major reasons why non-consolidated groups in the middle market do not embrace the tax consolidation regime. These groups are unlikely to form a tax consolidated group unless some of these other residual concerns are also addressed as a complete package.

3.1.6 We highlight that these concerns that we refer to were discussed in detail some 11 years ago in 1999, in the RBT report on tax consolidation. That report was based on a discussion paper ("A platform for consultation") that outlined the concerns of privately owned groups that would seek to apply a tax consolidation regime. In particular, the report highlighted that the tax consolidation regime should enable such groups to consolidate their wholly owned private groups and (or) facilitate appropriate restructuring to ensure that the privately group can be taxed as a wholly owned corporate group under the tax consolidation regime.

3.1.7 This ability to restructure appropriately is one key, fundamental, aspect that is missing in the consolidation regime for the middle market. While rollovers exist, our issue is that there are significant interaction issues that occur when applying the rollover provisions by privately owned groups. Furthermore, we highlight that such issues do not exist for widely held groups, which in itself is an anomalous outcome. As this is a major interaction issue for privately owned groups, and a real impediment to entering the consolidation regime, we believe that this issue needs to be addressed in the Board's final position paper.

3.1.8 In summary, we strongly support Position 5.1 as a key starting point. However, we express our concern that the Board appears to have taken a simplistic approach to its recommendation that deals with barriers to entry for the middle market. In our view, Position 5.1 alone will not result in a significant take-up of the consolidation provisions unless the Board also takes into account a number of the propositions put forward in this submission.

3.2 Summary of critical issues identified in this submission

3.2.1 While we have provided the Board with XX recommendations in this submission, we highlight that the majority of these submission points are minor in nature and could easily be addressed by the Board through minor tweaks to the current positions.

3.2.2 However, as summarised above in Section 3.1 of this submission, there are some critical issues that in our view must be addressed by the Board. We have provided a summary of those two critical issues below.

<u>Restructuring and dealing with privately owned groups</u>

3.2.3 We believe that the Board needs to acknowledge, in its position paper, that the consolidation provisions do not appropriately deal with the structure of privately owned groups in general.

3.2.4 As outlined in the RBT report, and as demonstrated by Figure 1 (later in this submission), privately owned groups will rarely consist of wholly owned corporate groups. We believe that the solution to this problem is to either allow a more flexible set of arrangements (e.g. a MEC type group for

SMEs), or alternatively, to allow privately owned groups an opportunity to appropriately restructure their corporate entities to take advantage of the tax consolidation provisions. Both of these two suggestions were made by the RBT in 1999 [known as Recommendations 15.6(a) and 15.6(b)].

3.2.5 In our view, the second recommendation is the easiest to implement. Privately owned groups generally already have access to rollover provisions, such as Subdivision 122-A and 124-M. However, these provisions do not interact with the tax consolidation provisions for privately owned groups. It is highlighted that there are special provisions that make these rollovers interact appropriately, however they can only be accessed by widely held groups. These issues, and our recommendations, are outlined in detail in this submission.

Dealing with majority owned entities

3.2.6 The Board's paper does not currently distinguish between majority owned entities and newly acquired entities. For middle market taxpayers, this distinction is very significant. We believe the Board needs to appropriately consider the tax consolidation interaction issues where entities have been majority owned for a period of time before they are subsequently acquired by a tax consolidated group.

3.2.7 Where this is the this case, we believe it would be inappropriate to apply an "acquisition model" to the majority owned entity, as it will be more appropriate to inherit history in relation to assets of the majority owned group. Furthermore, the ACA process in this case can result in inappropriate skewing to goodwill for such entities. Finally, there can be unwarranted compliance costs (e.g. valuations and tax cost calculations) that should also be addressed where such entities subsequently join a tax consolidated group. These issues are dealt with in some detail in this submission.

3.3 Fast tracking certain recommendations

3.3.1 The Board's position paper contains a number of important recommendations for the tax consolidation regime. However, as some of these recommendations may have revenue implications, we are concerned that this may delay consideration and implementation of the Board's recommendations by the Government.

3.3.2 In particular, if the on-going formation concessions are 'caught up' with other initiatives in the Position Paper, there may well be delays in the implementation of the general package of reforms - possibly even until the 2014/15 income year.

3.3.3 In our view, we would be surprised if Position 5.1 would have a revenue cost. Accordingly, we believe that it would be possible for this recommendation to be introduced independently of all other recommendations contained in the Board's position paper. We see no other impediments to this occurring and highlight that there have been examples of the Board fast tracking certain issues in the past where they are of priority (e.g. the capital election for MITs).

3.3.4 If the Government delays releasing its views on the recommendations contained in the Board's report, then this public release of Position 5.1 is likely to result in SME groups delaying consideration of the consolidation regime. That is, SME groups that are now eligible to consolidate (and are, in effect, about to consolidate) would prudently delay such consideration until the Government reports on the Board's position paper. This is because the difference between applying the recommendations as compared to the current regime (from the perspective of compliance costs and thus expected outcomes) is too significant to ignore from a privately owned group's perspective.

3.3.5 Accordingly, we not only agree with the Board that on-going formation concession should be available for privately owned corporate groups, but submit that there is an urgent need to accelerate this compliance initiative so that it is announced by the Government as soon as possible - i.e. independently of the other initiatives in the Position Paper.

3.3.6 Furthermore, for those privately owned groups that may consolidate from 1 July 2010, we would also request that the Board consider recommending an ability to apply the concessions from that date.

Recommendation 1

3.3.7 We request that the Board consider fast tracking a number of its positions to the Government. We believe that the Government could adopt the positions contained in Chapter 5 ahead of considering any other positions contained in the Board's report.

Recommendation 2

3.3.8 We request that the Board consider recommending a start date of 1 July 2010 for the concessions related to privately owned groups, in particular Position 5.1.

4 PROPOSED CONCESSIONS (CHAPTER 5)

4.1 Review of Business Taxation (RBT) Recommendation 15.6

4.1.1 Section 15 of the Review of Business Taxation ["RBT"] report in 1999 provided recommendations to the (then) Government to introduce a regime that would allow wholly owned corporate groups to be taxed as a single entity.

4.1.2 Importantly, the RBT report highlighted that privately owned groups were structured differently to widely held groups. Reference was made to Chapter 26 of the "A Platform for Consultation" ["APFC"] report, which discussed options that should be considered for privately owned groups. We have included the extract of this Chapter in Appendix A to this submission. In summary, the APFC report outlined the following broad positions:

- Consolidation should be extended to privately owned groups so as to allow the privately owned group of entities to be consolidated for tax purposes.

- A privately owned group could be defined by reference to a family trust election, identifying the relevant family group (and thus the entities wholly owned by that family group).

- The family group could consist of any types of entities within that group, being trusts, companies, partnerships etc.

- The family group could choose which entity would be the head company of that family group. The selection of the entity would determine the ultimate structure of the group.

- Transitional rollover relief would be offered to enable the entities with fixed interests to be rolled over (and therefore under) the chosen head company. This would not be required for other trusts within the family group.

4.1.3 Having considered this report and various submissions, the RBT made two important recommendations in Chapter 15 of the RBT report. These have been repeated below.

15.6 Consolidated taxation for family-owned groups

Option to consolidate

a) That an alternative, more flexible, set of arrangements be made available for groups of trusts and companies, 'owned' by members of the one family, to be taxed as a single consolidated entity.

Transitional rollover relief

b) That transitional rollover relief:

   i. be provided to enable those family groups that need to do so to restructure so that all fixed interests in group entities are directly or indirectly wholly owned by a head entity for the group; and

   ii. be available for the period from 1 July 2000 until 30 June 2002.

4.1.4 These two recommendations have now been lingering in the background to the tax consolidation provisions for some 11 years. Privately owned groups have been waiting for the Governments response on these two recommendations, which have not been into effect to date.

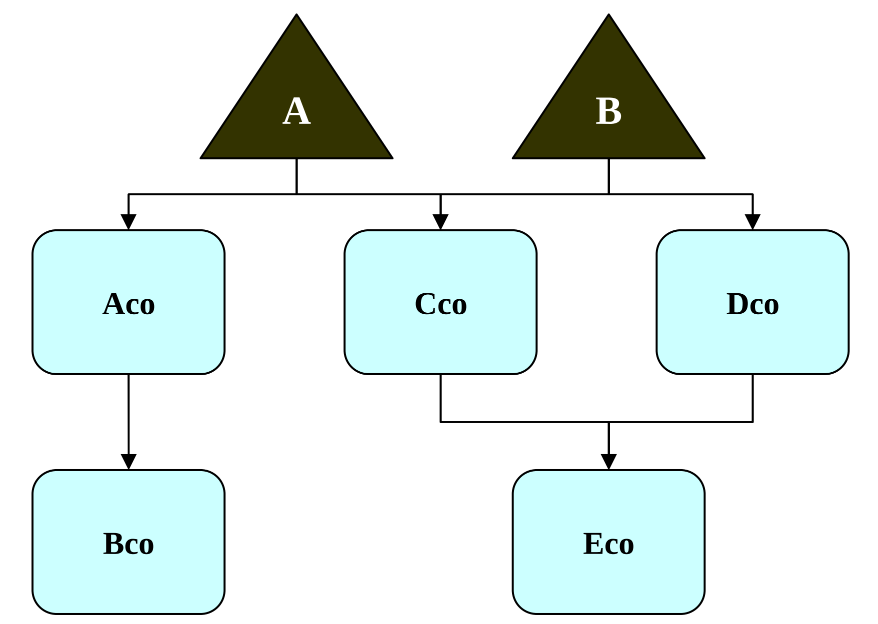
4.1.5 It is therefore somewhat disappointing that the Board has not acknowledged or even discussed Recommendation 15.6 in its position paper. It is further disappointing that the key differences, as outlined in the RBT report, have not been considered in developing the recommendations for the privately owned / SME groups in the Board's final position paper.

4.1.6 In our view, simply providing "formation" concessions for privately owned groups in the middle market will not entice those groups to consolidate, where they have not already done so. Such a view ignores the very nature and structure of a privately owned group and the reasons why such groups have not chosen to embrace the consolidation regime.

4.1.7 As highlighted in the APFC report, while family owned groups may contain a number of corporate entities within the group, it is unlikely that they will be structured neatly into wholly owned corporate groups. Furthermore, for commercial reasons such as asset protection and succession planning, privately owned groups will generally involve a flat structure, where companies in the group would ordinarily be owned by trusts that are controlled by the same family group.

4.1.8 To demonstrate, the following diagram [Figure 1] outlines a typical structure for a privately owned groups of entities.

Figure 1 – privately owned groups



4.1.9 In this diagram, the private / family group controls Trust A and Trust B (assumed to have both made family trust elections). Trust A wholly owns Aco and Bco. Trust A and B jointly own Cco. Trust B wholly owns Dco. Cco and Dco wholly own Eco.

4.1.10 While there are five corporate entities that are wholly owned by this family group, only Aco and Bco can consolidate for tax purposes.

4.1.11 Furthermore, there are limited rollover opportunities that may enable Cco, Dco and Eco to join the same wholly owned corporate group. Even if rollover were available, the current operation of the rollover can result in significantly inappropriate tax consolidation outcomes for the relevant group. This interaction issues are detailed in Section 7 of this submission. This significant interaction issue is the exact issue identified by Recommendation 15.6(b) that has yet to be resolved in 11 years.

4.1.12 Furthermore, under Recommendation 2.1 of the Board's position paper, all pre-CGT assets of any majority owned entity in this group that is subsequently rolled into the Aco group would be turned to post-CGT assets.

4.1.13 Unless the above critical issues are dealt with, privately owned groups receiving appropriate advice as to the risks of tax consolidation would unlikely to embrace the consolidation regime. There would be limited benefits in simply consolidating Aco and Bco in the example above. Accordingly, the simple formation concession provided by Position 5.1 would serve little purpose if it were not coupled with other appropriate interaction provisions. In our view, this is absolutely critical.

4.1.14 It is noted that either Recommendation 15.6(a) or (b) of the RBT report would help to cater for these issues identified. That is, Trust A and Trust B are assumed to have made the same family trust elections treating them as a family group for the trust loss provisions. As the companies are wholly owned by Trust A and B, they would also be within the same family group. Accordingly, Trust A could be selected as the head entity of the family tax consolidated group (effectively being a MEC type privately owned group).

4.1.15 Alternatively, under Recommendation 15.6(b), the group could instead be restructured under Trust A (via rollover relief), so that all five companies could form the same wholly owned group.

4.1.16 While the Board may have considered the issues highlighted above, we note that there is no discussion of these issues in the Board's position paper.

4.1.17 **Furthermore, the Board has not addressed any of the rollover interaction problems encountered by SME groups, even though these issues have been identified in many submissions and presentations to date as being a <u>key interaction issue</u> for privately owned groups.**

4.1.18 We therefore find it somewhat disappointing that the position paper fails to properly address both formation and continuance issues of privately owned groups. Accordingly, we make the following key recommendations that we believe need to be considered by the Board in finalising its position paper and its recommendations to Government.

Recommendation 3

4.1.19 We request that the Board provide its view on Recommendation 15.6 of the RBT report in its final position paper to the Government. We highlight that Recommendation 15.6(a) and (b) can be implemented independently of each other. As these two recommendations have been lingering for 11 years, we believe the Board either needs to accept these recommendations or outline that these recommendations should not be considered any further. We do not believe it is appropriate to perform a review of the consolidation provisions for SME groups and leave these recommendations outstanding after such a period of time.

Recommendation 4

4.1.20 We fully support Recommendation 15.6(a) of the RBT report that would allow a family owned group to be taxed as a single entity. The family owned group would be determined by way of a family trust election, which carries with it significant integrity provisions. Furthermore, if there were multiple entities at the top level (i.e. more than one trust), the group would have a choice of head company or instead could form a MEC type group.

Recommendation 5

4.1.21 We fully support Recommendation 15.6(b) of the RBT report that would allow privately owned family groups an ability to properly restructure or apply rollover provisions. We refer to Recommendation 24, Recommendation 25, and Recommendation 26 that provide specific recommendations on the existing interaction issues that are currently encountered by SME groups with the rollover provisions. We highlight that these issues can be addressed independently of our Recommendation 4 above. We note that, in our view, it is critical for the Board to at least address these interaction issues.

4.2 Threshold test for determining "small business" corporate groups

Appropriately targeting privately owned groups

4.2.1 We have a number of concerns with the proposed threshold test for determining an SME, as contained in Chapter 5 of the position paper.

4.2.2 Firstly, it is highlighted that the main benefit of the proposed concessions is that they will remove the requirement to obtain market valuations on formation. That is, a “stick option” together with a “1/3 loss option” would both remove the valuation requirement on resetting assets and the valuation requirement on calculating available fractions.

4.2.3 However, in order to determine whether the entity is an SME entity for the purpose of these concessions, the Board has recommended a turnover and valuation test based on the TOFA rules. We are not sure that the Board fully appreciates the operation of the test contained in section 230-455 of the 1997 Act. That is, those provisions require an SME to determine and value both its financial assets and all other assets on an annual basis. There is no definition of financial asset in the provisions. Furthermore, that test does not allow an SME to use its accounts where they are not prepared in accordance with the accounting standards. For many SME groups, it is common that special purpose accounts are prepared. Accordingly, where this is the case, the values are to be determined by obtaining a market valuation (we refer the Board to the requirement of paragraph 230-455(5)(d) of the 1997 Act). This issue will be significant for those entities that will be on the borderline of these threshold tests.

4.2.4 We find it unacceptable to provide market value concessions by requiring annual market valuations and testing. In our view, and in line with Recommendation 15.6 of the RBT report, the concessions contained in Position 5.1 should be appropriately aimed at “privately owned groups” without adding to additional compliance.

4.2.5 We highlight that Division 7 of the 1936 Act provides a definition of a privately owned company. At first instance, it would seem far more appropriate to use a concept of a privately owned group as opposed to an SME group. From an administrative and compliance perspective, such a test would more appropriately identify the groups that have not yet consolidated (i.e. the privately owned groups that are referred to in the RBT report).

Recommendation 6

4.2.6 As with our submission on Division 230, we do not support the definition of a SME entity as contained in section 230-455. The provisions require annual market valuations, which are contrary to the purpose of Position 5.1. As outlined in the RBT report, consolidation concessions should be targeted at “privately owned groups”. Accordingly, we consider that a simple definition of a private group or a closely held group (e.g. similar to Division 7 of the 1936 Act) would be far more appropriate.

Setting appropriate and consistent thresholds

4.2.7 We highlight that the proposed 'threshold' for small business groups - i.e. groups with an aggregated turnover of less than $100 million and asset of less than $300 million in an income year - does not match the tests used by the ATO for determining its market segments.

4.2.8 That is, according to the ATO, a large business will only exist if a corporate group has an annual turnover of over $250 million - a threshold that is some two and a half times greater than the one proposed by the Board. We therefore submit that it would be more appropriate to consistently determine a small business taxpayer in line with the ATO's simple annual turnover test.

Recommendation 7

4.2.9 Should Recommendation 6 not be accepted, we submit that consideration should be given to adopting a simple annual turnover test (in line with the test used by the ATO in the relevant income year) for determining eligibility for on-going formation concessions.

4.3 Subsequent acquisition of majority owned entities

4.3.1 As outlined earlier, in Figure 1, a typical privately owned group would consist of entities that are wholly owned by the private group rather than the corporate group. Accordingly, many privately owned consolidated groups will typically need to restructure their interests in companies that are already owned by the privately owned group (i.e. in order to form a tax consolidated group). For the purpose of this section, these entities are referred to as "majority owned" entities. Please refer to Section 5.2 of this submission for a definition of a majority owned entity (as currently contained in subsection 701A-1(2) of the Transitional Act) and a discussion of issues related to the subsequent joining of such entities.

4.3.2 In our view, the Board needs to appropriately deal with adverse tax consolidation consequences that would occur where a majority owned entity subsequently joins an existing tax consolidated group. Unless such issues are dealt with, we believe that this will present a real impediment to privately owned groups forming a tax consolidated group in the future.

Recommendation 8

4.3.3 It is critical that the Board adjusts its "acquisition model" to more appropriately deal with majority owned entities that subsequently join the tax consolidated group. In particular we refer to Recommendation 19 and Recommendation 20 of this submission for further specific details.

4.4 Stick or spread should be available on an entity by entity basis

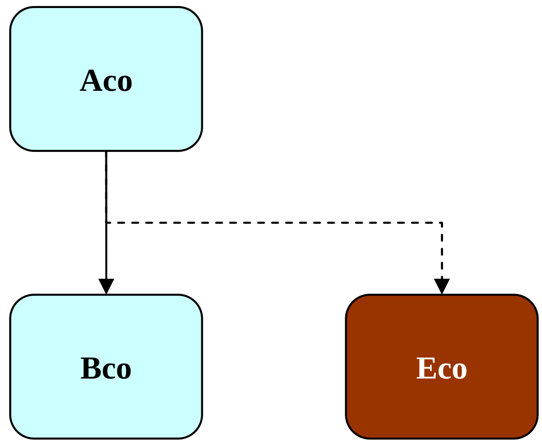
Option should be on an entity by entity basis

4.4.1 In principal we agree that the provision of a stick versus spread option on an entity by entity basis could result in significant compliance where the consolidated group has a large number of entities on formation.

4.4.2 However, from our understanding of those privately owned groups that have yet to consolidate, we are not aware of any such groups that consist of more than a handful of entities. Accordingly, after a thorough review of the Board's position, we are not convinced that the stick versus spread option on an entity by entity basis will add to compliance costs for those privately owned groups that have yet to consolidate.

4.4.3 We therefore do not support a stick versus spread option on a group basis. Furthermore, from our testing of this option, we believe it will clearly provide inappropriate outcomes in many cases. This is demonstrated by the following example contained in Figure 2 below.

Figure 2 – stick versus spread



4.4.4 Figure 2 outlines a non-consolidated group consisting of Aco and Bco that have always been part of the same wholly owned group. Assume that, in the last 12 months, Aco has acquired all of the interests in Eco.

4.4.5 Using the "spread" method would be the only way to appropriately determine the actual tax cost of the underlying assets of Eco. However, if the spread method is used for Bco, this would likely result in an (inappropriate) skewing of ACA to goodwill (and thus a reduction in the tax cost of real tangible assets that have always been owned by the group). If a stick method was used for the group, this may provide an appropriate result for Bco, but would result in wastage of tax cost for Eco. Accordingly, in this very simple case, the stick versus spread option is required to ensure an appropriate result for the group.

4.4.6 We believe that the stick versus spread choice on an entity by entity basis would typically be simple when groups are this small. Furthermore, a group could choose to simply use "stick" for all entities to avoid any compliance issues.

4.4.7 We further highlight that, in our view, the Board should not compare proposed concession (and associated compliance issues) with the concessions provided in formation cases of 2003. That is, in 2003, there were significantly large corporate groups (widely held groups) that needed to consider stick versus spread on an entity by entity basis. We do not believe that the proposed concession and choice would be any where near as complex in relation to the remaining groups looking to form a consolidated group now (where such groups generally consist of only a handful of entities).

Recommendation 9

4.4.8 In our view, privately owned groups that have yet to consolidate are not as complex as those that originally formed consolidated groups in 2003. In many cases, a stick or spread option on an entity by entity basis is the only way to ensure an appropriate ACA result. Accordingly, we believe it is critical to allow such a choice to be made on an entity by entity basis on formation of the group.

Spread option for newly acquired entities

4.4.9 If the Board does not agree with our Recommendation 9, then we submit that a choice to 'stick' or 'spread' on an entity by entity basis must, at the very least, be available for non-majority owned subsidiary entities that have been acquired within five years of the formation of the consolidated group.

4.4.10 To demonstrate, in the example contained in Figure 2 above, Eco is an entity that has been acquired in the last five years. It would therefore qualify for a choice of using stick versus spread. Bco would not have a choice and would be required to use the stick method (if a stick choice was made for the group). This alternative would clearly provide an appropriate result in the circumstances contained in the example.

4.4.11 If this alternative were adopted, we highlight that there is likely to be very few entities in the group that would qualify for such a choice of stick versus spread. Furthermore, the group will still have an option to use the stick method for all entities. Accordingly, we believe that this alternative option would not increase the compliance cost on formation under the concessions.

Recommendation 10

4.4.12 While we strongly recommend that the Board consider our Recommendation 9 outlined above, if this is not accepted, we believe it is critical that a choice be given for non-majority owned subsidiary entities that were acquired within five years of the formation of a consolidated group.

4.5 The stick and loss concessions should be independent

4.5.1 The Board's position paper is silent as to whether the stick and loss concessions could be available independently of each other. We submit that it is critical for this to be the case.

4.5.2 For example, consider a relatively small group of three companies where 90% of the group value is in the loss entity. In this case, the group would benefit from compliance by being able to use the stick option for its tax cost setting process. Furthermore, it would also ensure appropriate tax costs where the entities have always been majority owned since their inception. However, if this is coupled with a loss concession, the group would lose a 90% available fraction as compared to the proposed 1/3 loss.

4.5.3 Given that the two concessions relate to completely separate aspects of consolidation, the stick and the loss concessions should be dissected - i.e. a group should not be forced to use its losses over three years if it chooses to use the formation tax cost setting concession.

4.5.4 We believe that such a move would not necessarily add to complexity given that non-consolidated small business groups would usually have only a few entities within the corporate group (i.e. they are relatively uncomplicated) and therefore such a choice would not (in our view) add to the compliance burden for these groups.

4.5.5 Furthermore, we believe that not providing such a choice may act as an impediment for such groups forming a tax consolidated group, where either concession provides adverse consequences on their own.

Recommendation 11

4.5.6 We request that the Board accept that the stick and loss concessions can be made by taxpayers independently of each other.

4.6 Treatment of losses

4.6.1 The Board considers that the formation concessions should allow eligible wholly owned groups to utilise certain transferred losses over three years. We understand that the utilisation rule would be similarly framed to the original transitional three year loss concession. This would, according to the Board, meet the key objectives of reducing compliance costs and keeping it simple.

4.6.2 While this proposed concession is welcomed, we are concerned by the proposed limitations.

4.6.3 The purpose in adopting this particular rule would be to avoid the complex available fraction calculations that would otherwise apply to regulate the utilisation of such losses. As such, the concessionary treatment proposed would not extend to the loss and value donor rules that were also a feature of the original transitional rules because these are considered extremely complex for small groups to comply with. In principal we agree with this approach.

4.6.4 However, it is noted in paragraph 5.41 of the position paper that the proposed concession is to apply only to "certain losses". Footnote 59 suggests that this would be similar to the original transitional three year loss concession contained in section 707-350 of the Transitional Act. This concession provided a three year utilisation rule for losses made in an income year ending on or before 21 September 1999 income year ("the eligible time"), where such losses were transferred to the head company on the basis of satisfying the continuity of ownership test ("COT").

4.6.5 We are concerned that the Board is proposing a concession that is based on this transitional provision. That is, where a group has incurred losses that do not meet either of the eligibility criteria (for example, the losses are not incurred before the eligible time or the losses are not COT losses), then an available fraction would be required to be calculated for such losses. We are further concerned with the use of an "eligible time" test where the concessions are to be ongoing.

4.6.6 Where an available fraction calculation is required by the privately owned group, market values would need to be obtained for entities in the group. With no other concessional option available, such costs could be seen as a real impediment to entering the consolidation regime. This outcome would seem to be inconsistent with the key objectives of reduced compliance costs and simplicity.

4.6.7 Accordingly, in our view, the Board needs to recommend concessions for all types of losses transferred to the head company of an SME group. This should exist for both formation and joining cases. Where a loss is an SBT loss, we highlight that Division 707 requires stringent tests to be satisfied before such losses can be transferred to the head company. Accordingly, where such losses are transferred, we would recommend that a simple option be available for determining the utilisation rate of such losses.

4.6.8 Applying the proposed concession to all transferred losses would meet the Board's objectives of reduced compliance. If a proposed 1/3 loss utilisation rate is considered unacceptable for SBT losses, we would recommend that the Board consider an alternative rate that it considers more appropriate (for example, a 1/5 rate for SBT losses).

Recommendation 12

4.6.9 We highlight that the transitional three year loss rule required losses to be incurred before 21 September 1999 ("the eligible time). We request that the Board ensure that an eligible time period is not recommended in the proposed loss concessions in Position 5.1. Furthermore, we believe it is critical to extend some form of available fraction concession for all types of losses transferred to the head company of an SME group, as compared to a requirement to value all entities. The available fraction calculation and requirement to value each entity creates a real impediment and barrier to entry for SME groups. Accordingly, a concessional available fraction calculation should also be available for SBT losses on formation and COT and SBT losses on subsequent acquisitions.

4.7 Interaction with Subdivisions 165-CC, 165-CD and 170-D

4.7.1 Providing a stick option for privately owned groups will likely result in the application of Subdivisions 715-A to 715-D. These provisions deal with the loss duplication provisions contained in Subdivisions 165-CC, 165-CD and 170-D where an entity is a stick entity.

4.7.2 In our view, when these provisions apply, they are the most complicated interaction provisions contained in the tax consolidation regime. If such provisions remain in their current form, there would likely be significant non-compliance with such provisions.

Recommendation 13

4.7.3 We request that the Board consider a recommendation to re-write and simplify the interaction of the loss integrity provisions for SME groups. Furthermore, the current exception for SME groups (i.e. groups with net assets under $6 million) is clearly not sufficient and needs to be reconsidered. It is noted that these provisions will likely apply if Position 5.1 is adopted.

4.8 Offering a stick option on future acquisitions

4.8.1 Even if a group is formed under the proposed concessions, we suspect that many small businesses and their advisors would not, unfortunately, have the resources to perform detailed ACA calculations for future acquisitions.

4.8.2 We understand the loss integrity issues involved in offering a stick model on future acquisitions. However, we note that the current regime provides an exception from the loss integrity provisions contained in Subdivisions 165-CC and 165-CD where the entity is an SME entity based on the small business concessions in Division 152.

4.8.3 We therefore submit that there is a clear policy case to provide a stick option for entities that subsequently join certain privately owned groups. We believe that such an option would likely entice smaller non-consolidated corporate groups into the regime (i.e. it would significantly eliminate both the compliance costs on formation and the continuation of the group).

4.8.4 In our view, an SME group should have the option to stick with existing tax costs. However, as outlined earlier, an exception based on the current small business concessions in Division 152 is unlikely to be sufficient. We would recommend that the Board consider a more appropriate alternative threshold test of an SME for this purpose. For example, consideration of an additional and alternative threshold as contained in Division 974 for SME groups may be seen as acceptable.

4.8.5 If the Board is truly seeking methods to entice corporate groups into the tax consolidation regime, we believe it is only appropriate to ensure that ongoing compliance costs can be minimised for those small groups, where it is warranted.

Recommendation 14

4.8.6 We request that the Board consider a stick option for future acquisitions made by appropriate sized SME groups. We believe that this would significantly reduce ongoing compliance costs and would not result in integrity issues (given the current exceptions in Subdivision 165-CC and CD for SME groups).

4.9 Dealing with problems on rollover

4.9.1 We highlight that one of the most significant issues with the current consolidation regime for privately owned groups is that it does not deal appropriately with rollovers for such groups. As outlined in Figure 1 above, privately owned groups in the middle market are typically structured differently to publicly owned groups. Accordingly, restructuring is generally required to ensure that the corporate entities in the group can form a wholly owned corporate group.

4.9.2 While rollovers for large public groups are available with stick options, we highlight that a stick option is not available for privately owned group rollovers. Given that loss integrity issues and revenue considerations should be greater in relation to widely held public groups, we are unsure why these concessions do not apply to privately owned groups. We highlight this issue in detail in Section 7of this submission.

4.9.3 However, consistent with Recommendation 15.6(b) of the RBT report, we request the Board to seriously consider a recommendation to address these rollover interaction issues, so that a privately owned group is placed on par with a widely held group, where the rollover involves a commonly owned entity.

Recommendation 15

4.9.4 While large public groups are provided various stick options on entity rollovers into a tax consolidated group (i.e. where the entity is commonly owned), no such options are provided for closely held groups. As identified by Recommendation 15.6(b) of the RBT report, fixing this issue is critical to ensuring that SME groups enter the tax consolidation regime. Please refer to Recommendation 24, Recommendation 25, and Recommendation 26 of this submission for our specific recommendations.

4.10 12 month rule for large entities

4.10.1 Position 5.2 proposes an extension of the concessions contained in Position 5.1 to all entities for 12 months. As an election to consolidate is irrevocable, and must be considered properly, we do not believe that 12 months is sufficient time to appropriately consider all issues associated with forming a tax consolidated group. Accordingly, we suggest that the 12 month period be extended to 24 months.

Recommendation 16

4.10.2 We recommend that the 12 month period in Position 5.2 be extended to 24 months, to allow appropriate time to consider all of the ramifications of entering into the tax consolidation regime.

4.11 Why are foreign owned groups or MEC groups excluded?

4.11.1 We are unsure why foreign owned groups or MEC groups are to be excluded from the concessions proposed. There seems to be, in our view, no policy reason for this decision. Where such groups are small, the compliance issues are the same as for Australian owned groups. We do not believe that it is acceptable to simply carve out these groups without proper explanation.

Recommendation 17

4.11.2 We do not support the exclusion from Position 5.1 and 5.2 for foreign owned or MEC groups. There is no clear policy reason stated for this exception, especially where the group meets the relevant SME thresholds.

5 THE ASSET ACQUISITION MODEL (CHAPTER 2)

5.1 The proposed acquisition model

5.1.1 In principal, the proposed asset acquisition model, as contained in Position 2.1, has the potential to greatly simplify the operation of the consolidation tax cost setting provisions and provide clarity to the policy of the provisions.

5.1.2 However, we would be concerned where such an approach results in instances of double taxation for certain assets. These assets would, generally, be those where the acquisition price includes a component for future profits on existing arrangements (over and above the principal component of the arrangement).

5.1.3 Examples of these arrangements would be construction contracts, accrued income, service contracts, trailing commission contracts, etc. The current regime attempts to deal with these customer type contracts by providing a deduction for the TCSA allocated to the contracts, through section 716-405. While this provision is complicated, in our view it attempts to ensure that double taxation does not occur in relation to the acquisition of these underlying arrangements.

5.1.4 Under a proposed acquisition model, there would be a clearer distinction between capital and revenue. Furthermore, the acquisition of contracts in a "whole of business" acquisition would likely result in an argument by the ATO that the acquisition of such contracts were capital in nature[1]. Alternatively, while the acquisition of such contracts may be considered capital, the subsequent realisation of the contracts (and thus the costs incurred to acquire the contracts) may be taken into account under a net profit approach[2]. It is highlighted that a net profit approach in relation to such contracts would provide an appropriate result as compared to a capital approach (whereby the latter would likely result in double taxation – i.e. no recognition of the cost of the contracts).

[1] See for example the decision in *John Smith & Son v Moore* (1921) 2 AC 13

[2] See for example the High Court decision in *Xco Pty. Ltd. v. Federal Commissioner of Taxation* 71 ATC 4152

5.1.5 As the current law has a mechanism for dealing with this uncertainty (i.e. section 716-405), we are hesitant in providing our support for an acquisition model unless the Board recommends a clear approach for appropriately dealing with acquired profits that are not related to goodwill. Provided that this issue can be dealt with, we believe that a move to an acquisition model would help to remove uncertainty and provide a policy framework for the tax consolidation tax cost setting provisions as a whole.

5.1.6 We highlight, that the Board could alternatively achieve a similar outcome if subsection 701-55(6) were amended (and simplified) to remove the retention of the entry history rule (whilst retaining the existing composition of section 701-55).

Recommendation 18

5.1.7 Subject to Recommendation 19 and Recommendation 20, we (in principal) support the proposition to move to an asset acquisition model. This is on the proviso that the Board recommends that certainty be provided by the Government on the treatment of "acquired profits" that are not part of the goodwill of the business acquired. This proviso would retain the status quo in respect of the certainty currently offered by section 716-405. Accordingly, certainty should be provided by ensuring that a supporting provision allows an appropriate "net profit" realisation basis for such assets (to remove any doubt).

5.2 Exceptions to the acquisition model

5.2.1 Paragraph 2.75 of the Board's position paper states that "the Board notes that the application of the asset acquisition approach may need to be modified in some cases to ensure that the income tax law applies consistently to consolidated groups and other taxpayers having regard to the policy underlying other parts of the law."

5.2.2 We agree with this position and believe that there is a clear case for exceptions to be made where majority owned entities (that have been owned for a period of time) subsequently join a tax consolidated group. That is, we are significantly concerned with the possible application of an acquisition model to a majority owned entity that subsequently joins a tax consolidated group (where that entity has been owned for a long period of time).

5.2.3 Reference is made to the earlier example contained in Figure 1, whereby Cco, Dco and Eco were majority owned by the beneficiaries of Trust A and B (being the same family group). It would seem completely inappropriate if such entities were to lose pre-CGT states, the 15 year Division 152 status, and bad debt deductions on a subsequent acquisition by Aco or Bco. This is because there is no change in majority underlying ownership and thus the pre-CGT status of assets (under Division 149), no change in the ability to claim the 15 year exemption from a private group basis, and bad debts would not otherwise be lost to the group outside of tax consolidation (as COT would otherwise be satisfied in any case).

5.2.4 In our view, if history was not retained and "owned" characteristics were lost, entities would be reluctant to form a consolidated group, or subsequently have entities within the private group join a tax consolidated group. This would appear to create a real barrier to entering the tax consolidation regime.

5.2.5 In our view, there is a clear policy case to provide an exception to the acquisition model where the entity joining the group has been majority owned by the underlying group for a period of time (e.g. five years).

5.2.6 The consolidation regime has previously acknowledged these types of majority owned entities in the formulation of other interaction provisions. For example, in the transitional consolidation regime, a majority owned entity was defined under subsection 701A-1(2) of the Transitional Act as follows.

> A person or persons are the majority owners of an entity if they beneficially own, directly or indirectly through one or more interposed entities, membership interests in the entity whose market value is more than 50% of the market value of all of the membership interests in the entity.

5.2.7 Such a test looked to the underlying ownership of the entity to determine whether it was majority owned. In Figure 1 above, Cco, Dco and Eco would be majority owned by the same family group. This is consistent with the Commissioner's view in IT 2340.

5.2.8 Accordingly, if Aco were to acquire the interests in those entities after forming a tax consolidated group, such entities should <u>not be required</u> to apply the acquisition model. Or alternatively, there should be exceptions to the acquisition model for certain types of assets (e.g. pre-CGT assets, Division 152 assets, pre-13 May 1997 (Division 43) CGT assets, bad debts, etc). This rule could also be used for other integrity provisions being considered by the Board (e.g. the 200% diminishing value rate etc).

5.2.9 Unless such an exception is acknowledged and recommended by the Board, we do support a move to an acquisition model for the reasons outlined above.

Recommendation 19

5.2.10 There must be exceptions to the asset acquisition model for certain assets held by a majority owned entity, where that entity subsequently joins a tax consolidated group. Due to the implications this modification has for pre-CGT assets, pre-13 May 1997 (Division 43) assets, Division 152 assets, bad debts, etc, that are otherwise "owned" assets of the group, we would not otherwise support a shift to the asset acquisition model without such an exception for these types of entities.

5.3 Dealing with skewing issues for majority owned entities

Overview

5.3.1 Where a majority owned entity subsequently joins a tax consolidated group, the current ACA process results in an inappropriate skewing of ACA to goodwill. For example, if a group owns 90% of an entity at the formation time (whereby the entity has been owned for twenty years), the subsequent acquisition of 10% of the entity can result in a significant reduction in the tax cost of revenue assets held by the entity and an inappropriate skewing of ACA to goodwill. Such a consequence is a real impediment to forming a consolidated group for SMEs, where typically (as demonstrated in Figure 1) majority owned entities are held by the private group outside of the wholly owned corporate group structure.

5.3.2 It is believed that an alternative push down model should be provided to SME taxpayers where a majority owned entity subsequently joins the tax consolidated group. This alternative option (which is detailed below) would help to eliminate inappropriate skewing of ACA to goodwill and would help to eliminate the need for expensive valuations where the entity has not been acquired.

5.3.3 The advantage of this alternative option over a stick method is that this alternative would deal with the full allocable cost amount, thus being more consistent with the objects contained in Part 3-90 (i.e. the removal of duplicated gains and losses), without having a requirement to value assets.

Outline of alternative option for majority owned entities

5.3.4 In summary, this alternative model would still require a taxpayer to calculate the cost of an entity (i.e. the allocable cost amount) under section 705-60 by applying the eight steps. However, instead of allocating this amount to the underlying assets based on the market values, the entity would choose to retain the existing tax costs of the relevant tax assets. Any excess or shortfall of the allocable cost amount (as compared to the total of existing tax costs) would be provided a special tax treatment.

5.3.5 That is, the special tax treatment could either be to allocate the amount to capital assets other than membership interests in other group members (by selection of the taxpayer), to provide the taxpayer with a capital gain or loss at the time of joining, or to provide a deferred gain or loss on the entity (e.g. to be deferred until the time when the entity is sold, similar to the treatment under subsection 711-70(3), or to be written off over 10 years straight line).

5.3.6 It is noted that this alternative spread option for majority owned entities would only be provided as an alternative to a full reset of tax costs. Therefore, the net outcome of tax costs under this method would be the same as a proper reset calculation (i.e. a full allocation of tax cost is required).

5.3.7 However, the advantage of this alternative is that it can deal with the issues outlined earlier, which occur when a majority owned entity joins a tax consolidated group. Accordingly, this alternative would appeal to an SME group where such an entity joins the group.

5.3.8 It is noted that this alternative model provides (effectively) the same outcome that would occur if the group instead delayed formation and waited to acquire 100% of the shares of the majority owned entity (i.e. by utilising the formation concessions). As this alternative would exist to allow a stick option for all entities in the group, we believe that it is only appropriate to offer this alternative concession to groups that subsequently acquire such entities for commercial reasons (i.e. where there are commercial reasons for not being able to restructure a group for a period of time).

5.3.9 An example demonstrating this model has been provided in Appendix B to this submission[3].

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[3] . We highlight that this example is the same as the one provided in our TIA presentation on this issue at the 5th Consolidation Symposium

Recommendation 20

5.3.10 In addition to Recommendation 19, an alternative reset method should be provided for majority owned entities that subsequently join a tax consolidated group. We have provided details of this alternative method, which we believe addresses inappropriate skewing of ACA to goodwill that would otherwise occur for such entities, and the compliance costs in resetting the tax costs of majority owned entities (while being consistent with the objects of Part 3-90).

6 SINGLE ENTITY RULE (CHAPTER 3)

6.1 Integrity issues resulting from intra-group transactions

Appropriately targeting concerns

6.1.1 We have no objection in principle to the introduction of specific integrity provisions to address inappropriate outcomes that may arise from the use of intra-group transactions to create value shifts. However, we would be gravely concerned if these provisions were drafted in such a broad manner that they imposed compliance burdens on taxpayers in the middle market in relation to 'vanilla' transactions that do no more than 'tidy up' an entity prior to it leaving a consolidated group.

6.1.2 In particular, we understand that the Board is concerned by specific arrangements that may circumvent Division 723 of the 1997 Act. We draw this conclusion by reference to "encumbered assets" in the position paper. However, paragraph 3.52 of the position paper is drafted in a broad manner, where the reference to "encumbered assets" is provided as an example of a bigger problem, rather than the problem itself.

6.1.3 We have a significant concern if the proposed integrity provisions are to be drafted more broadly, such that they will have implications outside of Division 723. If the Board considers this issue to be broader than Division 723, we would request that appropriate consultation occurs before making a final recommendation to Government.

6.1.4 We have included an example in Appendix C of this document, to demonstrate that the current provisions adequately deal with value shifts that may occur under vanilla debt forgiveness transactions.

6.1.5 Accordingly, we recommend that the Board more appropriately frame Position 3.3 in relation to the integrity concern in question or alternatively consult on the issue further where it believes there is a more significant value shifting issue to address.

Recommendation 21

6.1.6 The proposed integrity provision contained in Position 3.3 is drafted quite broadly. As demonstrated by this submission, we are concerned that this may inappropriately require consideration of the provisions in unwarranted circumstances (e.g. a simple debt forgiveness of intra-group debts). If the Board or ATO have specific integrity issues in relation to specific provisions outside of Division 723, we recommend that the integrity provisions be more appropriately framed and targeted (rather than through a broad value shifting statement). We further recommend that the Board consult on the proposed integrity provision where it is considered that a wide provision is required.

Liabilities on exit

6.1.7 As outlined earlier, we understand that the Board is concerned that Division 723 may not appropriately interact with the tax consolidation provisions in relation to encumbered assets.

6.1.8 However, this position is predicated on the assumption contained in footnote 41 of the position paper. That is, a liability is not taken into account in relation to the encumbered asset. We highlight that this is a critical assumption and that the integrity provisions are unlikely to be required if a liability were taken into account by the leaving entity.

6.1.9 Accordingly, we recommend that the Board consider qualifying Position 3.3 where such a liability is so taken into account, as we believe the integrity issue would not occur.

Recommendation 22

6.1.10 Position 3.3 should be qualified so that it would only have application if the relevant liability of the encumbered asset is not otherwise taken into account in the exit calculation of the relevant subsidiary entity.

6.2 Extension of the single entity rule and other core rule

Principal based extension

6.2.1 We agree with Position 3.4, that the single entity rule and other core rules should be extended to third parties who are either shareholders[4] of the head entity in a tax consolidated group, or liquidators appointed to the head entity in a tax consolidated group. We believe that this recommendation will overcome many issues identified to date in relation to Division 115 and

[4] Where the head entity is a Division 6C trust, we take a reference to shareholder to include a unit holder that is deemed to be a shareholder for the purpose of applying the income tax provisions.

section 47. Furthermore, we believe that this recommendation provides a principle based approach to addressing the issue and future issues that may occur.

6.2.2 However, while we have not identified any exceptions to the above principle, it is not inconceivable that an exception may occur (or be identified) in relation to certain provisions in the future. Accordingly, we believe that the Board should allow scope for certain provisions to be carved out of the extension, as and when they are identified.

6.2.3 Furthermore, we highlight that there will also be cases where the core rules would need to be extended to other parties for certain provisions to operate. For example, we have identified two provisions that should be within the proposal, being Division 152 of the 1997 Act and Division 6 (and other related provisions) of the 1936 Act. These are discussed in detail below.

Extension to Division 152 concession stakeholders

6.2.4 Division 152 of the 1997 Act applies to CGT concession stakeholders, which can either be direct shareholders of the consolidated group or indirect owners of the consolidated group. It would seem anomalous if the core rules applied to direct shareholders (in determining whether the small business concessions apply) but would not apply to an indirect owner. In our view, a differential application would significantly increase the compliance costs of those applying the provisions and would also create anomalous results.

6.2.5 We believe that the small business concessions in Division 152 should apply in the same manner to an entity that is the head entity, a direct shareholder in the head entity or an individual who holds an indirect small business participation percentage in the head entity (i.e. an indirect CGT concession stakeholder). Accordingly, the core rules should be applied to all parties in determining whether they can, in fact, avail themselves of the concessions in Division 152. Therefore, we believe that the core rules in Division 701 should either extend to Division 152, or alternatively extend to CGT concession stakeholders for the purpose of applying Division 152.

Extension to Division 6 of the 1936 Act

6.2.6 Positions 4.1 and 4.2, of the Board's position paper, seek to address the issue of allocating net income during a non-membership period to beneficiaries. However, the positions do not address the interaction issue with the single entity rule when determining the "net income" of the trust for the whole income year under section 95 (from the perspective of the beneficiaries that have sold the relevant trust to the consolidated group). This is because the single entity rule does not apply for their taxation purposes.

6.2.7 This may create anomalies, being that the net income derived during the membership period may influence the total attributable income for the year that those beneficiaries could otherwise be allocated (i.e. if there is a deed that defines trust law income as section 95 income, the beneficiaries actual entitlement may change if the single entity rule is not applied for their purpose). We highlight that this is not a new issue and may not be addressed by changes proposed by Position 4.1 and 4.2.

6.2.8 We also highlight that the proposed core rule extensions in Position 3.4 will not address this issue, as it would need to be applied by previous beneficiaries (in an entry case) or new beneficiaries (in an exit case). Such parties are neither shareholders nor liquidators of the relevant member or head company of the group.

6.2.9 Accordingly, we recommend that the core rules in Division 701 be extended for the purpose of applying Division 6 of the 1936 Act (and any other similar or related provisions). Alternatively, the core rules in Division 701 should be extended to the beneficiaries of the entering or leaving trust for the whole of the relevant income year.

Other extensions

6.2.10 We note that there are a number of extensions contained in Division 715 that would need to be reviewed. A review would either result in either those extension provisions being repealed (i.e. if they are covered by the Position 3.4), or replaced within the new extension provision[5].

Related third party entities

6.2.11 Finally, we highlight that we would be opposed to a general extension of the core rules to third parties who are (merely) regarded as 'associates' of the head entity under the definition of that term in section 318 of the 1936 Act. This definition is not only extremely broad but it is notoriously difficult to interpret and apply.

[5] Section 715-70 (Subdivision 165-CC extension), Section 715-215 (Subdivision 165-CD extension), section 715-410 (value shifting extension), 715-875 (conduit foreign income extension).

6.2.12 We believe that this would create significant uncertainty in applying the consolidation provisions, whereby a mere associate would be required to consider all of its tax positions and dealings with an entity in the group as if the entity were the whole tax consolidated group. This would be even more difficult where, for example, the tax consolidated group were an MEC group.

Recommendation 23

6.2.13 In principle, we support Position 3.4 of the Board's position paper. However, we believe that the position should allow for exceptions to be made for certain provisions as and when they are identified as being appropriate. Furthermore, the Board should consider an extension to the core rules for Division 152 and Division 6 purposes, which we believe would be unintentionally excluded from proposed Position 3.4 in some circumstances. We also believe that the Board should recommend that the extensions currently contained in Division 715 be reviewed in light of proposed Position 3.4. Finally, we do not support an extension of the core rules to related third parties that are mere "associates", as the ability for these entities to apply the core rules to transactions (let alone be certain that they are associates in relevant cases) would constitute a significant compliance burden.

7 INTERACTIONS (CHAPTER 4)

7.1 Overview of interaction issues with rollover provisions

7.1.1 As demonstrated by Figure 1 (outlined earlier in this submission), privately owned groups in the middle market are typically structured in a way that will require corporate entities to be subsequently rolled into the wholly owned corporate group (in order for the corporate group to be a wholly owned group for the purpose of the tax consolidation regime).

7.1.2 As outlined by Recommendation 15.6(b) of the RBT report, it is critical that rollover and re-structuring provisions are provided to facilitate the appropriate creation of wholly owned corporate groups for privately owned groups, simply due to the way in which such groups are generally structured.

7.1.3 Currently there are two rollover provisions that are typically utilised by privately owned groups. The first is a Subdivision 122-A rollover, which allows the interposition of a new head company of a tax consolidated group by a trust or individual. The second is a Subdivision 124-M rollover, which allows an entity to be rolled into the consolidated group from either the privately owned group or by way of an acquisition for an external group.

7.1.4 However, as outlined in detail below, these rollover provisions do not interact with the tax consolidation provisions properly. Where the group is a privately owned group, there are significant adverse tax consequences that occur on the rollover, due to the lack of appropriate interaction provisions. We highlight that this is generally not the case for widely held groups, whereby special interaction provisions have been inserted into the Act for such groups (also outlined below).

7.1.5 We submit that, if the Board is serious in its desire to make the tax consolidation rules more attractive for small businesses and privately owned groups, then it is crucial that these adverse interaction issues are addressed as soon as possible.

7.2 Use of Subdivision 124-M rollover

7.2.1 The Subdivision 124-M rollover provisions enable an entity to be rolled into a tax consolidated group. Where there are common or significant stakeholders in the group conducting the rollover, special rules apply to ensure that there is no uplift in the cost base of the shares in the rolled over entity.

7.2.2 As there are no interaction provisions for privately owned groups, the provisions produce an ACA for the rolled over entity that generally results in a reduction of tax costs below their economic cost to the group. This is because the group retains the original cost base of shares under section 124-782 (i.e. its Step 1 amount) and loses all of the owned profits of the relevant entity as the profits are not technically "owned" under section 705-90 (i.e. its Step 3 amount). The result is clearly anomalous and inappropriate as it provides for a downgrade in tax costs due to these interaction issues. We have provided a calculation in Appendix D to demonstrate this issue further.

7.2.3 However, this consolidation interaction issue does not occur for widely held groups. That is, a new section 124-784B was introduced specifically (and only) for widely held groups to ensure that the Step 1 amount was equated to the underlying tax cost of assets (rather than the original cost base of shares). This amendment ensured that there was no reduction in the total tax cost of assets if the entity were subsequently consolidated. Furthermore, this provision provided a market value tax cost for pre-CGT assets, which dealt with assets that continued to satisfy Division 149 after the rollover.

7.2.4 In addition to the amendment in section 124-784B, Subdivision 715-W was also introduced to provide a tax consolidation stick option if the rolled over entity joined a tax consolidated group. The stick option further extended to a consolidated group being rolled into another consolidated group. Again, these options were only provided to widely held groups[6].

7.2.5 We are unsure why these provisions are not extended to privately owned groups that also satisfy the common stakeholder or significant stakeholder provisions. The issues addressed by the recent amendments above are exactly the same for privately owned (closely held) groups.

7.2.6 We see this interaction issue being one that could easily be addressed by the Board. As highlighted by the RBT report, it is critical for appropriate rollovers to be provided to privately owned groups to cater for their particular structures as well as to ensure inappropriate outcomes are removed. We therefore request the Board to seriously consider this proposed amendment.

[6] Due to the requirement in subsection 124-784A(1)(a)(ii).

Recommendation 24

7.2.7 A rollover under Subdivision 124-M will generally result in significantly adverse tax cost setting consequences for SME groups. We request that the Board recommend placing SME groups on par with publicly owned groups. This can be done by (a) where the common stakeholder or significant stakeholder test is satisfied, a privately owned group should be allowed to access the special cost base rules in section 124-784B instead of being required to apply the cost base rules in section 124-782, and (b) such rollovers be provided with the stick option and tax consolidation concessions contained in Subdivision 715-W that are currently only provided to widely held groups.

7.3 Use of Subdivision 122-A rollover

7.3.1 It is common in the middle market for a trust (generally a discretionary trust) to directly own all of the shares in one or more operating / investment companies.

7.3.2 If the trust wishes these companies to form a tax consolidated group then as the trust itself is not eligible to be the head entity of such a group it can utilise Subdivision 122-A to obtain rollover relief on the interposition of a wholly owned company ("new head company") between itself and the operating/investment companies. Utilising this rollover, the new head company can then subsequently form a tax consolidated group comprising itself, as the head entity, with the operating/investment companies as the subsidiary members. Furthermore, a consolidated group could also be rolled over to a new head company utilising Subdivision 122-A rollover relief.

7.3.3 However, where Subdivision 122-A rollover is utilised, inappropriate adverse tax consequences can also occur. This is due to the lack of interaction provisions between Subdivision 122-A and the tax consolidation provisions[7]. This issue is discussed in detail in the following sections.

Group breakup

7.3.4 Both Subdivision 122-A and 124-G rollover can be used to interpose a new head company over a tax consolidated group. Subdivision

[7] We also note that there are interaction issues with Subdivision 122-A and Division 152, whereby the history of the relevant asset (for the purpose of the 15 year rule) is lost on its rollover under Subdivision 122-A.

122-A rollover is used where there is a single owner of an existing group. Where there are multiple owners, Subdivision 124-G rollover must be used.

7.3.5 Where Subdivision 124-G rollover is used, section 703-70 of the tax consolidation provisions allows the original consolidated group to continue to exist with the new head company. There are no compliance costs in achieving this outcome. The new head company is simply substituted for the old head company.

7.3.6 However, if a shelf company is used under a Subdivision 122-A rollover, no such interaction provisions exist. Instead, the original consolidated group is discontinued, requiring Division 711 exit calculations to be performed for all entities. This also requires a determination as to whether any capital gains would accrue under CGT event L5. Furthermore, if the new group wished to form a tax consolidated group, this would require complex tax consolidation calculations and available fractions for losses (or alternatively the application of the stick concessions proposed, in the future).

7.3.7 While the Board’s Position 5.1 will allow a new group the option to stick with existing cost bases (which is similar to the effect of section 703-70), the benefit of section 703-70 is that complex exit calculations, CGT event L5 and available fraction calculations are avoided.

7.3.8 Accordingly, we see no reason why (from a policy perspective and consistent with Position 5.1) the Board would not support an amendment to section 703-70 to cater for Subdivision 122-A rollovers where the interposed entity is effectively a shelf company.

7.3.9 Consistent with the RBT recommendation 15.6(b), we highlight that it is critical to ensure that rollover provisions interact with the consolidation provisions appropriately to ensure that there is maximum take-up by SME groups.

Recommendation 25

7.3.10 Consistent with Position 5.1, section 703-70 must be amended to allow for the interposition of a new head company under Subdivision 122-A rollover, without the need for complex exit and entry calculations.

Correcting the Step 3 interaction problem

7.3.11 Where Subdivision 122-A rollover is used, the new head company will ‘inherit’ the same CGT cost bases that the trust had for the shares in the operating/investment companies. However, due to a problem with the operation of section 705-90, all profits in the underlying entities are treated as “acquired” rather than “owned” profits.

7.3.12 The failure of Step 3 to reflect the retained taxed profits of the relevant underlying companies can lead to the group having an insufficient amount of ACA to ‘push down’ into the assets of the group. In fact, the available ACA can often be far less than the existing values of those assets for (inter alia) capital allowance purposes. It is clear that this does not reflect an appropriate outcome.

7.3.13 This interaction issue has long been known to the middle market and has been previously flagged as an issue with Treasury. It is believed that this key interaction issue that needs to be addressed by the Board. Consistent with the RBT recommendation 15.6(b), we highlight that it is critical to ensure that rollover provisions interaction with the consolidation provisions appropriately to ensure that there is maximum take-up by SME groups.

Recommendation 26

7.3.14 If the Board does not accept our Recommendation 25, we request the Board to propose a recommendation that corrects the operation of section 705-90 (i.e. Step 3 profits) where Subdivision 122-A rollover is utilised. Alternatively, a cost base rule similar to section 124-784B should be introduced for Subdivision 122-A rollovers.

7.4 Interaction with Division 6

7.4.1 Position 4.1 and 4.2 propose new principles that are aimed at dealing with the tax consolidation interaction issues with Division 6 (i.e. the allocation of net income during a non-membership period). Our review of these two positions indicates that they may not provide an appropriate outcome when applied to a number of cases.

7.4.2 We have provided three examples in Appendix E to demonstrate our findings for the Board’s consideration. While we support a reasonable allocation of net income to old and new members of the trust joining the tax consolidated group, we do not believe that the positions proposed by the Board achieve this.

7.4.3 We therefore recommend that the Board more appropriately test its positions before making final recommendations to the Government. Outside of this submission, we have developed numerous examples and would be happy to consult directly with the Board on these examples. It is our view that targeted consultation is required to workshop these proposals.

Recommendation 27

7.4.4 Our testing of the Board's Positions 4.1 and 4.2 indicate that they do not provide an appropriate outcome in many circumstances. While we in principle support an allocation of net income on a reasonable basis, we believe the Board must conduct further testing of its positions before making a final recommendation to Government. We recommend that targeted consultation must occur on this issue. We have provided some worked examples that demonstrate the issue. However, we would also be happy to share our detailed testing of these two positions in the interest of trying to resolve this issue.

7.5 Trusts tax liability

7.5.1 Position 4.3 is clearly dependant on the operation of Position 4.1 and 4.2. That is, if the pre-joining time tax liability is allocated to the old owners, then a new tax consolidated group will not inherit a current tax liability related to the trusts net income.

7.5.2 However, where the head company inherits a pre-joining time tax liability of the joining trust, it is only appropriate that Step 2 be modified to incorporate this current tax liability amount.

7.5.3 We note that this should not be limited to a current tax liability and should also include certain deferred tax liabilities ["DTLs"]. For example, this would include a DTL that is inherited by the head company where it relates to a liability of the trust that is not reset (e.g. a DTL relating an unearned income liability).

7.5.4 We believe that the above two issues could possibly be dealt under a provision similar to subsection 705-70(1A). That provision currently deals with DTLs that are inherited by the head company where the amount differs to the amount recorded in the joining entity's accounts before the joining time. The same principle could be applied where the entity is a trust and the head company inherits a current tax liability and / or DTL post joining time. However, in order for the provision to work, subsection 705-70(1A) would need to operate in respect of a liability that is a "nil" amount to the trust at the joining time. This modification could be made in Subdivision 713-A.

Recommendation 28

7.5.5 We provide our support for Position 4.3. However, we note that it is also appropriate to deal with certain DTLs in the same manner as current tax liabilities. We believe that one possible way of dealing with this issue would be to modify the operation of subsection 705-70(1A) in Subdivision 713-A, so that the head entity can recalculate these tax obligations where there is otherwise a nil amount in the accounts of the trust before the joining time. Alternatively, a specific Step 2 amount could be included for these liabilities (however, as these liabilities may change in the head company, the Board may still need to consider the subsection 705-70(1A) interaction issues).

7.6 Trustee membership requirements

7.6.1 The Board's Position 4.4 states that a trustee, in its capacity as trustee, will be deemed to be a member of the same tax consolidated group as the trust. It is believed that this position will provide clarity to a number of interrelated issues.

7.6.2 We highlight, however, that it is our view that this already occurs under the current law. That is, we are unsure how the words used in Position 4.4 are any different to the words used in subsections 960-100(3) and (4). A comparison of Position 4.4 and those subsections are provided in the following table.

Position 4.4	**Subsection 960-100(3) & (4)**
The Board considers that a trustee, <u>in its capacity of trustee for a trust</u> that is a member of a consolidated group, be treated as a member of the same consolidated group as the trust.	A legal person can have a number of different capacities in which the person does things. In each of those <u>capacities</u>, the person is taken to be a <u>different entity</u>. If a provision refers to an entity of a particular kind [e.g. a trust], it refers to the entity in its capacity as that

	kind of entity, not to that entity in another capacity.

7.6.3 Our detailed analysis of the operation of section 960-100 is contained in Appendix F. Based on section 960-100 already being in operation, adding a replica provision for the purpose of the tax consolidation provisions only, will (in our view) create a significant level of confusion for the operation of the whole Act that relies on section 960-100. The consequences could also stretch as far as the GST regime, which also uses the same concept of entity as the 1997 Act.

7.6.4 We are of the strong view that the Board should reconsider its proposed Position 4.4, such that it is drafted as a "clarification" position only and not as an "amendment" position.

Recommendation 29

7.6.5 In our view, Position 4.4 is a restatement of section 960-100. Accordingly, we support the position, in principle, however, we highlight that this position must only be framed as an "avoidance of doubt" provision. We believe the Board will create significant uncertainty as to the application of the term "entity" for all other purposes of the Act if this recommendation is ignored.

7.7 Treatment of debt beneficiaries

7.7.1 In relation to Position 4.5, we agree that significant interaction issues occur for "debt beneficiaries", as they are still considered beneficiaries for the purpose of certain provisions (e.g. section 97 of the 1936 Act and other parts of the Tax Act). Accordingly, we believe that the Board's Position 4.5 will help to achieve certainty where this interaction issue still exists.

7.7.2 However, should debt beneficiaries be excluded from the operation of Division 6 and other provisions dealing with trusts under the Tax Act, we note that the interaction issues to be addressed by Position 4.5 will no longer exist. Accordingly, Position 4.5 would no longer be required. In our view, we would request that this interaction issue be acknowledged by the Board and that Position 4.5 should be contingent on a correction of the treatment of debt interest beneficiaries under the Tax Act.

7.7.3 Finally, the Board must consider transitional issues in relation to this proposed position, where the relevant trust is already a member of a tax consolidated group by a certain date. It would seem harsh to require exit calculations and possible CGT event L5 gains to accrue due to an amendment provision.

Recommendation 30

7.7.4 While we support Position 4.5, we highlight that the position will no longer be relevant if debt beneficiaries are not treated as a beneficiary of the trust for Division 6 purposes or for the purposes of other trust provisions of the Act. We recommend that the Board acknowledge this interaction issue (as it will be important if the Division 6 interaction issue is later dealt with). We also recommend the Board consider transitional issues for such trusts that are already part of a tax consolidated group.

7.8 Deferred tax assets and liabilities

7.8.1 In response to question 4.14, we believe that the inclusion of DTAs and DTLs in the tax cost setting process results in unnecessary complexity for the (vast) majority of SMEs that neither comply nor are required to comply with Australian accounting standards.

7.8.2 From the viewpoint of the middle market therefore, our initial response is that the removal of DTAs and DTLs would definitely simplify ACA calculations.

7.8.3 However, our more considered response is that there are interaction provisions in consolidation which need to be appropriately worked through. In some cases, it may not be a simple matter of having a ‘blanket removal’ of DTAs and DTL. For example, if DTLs were removed from Step 2, consideration would be required as to the flow on effect for the expense that has already been taken into account at Step 3 (owned profits). Logically, this would mean that the Step 2 amount would be replaced by a Step 3 amount, which would not resolve the complexity the proposal is trying to achieve.

7.8.4 We refer to the recent article “SMEs and tax consolidation[8]”, which highlighted numerous interaction issues that would need to be considered. We submit, therefore, that there is a need for a comprehensive workshop to

[8] Kokkinos, A., “5th Consolidation Symposium: Session 5B: SMEs and tax consolidation”, National Division, 14 October 2010, Sofitel Melbourne, Section 8.

properly consider all the interaction effects that would flow from the removal of DTA and DTLs.

Recommendation 31

7.8.5 While the removal of DTAs and DTLs may simplify the tax cost setting process, we are not sure that this will always provide for appropriate outcomes or simplification. We recommend that the Board consult and workshop this issue with ATO, industry and professional experts on this matter, before makings its final recommendation to Government.

Appendix A

A Platform for Consultation
Chapter 26 – Extract

How should family trusts and companies be consolidated?

26.22 The general consolidation regime outlined allows groups of companies and trusts to choose to consolidate their taxation position, where certain conditions are satisfied. It follows that groups of trusts and companies 'owned' by members of the one family could also choose to consolidate their taxation position under the regime, so long as the general requirements of the regime are met. This would be one option for including groups of family trusts and companies in the consolidation regime.

26.23 A second option could be to design a special optional consolidation regime for family groups, drawing on certain features of the existing trust loss measures. The key differences with this option are the availability of transitional rollovers and the greater flexibility with trust distributions. The option is outlined below.

Defining the group

26.24 When including groups of family trusts and companies in a special consolidation regime, the general consolidation principles would be adhered to. Further, a requirement that there be an ultimate head entity of the group, as in the case of company groups, would be important to ensure that provisions dealing with loss duplication and value shifting were not required to operate within the consolidated group.

26.25 The entities which could be included in a family group which chooses to consolidate could be determined by reference to a particular individual and the family members of that individual. The individual and family members could make an irrevocable election for the group to consolidate. Each family member would be able to elect whether or not to consolidate their taxation affairs in the group.

26.26 The family members who could be included in the election could be based on the existing trust loss measures. For example, family members could include defined relatives of either the individual or the individual's spouse. Defined relatives could include, among others, a child, parent, brother or sister. In addition, registered charities could be included in the election.

26.27 The consolidated family group would then include all companies and fixed trusts wholly owned by the family members who elected to consolidate (and the entities that those entities wholly own).

26.28 The group could also include discretionary and hybrid trusts on a similar basis to that outlined above. In this case, where the only objects of a discretionary trust were members of the consolidated group and/or family members who elected to consolidate, the trust would be included in the consolidated group. Similarly, where all of the fixed and discretionary objects of a hybrid trust were members of the consolidated group and/or family members who elected to consolidate, the trust would be included in the consolidated group.

26.29 In other cases, a discretionary trust could be included in a consolidated group if a member of the group was an object of that trust. Similarly, a hybrid trust would be included in a consolidated group if all the fixed interests in the trust were held by group entities and at least one group entity is a discretionary object of the trust. However, a trust would not be included in a consolidated group if it could be shown that the control of the trust and the consolidated group was exercised by different taxpayers.

26.30 Only one entity could be the head entity for the group. The selection of the head entity of the group would determine the ultimate structure of the group. This is because once an entity was selected as the head entity, all fixed interests in other entities included in the group would need to be wholly owned directly or indirectly by that head entity. For example, where a discretionary trust was chosen to be the head entity of the group, the shares in companies previously wholly owned by family members who elected to consolidate (and thus included in the consolidated group) would have to be transferred to the head entity or an entity wholly owned by the head entity.

Facilitating restructure through rollover

26.31 In many cases, family trusts and companies that are to be consolidated would already have a head entity that would own, directly or indirectly, all of the interests in the trusts and companies. The family members would be beneficiaries or shareholders of that head entity.

26.32 As a transitional measure for groups of entities which are not in this position, limited rollover relief could be considered for restructuring necessary to set up a head entity that would hold the interests in the entities to be grouped. For example, rollover relief could be considered for existing family groups (as defined in the existing trust loss measures) which consolidate within, say, two years of the consolidation regime being introduced.

26.33 Under existing State and Territory taxation legislation, stamp duty may be imposed on transactions undertaken by a family group in arranging a head entity that would hold the interests in the entities to be grouped. The proposal to remove stamp duties levied by States and Territories on marketable securities from 1 July 2001, as part of the reform of Commonwealth State financial relations, should reduce the impact of this.

26.34 It would be open to State and Territory Governments to provide stamp duty rollover relief or other transitional measures to assist family groups to consolidate.

Making distributions from the group

26.35 Under family group consolidation, where a discretionary or hybrid trust is a member of a consolidated group, the trust could make distributions directly to family members who elected to consolidate, rather than indirectly through the head entity. The trust should not be able to distribute to anyone else because this would potentially allow the benefits derived by the consolidated group to be distributed outside of the family members who elected to consolidate.

26.36 Again, one option for dealing with this situation would be to apply a final penalty tax regime to all distributions made by a trust to an object other than a family member who elected to consolidate. As discussed above, the regime could be based on the family trust distributions tax in the existing trust loss measures.

Transitional issues

26.37 As outlined in A New Tax System and in Principle 3 below, a consequence of the introduction of a consolidation regime will be the repealing of existing grouping concessions. For the existing trust loss measures, this would mean that the family group concessions in relation to the income injection test and the deducting of certain losses and debt deductions would be removed.

Appendix B

Alternative Reset Method for majority owned entities

Example to demonstrate the model

7.8.6 The following simple example is used to demonstrate how the alternative reset model would work where the entity has been predominantly owned for a long period of time. Assume that the joining entity (Aco) has the following balance sheet.

Balance sheet	Accounting	Tax	Market value
Cash at bank	300,000	300,000	300,000
Trade debtors	3,000,000	3,000,000	3,000,000
Depreciable assets	2,000,000	2,400,000	2,650,000
Trading stock	1,000,000	1,000,000	1,000,000
Consumables	200,000	-	200,000
Goodwill	-	-	14,000,000
Land and buildings	7,000,000	5,000,000	7,000,000
DTA	210,000	-	210,000
DTL	(60,000)	-	(60,000)
Loan payable	(8,000,000)	(8,000,000)	(8,000,000)
Employee provisions	(300,000)	-	(300,000)
Net assets	5,350,000	3,700,000	20,000,000
Equity	1,000,000		
Retained profits	2,350,000		-
Reserves	2,000,000		
Net equity	5,350,000		

7.8.7 Assume that Aco has been 90% majority owned for more than 30 years and that the remaining 10% of shares were acquired just after the group had formed a tax consolidated group. Assume that the goodwill of the business and the land are pre-CGT assets prior to joining the group. Assume that $2 million was paid to acquire the remaining 10% interest (i.e. 10% x $20 million).

7.8.8 In this example, a majority owned rule would be used to (a) ensure there is a retention of history so that the goodwill and land maintain their pre-CGT status (refer to Recommendation 19), (b) allow an alternative reset method to be utilised so that ACA is not inadvertently skewed to the goodwill asset (refer to Recommendation 20), and (c) to avoid costly valuations where the entity has not been acquired outright.

Outcome of alternative reset method

7.8.9 Based on the above balance sheet, the following allocable cost amount would normally be calculated for Aco.

Steps	Item	Section	Amount
Step 1	Cost base of membership interests	705-65	3,000,000
Step 2	Accounting liabilities	705-70	8,360,000
Step 2	Future deductible amounts	705-75	(90,000)[9]
Step 3	Undistributed taxed profits (90% x 2,350,000)	705-90	2,115,000
Step 8	**Total allocable cost amount**		**13,385,000**

7.8.10 Furthermore, the total allocable cost amount of $13,385,000 would be allocated to the assets of Aco based on the market values of the relevant assets, as follows.

Asset	Type	TV	MV	Reset %	TCSA
Cash at bank	Retained	300,000	300,000	N/A	300,000
Trade debtors	Retained	3,000,000	3,000,000	N/A	3,000,000
Depreciable assets	Reset	2,400,000	2,650,000	10.61%	1,070,294
Trading stock	Reset	1,000,000	1,000,000	4.00%	403,885
Consumables	Reset	-	200,000	0.80%	80,777
Goodwill	Reset	-	14,000,000	56.07%	5,654,385
Land and buildings	Reset	5,000,000	7,000,000	28.03%	2,827,193
DTA	Reset	-	120,000 **	0.48%	48,466
Total		**11,700,000**	**28,270,000**		**13,385,000**

*** Note $90,000 is treated as an excluded asset due to the section 705-70 adjustment*

7.8.11

[9] For simplicity, section 705-80 has been ignored. This provision would likely operate to create Step 5 or 6 losses, depending on whether they are owned losses or acquired losses. This may have an immaterial impact on the total ACA calculation.

7.8.12 In this example, the allocable cost amount under section 705-60 is calculated to be $13,385,000. As the existing assets have a tax cost of $11,700,000, this represents an uplift in total assets of $1,685,000 (predominantly attributable to the price paid to acquire the 10% interest).

7.8.13 The following table provides a comparison of the alternative reset method proposal contained in this submission and the spread of the allocable cost amount as required currently by section 705-35.

Asset	Type	Current	Alternative	Skewing
Cash at bank	Retained	300,000	300,000	0
Trade debtors	Retained	3,000,000	3,000,000	0
Depreciable assets	Reset	1,070,294	2,400,000	(1,329,706)
Trading stock	Reset	403,885	1,000,000	(596,115)
Consumables	Reset	80,777	-	80,777
Goodwill	Reset	5,654,385	-	5,654,385
Land and buildings	Reset	2,827,193	5,000,000	(2,172,807)
DTA	Reset	48,466	-	48,466
Total		**13,385,000**	**11,700,000**	**1,685,000**
Excess ACA		**-**	**1,685,000**	**(1,685,000)**
Total amount		**13,385,000**	**13,385,000**	**-**

7.8.14 As demonstrated by the above table, the alternative reset method retains the existing tax values, and provides an excess ACA amount of $1,685,000. This excess amount could be deemed to be a capital loss, could be deemed to be added to the cost base of CGT assets at the choice of the taxpayer (other than to membership interests of entities in the group), or alternatively could be deferred until a disposal of Aco by the group.

7.8.15 We highlight that no valuations are required in this example. The entity would simply complete the eight steps in calculating an ACA (i.e. $13,385,000) and compare that amount to existing tax costs ($11,700,000).

7.8.16 The above alternative could therefore help to address issues such as valuations, as well as the skewing problem identified by stakeholders. Furthermore, history is used to retain the pre-CGT status of the underlying land and goodwill. Accordingly, we believe there is significant merit in adopting this alternative model for “majority owned” entities that join SME groups post formation.

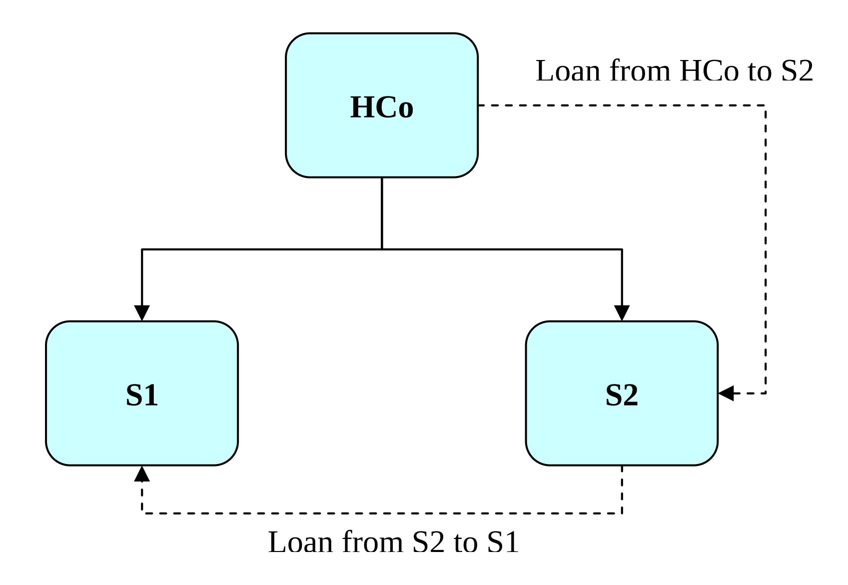
Appendix C

Value shifting and debt forgiveness

Example

7.8.17 The following example (outlined in Figure 3 below) is provided to demonstrate that simple intra-group debt forgiveness transactions are appropriately dealt with under the existing cost setting mechanics.

Figure 3 – privately owned groups



7.8.18 Assume the head company ("HCo") of the tax consolidated group wished to sell its subsidiary S2. As part of the 'tidying up' of S2 for sale, assume that the intra-group debts or loans involving that company are forgiven. In our view, the operation of Division 711 in this case would provide an appropriate outcome.

7.8.19 That is, if the loan from HCo to S2 is forgiven, value will actually be shifted into S2. This will give rise to the same capital gain that would have otherwise occurred under Division 711 (i.e. due to the operation of section

711-45(4), which picks up the same “market value” of liabilities of the leaving entity to group members). We would be concerned if the proposed value shifting integrity rules would need to be considered in this case, as this would result in unnecessary additional compliance costs.

7.8.20 Furthermore if the loan from S2 to S1 were also forgiven, this would shift value away from S2. However, there would also be a reduction in the tax cost setting amount under section 711-40 equal to the same value. This is because intra-group debts are only counted in the exit process based on their “market value” under Step 3. Again, we would concerned if the proposed value shifting integrity rules would need to be considered in this case, which would result in unnecessary additional compliance costs.

Appendix D

Example demonstrating a Subdivision 124-M rollover and its implications for privately owned groups

Example

7.8.21 Individuals A and B both individually own 100% of the shares in two small companies (Company A and Company B respectively) that operate in different geographical segments of the same industry in Australia.

7.8.22 Companies A and B have the same amount of retained earnings ($100,000), plant and equipment ($50,000 tax and accounting written down values), and cash/receivables ($50,002)[10].

7.8.23 Individuals A and B both have the same cost bases for their shareholdings in their respective companies - i.e. $2.00 in each case.

7.8.24 As a part of a commercial transaction, A and B agree to form a new company ("New Co") which they each own as to 50%. New Co then acquires 100% of Company A from individual A and 100% of Company B from individual B using the scrip for scrip rollover rules in Subdivision 124-M of the 1997 Tax Act. New Co then chooses for the group to enter tax consolidation.

7.8.25 As individuals A and B wholly owned their respective companies and will jointly own New Co, they will be "significant stakeholders" as defined in section 124-783 of the 1997 Tax Act. Because individuals A and B are "significant stakeholders", New Co will 'inherit' the CGT cost bases that they had (i.e. $4.00 in total) for the shares it now owns in Companies A and B[11] - it will thus, only have a nominal amount for the purposes of Step 1 of the ACA process.

7.8.26 In addition, as the profits were derived prior to New Co's period of ownership, no part of the retained earnings in either Company A or Company B can be taken into account at Step 3 of the ACA process (as they will not satisfy the "owned" profits test in section 705-90(6).

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[10] All of these amounts are in $A.

[11] See section 124-782 of the 1997 Tax Act.

7.8.27 In short, the sum of Steps 1 and 3 of the ACA process will be $4.00. This amount will need to be 'pushed down' into the underlying assets of the subsidiary entities (that have an existing tax cost prior to tax consolidation of $200,004).

7.8.28 The tax cost setting provisions require the cash and receivables (the retained cost base assets) to retain their tax cost amount. Accordingly, the tax cost setting amount for the retained cost base assets that New Co is deemed to hold under tax consolidation will be $100,004 - being the sum of the cash/receivables in Companies A and B.

7.8.29 Because the sum of the tax cost setting amounts for the retained cost base assets that New Co holds under tax consolidation (i.e. $100,004) exceeds the ACA for the reset cost base assets it owns (i.e. $4.00), New Co will incur an immediate capital gain of $100,000 under CGT event L3 of the 1997 Tax Act.[12]

7.8.30 Furthermore, there is no ACA remaining to allocate a tax cost to the depreciable assets. Accordingly, as no amount has been recognised for Step 3 profits of $200,000, and given that section 124-784B does not apply to a closely held group, New Co effectively is required to incur a tax cost on $200,000 (being the CGT event L3 gain of $100,000 and the reduction of tax costs in depreciable assets of $100,000).

7.8.31 As outlined in this submission, this issue is avoided for certain widely held entities. That is, such groups are provided with an alternative calculation, under section 124-784B, to calculate the cost base of shares more appropriately. Furthermore, Subdivision 715-W allows an ability to stick with existing tax cost bases in certain cases. It is submitted that such an ability to stick in these cases is warranted and should be extended to SME groups.

7.8.32 As provided by our Recommendation 24 to Recommendation 26, the Board must provide recommendations to Government to correct these anomalous outcomes that occur under the tax consolidation provisions.

[12] See section 104-510 of the 1997 Tax Act.

Appendix E

Allocation of net income under Position 4.1 and 4.2

Overview

7.8.1 As outlined in our submission, we have completed detailed testing of Positions 4.1 and 4.2 and found there to be many instances where the positions do not (in our view) provide appropriate outcomes. Following are three examples to demonstrate this.

Example 1 – trust loss incurred in membership period

7.8.2 Using the example contained in paragraphs 4.16 and 4.17 of the Board's position paper, assume that the income of the trust under the deed is based on ordinary concepts. Furthermore, assume that the trust makes a trust gain of $4,000 in the non-membership period (as per paragraph 4.16), but instead incurs a trust loss of $2,000 in the non-membership period.

7.8.3 While the old beneficiaries may have been entitled to $4,000 at the joining time, the trust will only have $2,000 of income at the end of the year to distribute under ordinary principles. Accordingly, the trustee will only be able to make beneficiaries presently entitled to $2,000 (in total) at that time.

7.8.4 In this altered example, there is a risk that a section 99A assessment may occur, as beneficiaries can only taken to be entitled to $2,000 of income of the trust for the non-membership period (i.e. if there were a distribution of $4,000, the remaining amount would be capital of the trust). This may result in the trustee being assessed on 50% of the net income of the trust for the non-membership period under section 99A.

Example 2 – sale of units in the trust

7.8.5 Furthermore, compare the example in the Board's report to an example where a single unit holder sells all of the units to a consolidated group. Using the facts in example 1 above, assume a pre-sale distribution of $4,000 is made to the old unit holder. Again, in this example, it is only possible for $2,000 of this pre-sale distribution to be treated as a distribution of income of the trust under the deed (due to the facts in example 1).

7.8.6 If position 4.1 deems the income of the trust for the non-membership period to be $4,000, this would mean that no-one is presently entitled to $2,000 of the income of the trust. In our view, there is a risk that this would result in a section 99A assessment for 50% of the trusts net income for that period and a CGT event E4 capital gain for the $2,000 of capital that has been distributed to the old beneficiaries.

Example 3 – exit calculations

7.8.7 We highlight that the same exact issue can also occur where there is an exit from the tax consolidated group and a loss is incurred either during non-membership period.

7.8.8 For example, assume that the trust deed is the same as example 1. However, trust income of $4,000 is derived during the membership period, while a $2,000 loss is derived during the non-membership period. Assume the new owners become presently entitled to $2,000 of the income of the trust at the end of the year (i.e. the whole of the income of the trust).

7.8.9 Under the Board's recommendation, there is a trust loss during the non-membership period. Accordingly, there would be a risk that there would be section 99A assessment for all of the net income during the non-membership period. This would be the case, even though the new beneficiaries are presently entitled to all of the income of the trust for the income year.

7.8.10 Furthermore, as the distribution of $2,000 to the beneficiaries is not assessable, this will result in a CGT event E4 capital gain of $2,000 (or a reduction in cost base of that amount).

Appendix F

Position 4.4 and section 960-100

Example

7.8.11 The following section provides an example to outline our view of the operation of the existing law (i.e. section 960-100) where a trustee (in its legal capacity as a company) is not a member of a tax consolidated group.

Figure 4 – trustee outside of group
ABC is a corporate entity and is the trustee of the XYZ trust discretionary trust. All potential beneficiaries of the trust are members of the XYZ tax consolidated group. ABC is wholly owned by two individuals.

Application of section 960-100 to the membership rules

7.8.12 A number of commentators have stated that there is an issue of uncertainty as to whether a trust can form part of the tax consolidated group where the trustee was not wholly owned by the tax consolidated group. In our view, there is no issue with the operation of the membership rules contained in subsection 703-15(2). The following provides a view as to how we believe the existing provisions apply.

7.8.13 Subsection 703-15(2) states that an entity that is a company, a partnership or a trust can be a member of a consolidated group, subject to certain conditions. An "entity" is defined in subsection 995-1(1), which states that unless there is a contrary intention, the term has the meaning given in section 960-100. While the word entity, as used in section 703-15, does not have an asterisk, section 2-15 provides that this is not required for that term. Accordingly, unless a contrary intention can be evidenced, section 960-100 would be used to determine the boundaries of a trust as an entity.

7.8.14 Subsection 960-100(1) clearly identifies a relevant 'entity' for the purpose of applying the relevant tax laws. This provision specifically includes a trust. Subsection 960-100(2) then specifies that the trustee of the trust is the 'person' who is regarded as the 'entity'. At this point, what this means is that ABC would be identified as a legal entity. This provision would not deal with

ABC in any capacity in particular, but rather would simply identify ABC as the relevant legal entity for section 960-100 purposes.

7.8.15 If the provision stopped there, this would definitely create a problem. That is, ABC would hold property in two capacities (its own capacity and as trustee of the XYZ trust). By identifying ABC as a single legal entity, these two capacities would be mixed. Accordingly, subsection 960-100(3) is aimed at resolving this issue by applying where a legal entity acts in more than one capacity. The provision states that:

> A legal person can have a number of different capacities in which the person does things. In each of those capacities, the person is taken to be <u>a different entity</u>. [<u>emphasis added</u>]

7.8.16 The note to the provision specifically highlights that a trustee will be considered to be more than one entity, being an entity in its own capacity (the legal entity) and an entity as trustee of a trust in that capacity (the trust entity). In this example, this means that ABC will be taken to be two entities under section 960-100, being both a company in its own right and a trust (where it acts as trustee of the trust). Furthermore, subsection 960-100(4) states that the provisions will apply to that entity in its capacity as that entity.

7.8.17 At this point, it is highlighted that the words in subsection 960-100(3) and (4) are the same as that proposed by Position 4.4.

7.8.18 Turning back to subsection 703-15, a ‘trust’ entity will be considered to be a member of a consolidated group where the entity is a wholly owned subsidiary of the head company. This term is defined in section 703-30, which effectively requires the group to beneficially own all of the membership interests in the trust. A member of an entity is defined in section 960-130. The meaning of the term is dependent on the relevant entity in question. While ABC is a company, subsection 960-100(3) specifically requires ABC to be considered to be a different entity, being the XYZ trust, unless there is a contrary intention.

7.8.19 For a trust, a member is defined as a beneficiary, unitholder or object of the trust [subsections 960-130(1), item 2]. Membership interest is defined in section 960-135, and includes all interests and rights by virtue of which you are a member. Accordingly, the provision requires one to solely look at the membership interests of the XYZ trust and not the legal entity ABC. The legal ownership of ABC is ignored for the purpose of applying these sections, as ABC is not examined in its own capacity. As stated in the note to subsection 960-100(3), it is treated as a different entity when dealing in its own capacity.

7.8.20 Therefore, under the current law, provided that the beneficiaries own their beneficial interest in the XYZ trust and that they are all members of the tax consolidated group, it would appear that the XYZ trust (as an entity) would become a member of the XYZ group. If this analysis holds true, there would currently be no requirement for a trustee to be a member of the tax consolidated group in order for the trust to join the group. This is because subsection 960-100(3) would state that the entity (being the trust) is really the trustee in its capacity as trust. Essentially, in our view, Position 4.4 would simply state the same thing as the current law states in section 960-100.

7.8.21 Accordingly, in the case of the "membership" rules, it is considered that Position 4.4 would do no more than clarify the current position under the law. That is, to the extent that there is uncertainty in relation to the analysis provided above, Position 4.4 should only be provided to avoid doubt on the intended application as outlined above.

7.8.22 We are therefore opposed to the introduction of a provision that would be seen to do more than clarify the law. We recommend that the Board state (in Position 4.4) that the position is for "the avoidance of doubt" only and that the application of the existing provisions (contained in section 960-100) should already achieve this outcome. In our view, any other position will result in unintended additional consequences for the operation of many provisions in both the Income Tax Act and other Acts that use a similar concept of an "entity".

Application to section 97

7.8.23 Commentators may also suggest that the above analysis may work for the "membership rules", but does not extend to provisions of the 1936 Act, such as Division 6. However, we do not share that same view. Again, it is our view that the provisions do indeed work, and that Position 4.4 should instead provide a resolution for "the avoidance of doubt" rather than be seen to change the way in which the law already operates. Our view on the mechanics of the relevant provisions is outlined below.

7.8.24 To demonstrate our view, consider the operation of Division 6 of the 1936 Act dealing with trust income. The relevant provisions in Division 6 do not refer to a trust as an entity. Instead, the provisions refer to a trust estate.

The provisions also make reference to the relationship that a trustee and beneficiary has with the trust estate. Consider the words in sections 97 and 98.

> S97(1). Subject to Division 6D, where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate
>
> S98(1). Where a beneficiary of a trust estate who is under a legal disability is presently entitled to a share of the income of the trust estate, the trustee of the trust estate shall be assessed and liable to pay tax in respect of ...

7.8.25 As outlined above, a beneficiary and a trustee are examined in terms of their 'relationship' with the trust estate in the 1936 Act, rather than in their capacity as an entity. Accordingly, where a company is the trustee of a trust, section 97 deals with the company in terms of its relationship with the trust property. It is still regarded as a company for the purposes of applying that provision. As compared to section 960-100, Division 6 does not turn the trustee into another entity (i.e. a trust) for the purposes of applying Division 6.

7.8.26 A discussion of the difference between this 'relationship' concept with a trust estate in the 1936 Act as compared to the capacity of entities in Division 960 of the 1997 Act is contained in the High Court transcript of *Bamford v FCT*. An extract of the discussion is provided below.

> GUMMOW J: Is this expression "trust estate" defined?
>
> MR SLATER: No, your Honour. There is a definition of "entity" in section 960.100 of the 1997 Act which defines "entity" to include "a trust" as if a trust were a person, but there is no definition of "trust estate". If I could take your Honours back to tab 5 and section 97, the problem which gives rise to these appeals is that - - -
>
> GUMMOW J: So the statute seems to turn relationships between trustees and beneficiaries into a creature of itself. There is no such thing as the income of a trust estate. The trustee might derive something and might then hold it on trust for somebody.
>
> MR SLATER: Yes, your Honour.
>
> ...
>
> MR SLATER: There is, your Honour, and the difficulty with which we are confronted is that the drafting of Division 6 does not actually accommodate trust principles. It is not as egregious as section 960.100 which treats a trust as if it were a person, but still there is this difficulty that the language of the statute does not fully accommodate the sort of issues which their Honours deal with here. In similar vein, there is an extract from Pearson v Lane at about line 35. It may be said that the observations in that passage, at about line 35 to line 45, require some reconsideration in the light of the decision in

> CPT Custodian. I should have given your Honours the citation to CPT Custodian. It is 224 CLR 98.

7.8.27 In its decision, the High Court did not try to equate the term ‘trust estate’ with the term ‘trust’ as an entity as used in section 960-100. That is, at para 27, the High Court stated:

> 27. The term “trust estate” appears throughout Div 6 and is attached to the term “trustee”, but not defined. Nor is the term “beneficiary”. However, the term “trustee” is defined in s 6(1) in terms that take the reader immediately beyond a realm limited to the trusts of a settlement or testamentary trust.

7.8.28 The court then went on to consider the ordinary meaning of the term ‘trust estate’. This is outlined in paragraph 38 of the decision.

> 38. The identification in s 97(1) of “a trust estate” of which there is “a beneficiary” also bespeaks the general law of trusts. It is true that s 97(1) must be read with s 96. This is addressed to “a trustee”, and the effect of the decisions to which reference has been made is that there may be a trustee of a trust created by the operation of a legislative regime not by settlement inter vivos or testamentary disposition. Nevertheless, there must be a “trust estate”.

7.8.29 What this appears to mean is that, for the purpose of Division 6, a trustee and a beneficiary are identified as a taxpayer based on their relationship with a trust estate. The trust estate is not deemed to be an entity for tax purposes in Division 6 and neither is the trustee or a beneficiary deemed to be separate entities. Instead, for the purpose of Division 6, it can be said that a trust estate is merely a reference to the property that is held on trust. This issue was discussed at some length in the High Court decision of *Accident Compensation Tribunal (Vic) v FC of T*.

> A ``trust estate'' for the purposes of Div. 6 of Pt III of the Income Tax Assessment Act must bear a corresponding meaning, that is, property of any kind held or controlled by a trustee in one or other of the capacities prescribed by the definition. In Manning v. FC of T,80 Knox C.J. said in reference to the definition of ``trustee'' in the Income Tax Assessment Act 1922-1925 (Cth):
>
> > ``Wide as this definition is, it requires at least as an essential ingredient in the position of `trustee' under the Act the existence of a fiduciary obligation towards some other person. The existence of a fiduciary obligation to another person must, I think, always involve a liability to account at the instance of that other person, and if I am right in thinking that the gift of income to the appellant involves no

> such liability it seems to me to follow that she is not a trustee of the income within the meaning of the Act."

> The applicability of this observation to the Income Tax Assessment Act 1936 must be tested, of course, by reference to the entirety of that extensive legislation. But we see no reason to treat the observation as inapplicable to the present definition of ``trustee''. The opening words of the definition speak of a trustee in the ordinary sense of a person who holds property on trust. Paragraph (a) comprehends persons who, whether or not they hold the relevant property, have control over it and owe a fiduciary duty to another in exercising that control. Paragraph (b) also comprehends persons who owe a fiduciary duty, but the duty must relate to the administration or control of relevant property.

7.8.30 Applying this to the example, ABC would be the trustee. While section 960-100 would say that this is in its capacity as trustee (and thus ABC would be considered a trust), this would be irrelevant for Division 6 purposes, as considered by *Bamford's* case.

7.8.31 Therefore, for Division 6 purposes, the trust estate is property that is legally owned by a trustee (being ABC). If Division 6 requires the trustee to be considered (in its own capacity) in respect of its relationship to trust property, then (on one view), this may result in ABC having obligations that are outside of the tax consolidated group. For example, considering section 99A, the provision states that ABC would be liable to pay tax on that part of the net income which is not included in the assessable income of the beneficiary. Accordingly, prima facie, ABC could be liable where the ABC Trust accumulates income.

7.8.32 However, whether ABC will be liable to tax under section 99A requires an appropriate consideration of the single entity rule and whether it covers ABC. Subsection 701-1(3) outlines the core purpose of the single entity rule for subsidiary entities of the group. The provision states that the entity is treated as part of the head company for the following purposes:

> (3) The purposes covered by this subsection (the entity core purposes) are:
>
> (a) working out the amount of the entity's liability (if any) for income tax calculated by reference to any income year in which any of the period occurs or any later income year; and
>
> (b) working out the amount of the entity's loss (if any) of a particular * sort for any such income year.

7.8.33 In other words, the single entity rule applies for the purpose of working out the amount of the "entity's" liability for income tax. In this case, the legal entity is ABC, however, subsection 960-100(3) explicitly states that the relevant entity (i.e. the trust) for single entity purposes would be ABC in its capacity as trustee. Accordingly, we believe that subsection 701-1(3) would extend to a tax liability of ABC in its capacity as trustee. Again, we see Position 4.4 doing no more than what subsection 960-100(3) already does.

7.8.34 Accordingly, in our view, we support Position 4.4 in relation to the above issue, provided it simply provides for the “avoidance of doubt” in relation to the operation of section 960-100.

Application to Division 40

7.8.35 Commentators have also suggested that there are technical difficulties where depreciating assets are held by a consolidated group through a trust. This is because section 40-40 requires one (in certain cases) to consider the “legal ownership” in preference to “equitable ownership” of an asset. If the trustee were outside of the consolidated group, then arguably this would mean that the legal ownership of the asset would be outside of the tax consolidated group.

7.8.36 For reasons stated earlier, as section 40-40 refers to an “entity”, it is believed that the legal ownership would be determined to be the trustee in its capacity as trustee, under subsection 960-100(3). Accordingly, in our view, the law would operate to treat the consolidated group as both the legal and equitable holder of the property.

7.8.37 Accordingly, again, we believe that Position 4.4 should simply provide for the “avoidance of doubt” on the operation of section 960-100, rather than anything else.

Trustee as a member of two tax consolidated group

7.8.38 Commentators have also suggested that Position 4.4 may result in a trustee being a member of two or more consolidated groups. We highlight that this is already possible under section 960-100. That is, subsection 960-100(3) clearly states that the legal entity can have different capacities and accordingly be treated as more than one entity for tax purposes.

7.8.39 Position 4.4 will do not more than clarify what already can occur under the existing law. Furthermore, while commentators have expressed a view that this can result in tax sharing arrangement complications, we highlight that this issue is not new and already exists. That is, a “trust” does not legally exist and can only be a signatory to a TSA if the trustee signs the relevant document. Under the current law, if the company is the trustee of two trusts that are members of different consolidated groups, the trustee will be a signatory to two TSAs, in its capacity as trustee for each trust.

Conclusion

7.8.40 Accordingly, we see that Position 4.4 is no more than a restatement of section 960-100. We therefore support Position 4.4 provided that it is drafted as an avoidance of doubt provision rather than a statement of law that would not otherwise occur. We re-iterate that the Board will create significant interaction issues with section 960-100 for all other components of the Tax Act if this recommendation is ignored.