Australian Government

The Board of Taxation

POST-IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE CONSOLIDATION REGIME

Discussion Paper

the board of taxation

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FOREWORD

The introduction of the consolidation regime in 2002 was a significant business tax reform that allows a wholly-owned corporate group to be treated as a single entity for income tax purposes.

The objective of the regime is to promote business efficiency, improve the integrity of the Australian tax system and reduce ongoing income tax compliance costs for wholly-owned corporate groups that choose to consolidate.[1]

A significant number of amendments have been made to refine the consolidation regime since its introduction. The Australian Taxation Office (ATO) has also produced a significant number of rulings relating to the operation of the regime.

In this context, the Board welcomes the opportunity to conduct a post-implementation review on certain aspects of the consolidation regime. The review will focus on the high level principles and core rules of consolidation, and on the practical experience of business, including small business.

Richard Warburton AO
Chairman, Board of Taxation

1 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 1.9, 2.4, 14.6 and 14.7.

CHAPTER 1: INTRODUCTION

1.1 On 3 June 2009 the Government asked the Board of Taxation to undertake a post-implementation review of certain aspects of the consolidation regime.

1.2 The Board's intention in undertaking post-implementation reviews is not to re-open debates about policy intent. Instead the focus is on whether the legislation is operating as intended or whether its implementation can be improved. This can have the added benefit of improving future policy development and its implementation.

SCOPE OF THE REVIEW

1.3 As it is not feasible to review the whole of the consolidation regime, the Board of Taxation has been asked to focus on the following three key elements of the consolidation regime:

- the operation of the single entity rule;
- the interaction between the consolidation provisions and other parts of the income tax law; and
- the operation of the inherited history rules.

1.4 In addition, in light of empirical evidence which indicates a relatively poor take-up of the consolidation regime by eligible small business groups, the Board will also consider the effectiveness of the consolidation regime for these small business groups.

1.5 Conducting post-implementation reviews is consistent with one of the Board's functions, namely to advise the Treasurer on 'the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design'.[2] The Board has established criteria against which it evaluates legislation selected for a post-implementation review. The criteria include the extent to which the legislation:

- gives effect to the Government's policy intent, with compliance and administration costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;

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2 The Charter of the Board of Taxation.

- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.

1.6 These principles are drawn from the Board's report on *Government Consultation with the Community on the Development of Taxation Legislation*.[3]

THE REVIEW TEAM

1.7 The Board has appointed a Working Group of its members to oversee the review. The members of the Working Group are Richard Warburton AO (Chairman) and Keith James. Geoffrey Lehmann has been engaged as a consultant to assist with the review. The Board has also appointed an Expert Panel to provide further specialist assistance to the Board in understanding the complex operation of the relevant taxation law and its practical application.

1.8 The Working Group is being assisted by members of the Board's Secretariat and by staff from the Treasury and from the ATO.

REVIEW PROCESSES

1.9 The Board plans to consult with all stakeholders that have an interest in the consolidation regime.

1.10 When the Review was announced in June 2009 the following outline of the review process was placed on the Board's website.

- In conducting this review the Board proposes to consult widely and provide all stakeholders with the opportunity to participate in the review.
- Initially the Board will prepare a discussion paper on the aspects of the consolidation regime that are being reviewed. The Board will conduct targeted consultation meetings to assist with the preparation of the discussion paper.

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3 Board's report to the Treasurer and Minister for Revenue and Assistant Treasurer on Government Consultation with the Community on the Development of Taxation Legislation, March 2002, paragraph 61.

- The Board expects to release this discussion paper in the last quarter of 2009.
- In conjunction with the release of the discussion paper the Board will invite public submissions to the review and conduct public consultation meetings. At that time the Board will advise stakeholders of the timing of the various consultation processes as well as the likely reporting date.

1.11 To facilitate the public consultation process, the Board has developed this paper as a basis for further discussions. In developing the paper the Board has consulted with the Expert Panel, as well as Treasury and the ATO. The Board acknowledges that the issues addressed in this discussion paper reflect to a large degree those issues previously raised by industry in the ATO facilitated National Tax Liaison Group (NTLG) Consolidation Sub-group that continue to remain unresolved. To the extent they are relevant to the terms of reference, this paper draws on those consultations in canvassing issues that continue to create uncertainty or unfairness for taxpayers in applying the consolidation provisions.

1.12 The paper provides a framework for consideration of the key issues that have been brought to the attention of the Board and poses questions to be addressed as part of the consultation process. It is not expected that all stakeholders will necessarily respond to all of the issues and questions identified in the paper. Rather, some stakeholders may only wish to respond to those issues of direct relevance to them. In addition, all stakeholders are invited to comment on any additional issues within the Board's terms of reference for the Review that are not specifically raised in this discussion paper.

1.13 Given the time available, and the potential breadth of issues associated with the Review, the Board intends to undertake this post-implementation review as a multi-stage process, and expects to release a further position paper in the second quarter of 2010. The position paper will highlight key areas of concern in relation to implementation of the consolidation rules and detail specific design principles to strengthen the operation of the consolidation regime to ensure the legislation is operating as intended. The submissions received in relation to this discussion paper and other advice received by the Board will form the basis of this position paper.

1.14 Depending on the issues raised during consultation, the Board expects to present its recommendations to Government for consideration by the end of 2010.

Making submissions

1.15 The Board welcomes submissions on the issues raised in this discussion paper. The closing date for submissions is 26 February 2010. Submissions can be sent:

By email to:

taxboard@treasury.gov.au

By facsimile to:

(02) 6263 4471

By post to:

Post-implementation Review into Certain Aspects of the Consolidation Regime
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600
AUSTRALIA

1.16 Submissions should include a brief summary of major points and recommendations. They should also include contact details so that the Board can contact those making the submission to discuss points raised if required. Submissions will be published on the Board's website (www.taxboard.gov.au) unless it is clearly stated that the submission is confidential.

CHAPTER 2: BACKGROUND

BACKGROUND TO THE CONSOLIDATION REGIME

2.1 Prior to 1 July 2002 Australian resident companies were taxed as separate entities. Specific grouping rules in relation to wholly-owned corporate groups allowed:

- losses to be transferred between group members;
- dividends to be paid tax free to another member of the group; and
- capital gains and losses to be rolled-over when assets were transferred between group members.

2.2 The consolidation regime was introduced following a recommendation of the Review of Business Taxation in 1999 to overcome efficiency and integrity concerns that arose under the previous corporate tax system. These included:

- tax impediments to business reorganisations — for example, possible tax costs of liquidating a redundant company in a wholly-owned group or buying back shares from a group entity;
- high compliance costs and complex tax laws to deal with groups — for example, the costs of dealing with the tax implications of group reorganisations, intra-group dividends and disposals of ordinary assets and revenue assets (including trading stock) within groups;
- double taxation — where gains realised in ordinary commercial transactions are taxed again on the disposal of equity;
- loss duplication — where losses realised in carrying on a business or on disposal of assets are realised again on the disposal of equity;
- loss cascading — where group companies (as well as companies that are less than 100 per cent owned) can use a chain of companies to create multiple tax losses based on one initial economic loss;
- value shifting — where artificial losses are created (where there is no economic loss) through shifting value between group companies; and

- tax avoidance through intra-group dealings — for example, manipulating dealings between group companies to reduce or defer tax.[4]

2.3 The consolidation regime was introduced as a structural solution which addressed these problems by:

- ceasing to recognise multiple layers of ownership within a wholly-owned group; and

- treating wholly-owned groups as a single entity for income tax purposes — that is, members of a consolidated group lose their separate tax identity when they join a consolidated group and acquire a new tax identity when they leave the group.[5]

BROAD OUTLINE OF THE CONSOLIDATION REGIME

2.4 The former government accepted the Review of Business Taxation's recommendation to implement the consolidation regime. The consolidation regime is contained in Part 3-90 of the *Income Tax Assessment Act 1997* (the ITAA 1997), which was introduced with effect from 1 July 2002. Various refinements have been made to the regime since 2002.

2.5 The consolidation regime applies primarily to wholly-owned groups of Australian resident entities that choose to form a consolidated group.

2.6 A consolidated group generally consists of an Australian resident head company and all of its wholly-owned Australian resident subsidiaries. Specific rules allow certain resident wholly-owned subsidiaries of a foreign holding company to consolidate (a multiple entry consolidated group (MEC group)). Unless otherwise specified, references in this discussion paper to a consolidated group include a MEC group.

2.7 Following a choice to consolidate, the members of a consolidated group are treated as a single entity for income tax purposes. Subsidiary members lose their individual income tax identities during the time they are members of the consolidated group and are treated as parts of the head company. This means that:

- a single income tax return is lodged by the group and the group pays a single set of pay as you go instalments;

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4 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.3.

5 ibid, paragraph 1.10.

- losses, franking credits and foreign income tax offsets are pooled in the head company;
- the assets and liabilities (other than intra-group assets and liabilities) of the subsidiary members are treated as if they were assets and liabilities of the head company;
- the actions of the subsidiary members (for example, acquisition or disposal of assets) are treated as if they had been undertaken by the head company; and
- intra-group transactions (for example, the transfers of assets between group members) are treated as arrangements between divisions of a single company.[6]

2.8 The consolidation regime is only relevant for income tax purposes. It does not affect, for example, an entity's goods and services tax obligations or its fringe benefits tax obligations.

POLICY BENCHMARKS FOR CONSIDERING THE EFFECTIVENESS OF THE OPERATION OF CERTAIN AREAS OF THE CONSOLIDATION REGIME

2.9 The primary objectives behind the introduction of the consolidation regime were:

- to promote business efficiency;
- to improve the integrity of the Australian tax system; and
- to reduce ongoing income tax compliance costs for wholly-owned corporate groups that choose to consolidate.[7]

2.10 The Board's intention in undertaking post-implementation reviews is not to re-open debates about policy intent. Instead the focus is on whether the legislation is operating as intended or whether its implementation can be improved.

2.11 However, in considering whether the legislation is operating as intended and whether its implementation can be improved, the Board welcomes stakeholder comments on the following questions.

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6 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.5 and 2.7.

7 ibid, paragraphs 1.9, 2.4, 14.6 and 14.7.

Question 2.1

The Board seeks stakeholder comment on:

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

(b) For those corporate groups that have elected into the consolidation regime, has the introduction of the consolidation regime reduced the ongoing tax compliance costs associated with carrying on the group's business? If not, what are seen as the key impediments to achieving reduced compliance costs?

(c) For those corporate groups that have not yet elected to consolidate, what are the key concerns that are keeping corporate groups out of the consolidation regime?

CHAPTER 3: OPERATION OF THE SINGLE ENTITY RULE

3.1 Treating wholly-owned corporate groups as a single entity is the cornerstone principle of the consolidation regime.

3.2 This Chapter outlines some of the issues in relation to the operation of the single entity rule that the Board has been made aware of. The Board acknowledges that many of these issues have previously been raised by industry participants with the ATO, yet at present remain unresolved. The Board is seeking comments on the issues raised in this Chapter, and on any other issues that arise with the practical operation of the single entity rule.

3.3 The Board has been advised that in most cases the single entity rule produces appropriate outcomes. However, in certain circumstances issues have arisen with the practical operation of the single entity rule. This has led to a degree of uncertainty for taxpayers in applying the single entity rule and resulted in a lack of symmetry and unfairness. In some cases this uncertainty or unfairness provides favourable outcomes for taxpayers. However, in other cases the outcomes for taxpayers are unfavourable.

Question 3.1

The Board seeks stakeholder comment on:

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

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

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

THE SINGLE ENTITY RULE

3.4 The single entity rule treats a wholly-owned corporate group as a single taxpayer. The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 specified the intended outcome of applying the single entity rule as follows:

> The single entity treatment, coupled with the inherited history rules and special rules for setting the cost for tax purposes of assets of entities joining and leaving consolidated groups, will:
>
> - simplify the tax system and reduce on-going compliance costs;
> - promote economic efficiency by providing a taxation framework that allows Australian businesses to adopt organisation structures based more on commercial rather than tax considerations; and
> - promote equity by improving the integrity of the tax system.[8]

3.5 The single entity rule is expressed in the income tax law as a principle which provides that, for the 'core purposes', the subsidiary members of the group are treated as parts of the head company, rather than as separate entities.[9]

3.6 The core purposes are, broadly, the purposes of working out the amount of the taxable income, or tax losses, of the head company of the group or of any other entity that is a member of the group.

3.7 The underlying intention of the single entity rule is that the application of the income tax law to consolidated groups should align with its application to single companies operating by divisions. In this regard, the Explanatory Memorandum states:

> The income tax treatment of a consolidated group flows from the rule that an entity is treated as part of the head company while it is a subsidiary member of a consolidated group. Actions of the subsidiaries are treated as actions of the head company, as this is the only entity the income tax law recognises for the purposes of working out the income tax liability or losses of a consolidated group. For example, a transfer of an asset from one subsidiary member to another is treated like a transfer from one division of a company to another division. Such a transaction could not have any income tax

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8 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.4.

9 Section 701-1 of the ITAA 1997.

consequences, as no disposal between distinct entities would have occurred (an entity cannot transact with itself).[10]

3.8 The Explanatory Memorandum goes on to state that:

> The single entity rule will ensure that the ITAA 1997 and the ITAA 1936 operate in respect of a consolidated group **as if the subsidiaries are absorbed into the head company, which is the relevant taxpayer**. A number of implications flow from the application of this rule.[11] [emphasis added]

3.9 Examples of the effect of this absorption are that:

- the consolidated group lodges a single income tax return, with no separate lodgement requirements imposed on its members;
- the taxable income of the taxpayer refers to that of the head company — this calculation is made on the basis that income and deductions are assessed or allowable to the head company only;
- the obligations to keep records rest with the head company as it is regarded as the taxpayer during the period of consolidation;
- for the purpose of determining any relevant income tax consequences arising out of the holding or disposal of assets:
  - assets that an entity brings into a consolidated group are taken to be held by the head company as well as assets that the entity acquires during the period that it is a member of the group;
  - the head company is taken to hold any assets for so long as they are held by an entity while it is a subsidiary member of the group and to do anything in relation to those assets that is done by the subsidiary member;
  - if a capital gains tax (CGT) event happens in relation to any CGT assets held by any entity while a subsidiary member of the group, that event is taken to happen in relation to the asset while held by the head company and anything done by the subsidiary entity as part of the CGT event is taken to have been done by the head company; and

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10 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.12.

11 ibid, paragraph 2.16.

- the trading stock that is sold between members of the same wholly-owned group is no longer recognised as trading stock and is treated as consumables — this is because, following consolidation, intra-group transactions are ignored for income tax purposes.[12]

3.10 Interactions with other provisions of the income tax law need to be taken into account when applying the single entity rule. In doing so, the way the law applies is dependent upon legislative intent and the words of the provisions under consideration. Section 701-85 of the ITAA 1997 gives effect to this approach to statutory interpretation. The Board understands that some industry participants have raised concerns that the operation of section 701-85 causes confusion and uncertainty as the circumstances in which it applies, if any, are unclear.

THE ATO'S VIEW ON THE OPERATION OF THE SINGLE ENTITY RULE

3.11 The Commissioner of Taxation's view on the operation of the single entity rule is set out in Taxation Ruling TR 2004/11. The Ruling states:

> The single entity rule, broadly speaking, allows for parity between the income tax position of a consolidated group, treated as a single entity, and of a company carrying on business in divisions.[13]

3.12 Taxation Ruling TR 2004/11 adopts the divisional company model view of the single entity rule, consistent with the intent of the legislation as outlined in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002.

3.13 Senior representatives of the ATO recently presented a paper at the Taxation Institute of Australia 4th Consolidation Symposium on 29 April 2009 and 1 May 2009 (the ATO Consolidation Symposium paper) which outlined some ATO perspectives on unravelling the mysteries of the single entity rule. A compendium of ATO views that address single entity rule issues which was attached to the paper is at Appendix 2.

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12 ibid, paragraph 2.2.
13 Taxation Ruling TR 2004/11, paragraph 35.

Question 3.2

The Board seeks stakeholder comment on:

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

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

(c) Does section 701-85 of the ITAA 1997, which sets out the approach to the interpretation of the core consolidation provisions, increase uncertainty in the application of the single entity rule? If so, how can this uncertainty be alleviated?

PRACTICAL OPERATION OF THE SINGLE ENTITY RULE

3.14 The Board has been advised that both stakeholders and the ATO consider that the single entity rule using the divisional model is working effectively and results in appropriate outcomes in most cases.

3.15 However, the ATO Consolidation Symposium paper outlined some ATO concerns about the practical operation of the single entity rule, as follows:

> In relation to the ATO's approach to the single entity rule, any mechanically consistent approach produces anomalies and where that arises it is necessary to give priority to the legislative purpose. It is therefore necessary to consider the purpose of the provisions being affected by the single entity rule.
>
> The ATO tried to get a consistent approach and has found that anomalous outcomes cannot be avoided.[14]

3.16 Further:

> The ATO's administration of the single entity rule's application and operation in relation to other areas of the *Income Tax Assessment Act*, particularly regarding transactions between the group and third parties, is clearly proving to be far from straightforward and will certainly be an ongoing process.[15]

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14 Des Maloney and Peter Walmsley, *ATO Perspective on Consolidation – Unravelling the Mysteries of the Single Entity Rule*, pages 14 and 15.

15 Des Maloney and Peter Walmsley, *ATO Perspective on Consolidation – Unravelling the Mysteries of the Single Entity Rule*, page 15.

3.17 The issues raised by the ATO in relation to the practical operation of the single entity rule broadly fall within two main categories:

- whether the single entity rule should be modified to deal with intra-group assets; and
- whether the single entity rule should be extended to third parties that deal with a consolidated group.

THE SINGLE ENTITY RULE AND INTRA-GROUP ASSETS

3.18 The purpose of the single entity rule is to ensure that the income tax law applies to a consolidated group in the same way that it applies to a single entity. In this regard, dealings between members of the group are ignored for income tax purposes — in the same way that dealings between divisions of a company are ignored for income tax purposes.

3.19 This requires putting aside the legal form of membership interests and intra-group contractual relationships, and looking at the consolidated group as a single taxpayer. Transactions between members of such a group (such as the transfers of assets or the payment of money) have no financial impact on the group as a whole. Instead, they are commercially analogous to functional arrangements between divisions of a single company.

3.20 The single entity rule has no impact on the legal status of intra-group dealings for other purposes. Implementation of the divisional company model therefore requires the imposition of a fiction on, or deeming of, the legal facts.

3.21 Some divergence from the divisional model in respect of intra-group assets that emerge from a consolidated group is demonstrated by Taxation Ruling TR 2004/11, which states that:

> The transfer of intra-group assets to non-group entities will have income tax implications for the head company. The single entity rule gives effect to the legislative intention that the consolidated group (being the head company) should be treated in a similar way to a single company for income tax purposes. An analogy used is that the income tax outcomes of transactions within the group should be similar to the outcomes for a single company that operates through divisions. However, the intra-group assets of a consolidated group represent rights between members of the group. Such rights could not exist between divisions of a divisional company. **Accordingly, the income tax law**

> **has regard to intra-group assets on being transferred to a non-group entity.**[16] [emphasis added]

3.22 The ATO Consolidation Symposium paper raised further concerns about the wider consequences of the divisional model's requirement to disregard intra-group assets and transactions to prevent double taxation and double losses. In this context, the paper stated:

> However, more than avoiding double tax or double losses may result from disregarding intra-group transactions. Disregarding transactions, as we know from section 260 of the *Income Tax Assessment Act 1936*, has its problems. It is fine if all you want to do is annihilate something and pretend that it never happened, but complications arise if you also want to pretend that something else happened instead of the annihilated transaction. If the intra-group transaction is connected with something that happened to a third party (it will not be possible or appropriate to disregard what happened in connexion with the third party) the question will be whether and to what extent disregarding the intra-group transaction requires re-characterisation of the transaction with the third party.
>
> One view is that you read the single entity rule absolutely literally and you characterise transactions as if there were literally just one company in existence, being the head company, who engaged in transactions that just one company can enter into. That means you reconstruct transactions that never happened to replace the ones that did happen, but which you have to disregard. This view poses the question, what would or could have happened if this head company had been a divisional company? The answer is taken to be the outcome of applying the single entity rule.
>
> Notwithstanding the above concerns, the Commissioner arrived at the view that for the purpose of administration a Divisional Model should be adopted as it best represented the intent of the legislature.[17]

3.23 The ATO Consolidation Symposium paper suggests that, although the divisional model is to be applied wherever possible, this may be problematic in some situations, such as dealings in intra-group assets with non-group members, which have no equivalent for a single company operating by division. In this regard, the paper states:

> The divisional model is applied … unless the situation being considered could not have an equivalent for comparison in a divisional company. This means that intra-group transactions and dealings involving assets (not being intra-group assets) generally have no tax consequences.

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16 Taxation Ruling TR 2004/11, paragraph 36.

17 Des Maloney and Peter Walmsley, *ATO Perspective on Consolidation – Unravelling the Mysteries of the Single Entity Rule*, page 10.

> Where the situation does not have an equivalent in a divisional company, the single entity rule is applied in light of the facts relating to the situation, and the approach in paragraphs 26 to 28 [of Taxation Ruling TR 2004/11]. This means that dealings in intra-group assets with non-group members will generally be treated as 'disposals'. The legal existence of the assets disposed of is relevant; there is no 'statutory' or other creation of such assets for tax purposes.
>
> The exception to this approach is debt like instruments — where a practical outcome is required.[18]

3.24 Therefore, the ATO has identified some practical difficulties in applying the divisional model underlying the single entity rule to transactions that could not be undertaken by a divisional company.

3.25 This primarily relates to intra-group assets constituted by contractual rights between group members which are disregarded by the head company. Examples include:

- rights relating to intra-group shares in subsidiary companies or units in subsidiary trusts;
- rights relating to intra-group debt; and
- rights relating to other intra-group contracts (such as leases, licences and options).

3.26 These kinds of intra-group assets may emerge, or re-emerge, for income tax purposes when:

- the head company disposes of rights under an intra-group asset (such as a lease, licence or option) directly to a non-group member; or
- a subsidiary member which holds an intra-group asset leaves a consolidated group.

3.27 When intra-group assets emerge or re-emerge from a consolidated group, issues may arise in relation to:

- the tax costs of intra-group assets that are acquired by a consolidated group;
- the tax costs of intra-group assets that are disposed of by a consolidated group; and
- the other tax history of intra-group assets.

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18 Des Maloney and Peter Walmsley, *ATO Perspective on Consolidation – Unravelling the Mysteries of the Single Entity Rule*, page 14.

The tax costs of intra-group assets that are acquired by a consolidated group

3.28 Transactions by a consolidated group with third party entities may become intra-group arrangements. This can happen where:

- a member of a consolidated group has a contract with a third party entity and another member of the group acquires the third party entity's rights under the contract; or
- a consolidated group acquires all of the membership interests in a third party entity, so that the third party entity becomes a subsidiary member of the group.

3.29 The consolidated group may incur costs that reflect a genuine outgoing to re-acquire the rights from the third party entity. However, as those rights become intra-group assets of the group, these costs are not recognised for income tax purposes. In some cases this outcome may be appropriate. In other cases the lack of recognition for these costs may be inappropriate.

3.30 In this regard, the ATO Consolidation Symposium paper states:

> Situations may arise where there has been a real economic outlay to a third party for an asset (for example a lease, licence or option) that does not have a corresponding accounting liability, and that asset becomes an intra-group asset. This could occur where the corresponding (non-accounting) liability or obligation is with a member of a consolidated group and:
>
> - the acquirer of the asset becomes a member of the same consolidated group; or
> - a member of the consolidated group acquires the asset from the third party and it becomes an intra-group asset because another member of the same group has the corresponding non-accounting liability or obligation.
>
> Neither the tax cost setting amount nor the expenditure incurred for the asset will be recognised for the head company core purposes when it becomes an intra-group asset.[19]

Direct acquisition of an intra-group asset

3.31 Where a consolidated group owes an accounting liability that corresponds with an asset that becomes an intra-group asset, both the asset and the liability are disregarded. This could arise where the group has an asset that is, in substance, a debt which is owed by the group to a third party entity.

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19 Des Maloney and Peter Walmsley, *ATO Perspective on Consolidation – Unravelling the Mysteries of the Single Entity Rule*, pages 15 and 16.

3.32 In these circumstances, as illustrated in Example 3.1, any costs incurred to acquire the right should not be recognised in the cost base of an asset or allowed as a deduction.

Example 3.1: Direct acquisition of an intra-group asset that is a debt

A member of a consolidated group (Sub A) enters into a loan agreement with a third party (Third Party Co) in 2009.

In 2012, Third Party Co assigns the debt to another member of the consolidated group (Sub B) for $25 million (that is, the market value of the debt).

As a consequence of the single entity rule, the debt will become an intra-group asset. However, the head company of the group (Head Co) cannot deduct the expenditure incurred to acquire the debt ($25 million).

This outcome is appropriate because both the asset and liability have been brought within the group.

3.33 However, except for assets that are effectively loans, rights under a contract do not generally give rise to a corresponding accounting liability. For example, a member of a consolidated group may acquire a third party entity's rights against another member of the group under a commercial contract (such as an operating lease or licence) which then becomes an intra-group asset.

3.34 As a result, as illustrated in Example 3.2, any costs incurred by the group to acquire the rights under the lease or licence are not recognised by the group for income tax purposes. This can result in some unfairness as the outcome that arises from the disposal of an intra-group asset may be different to the outcome that arises from the disposal of an entity that holds an intra-group asset (see Example 3.4).

Example 3.2: Direct acquisition of an intra-group licence

The head company of a consolidated group (Head Co) creates a software application (that is, an intellectual property asset) which it patents.

In 2009, Head Co grants a licence to use the software to a third party (Third Party Co) for 5 years. Head Co receives consideration of $5 million for the grant of the licence. As a consequence, Head Co includes a capital gain under CGT event D1 (section 104-35 of the ITAA 1997) of $5 million in assessable income.

In 2012, another member of the group (Sub A) acquires the licence from Third Party Co for $5 million.

As a consequence of the single entity rule, the licence will become an intra-group asset. Therefore, the expenditure incurred to acquire the licence ($5 million) is not recognised by Head Co.

Therefore, as no tax cost is recognised, if Head Co subsequently disposes of the licence and does not incur any incidental costs, Head Co will make a capital gain equal to the capital proceeds received. Alternatively, if the licence comes to an end while in the group, Head Co will not recognise any capital loss.

Indirect acquisition of an intra-group asset

3.35 The outcome that arises in the case of a direct acquisition of an intra-group asset can also arise where a consolidated group acquires all of the membership interests in a third party entity, so that the third party entity becomes a subsidiary member of the group. Example 3.3 illustrates the outcomes that arise when an intra-group asset is acquired indirectly.

Example 3.3: Indirect acquisition of an intra-group licence

Assume the same facts as in Example 3.2. However, in 2012 Head Co acquires all the membership interests in Third Party Co for $5 million. As a result, Third Party Co becomes a subsidiary member of Head Co's consolidated group.

As Third Party Co becomes a member of the same consolidated group, the licence will receive a tax cost setting amount based on its relative market value under the consolidation tax cost setting rules.

As a consequence of the single entity rule, the licence will become an intra-group asset. Therefore, Head Co cannot take the tax cost setting amount into account when something happens to the licence (section 701-58 of the ITAA 1997).

Therefore, as no tax cost is recognised, if Head Co subsequently disposes of the licence and does not incur any incidental costs, Head Co will make a capital gain equal to the capital proceeds received. Alternatively, if the licence comes to an end while in the group, Head Co will not recognise any capital loss.

The tax costs of intra-group assets that are disposed of by a consolidated group

3.36 Intra-group assets can be disposed of by a consolidated group where:

- the rights under a contract between members of the group are disposed of to a third party entity; or
- a subsidiary member of the group leaves the group taking rights under a contract with another member of the group with it.

Direct disposal of an intra-group asset

3.37 The ATO has issued several taxation determinations which outline the consequences that arise when the rights under a contract between members of the group are disposed of to a third party entity.

3.38 Taxation Determination TD 2004/33 concludes that a CGT event does not happen to the head company of a consolidated group if a debt is created within the group and is later transferred to a third party entity. The Taxation Determination states:

> The income tax laws treat the conferring of rights under the debt in the non-group entity by the head company (on behalf of the consolidated group) as the borrowing of money or obtaining of credit from another entity. Because of this, a CGT event does not happen to the head company.[20]

3.39 In contrast, Taxation Determination TD 2004/34 concludes that a CGT event does happen to the head company of a consolidated group where an option granted within the group is later transferred to a third party entity. However, only incidental costs incurred by the group to third party entities relating to the transfer are included in the cost base of the option.

3.40 A similar outcome arises where an intra-group licence is transferred by a member of a consolidated group to a third party entity (Taxation Determination TD 2004/35).

3.41 However, where a member of a consolidated group assigns the principal of a loan owed to it by another member (that is, an intra-group debt) to a third party entity, the arrangement is treated as the issue by the head company of a security under section 159GP of the ITAA 1936 (Taxation Determination TD 2004/84). The Taxation Determination states:

> Applying the single entity rule …, the head company will be taken to be the issuer of the security once the member assigns the right to the principal to an entity outside the group. The head company will be able to claim deductions on an annual accruals basis in relation to the discount or deferred interest component of the security under Division 16E of Part III (Division 16E) of the ITAA 1936 if the security satisfies the conditions for a 'qualifying security' under subsection 159GP(1) of the ITAA 1936 at the time of the deemed issue by the head company and the conditions of section 159GT of the ITAA 1936 are otherwise satisfied.[21]

3.42 In relation to the single entity rule, the Taxation Determination states:

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20 Taxation Determination TD 2004/33, paragraph 4.
21 Taxation Determination TD 2004/84, paragraph 2.

> Under the single entity rule, an arrangement between members of a consolidated group is taken to be an arrangement between parts of the head company. Where such an arrangement involves a loan, the loan or interest obligations and payments will not be recognised and the income tax law … cannot apply to them, as the head company is notionally both the debtor and the creditor as long as the arrangement subsists within the group.
>
> If a debt (*chose in action*) held by the member lender is subsequently assigned to an entity outside of the consolidated group ('non-member entity'), income tax consequences can arise for the consolidated group. Those consequences are viewed from the perspective of the head company as a result of the single entity rule. Notwithstanding that under the single entity rule the head company did not recognise the intra-group transaction between the members of the group for the purposes of working out its own income tax, this underlying agreement may still be relevant in determining what rights and obligations the head company is taken (because of the single entity rule) to have entered into with the non-group member.[22]

3.43 A similar outcome arises where an intra-group income stream is assigned by a member of a consolidated group to a third party entity (Taxation Determination TD 2004/85).

Indirect disposal of an intra-group asset

3.44 When an entity leaves a consolidated group, the tax costs of its membership interests are reconstructed by, broadly, subtracting the value of the leaving entity's liabilities from the tax costs of its assets — that is, by working out the 'old group's allocable cost amount'.[23]

3.45 When an asset of the leaving entity corresponds to a liability that is actually owed to the leaving entity by a member of the old group, the old group's allocable cost amount is increased to reflect the market value of the asset. This adjustment to the old group's allocable cost amount effectively increases the tax costs of the membership interests held by the consolidated group in the leaving entity.

3.46 If the intra-group asset is a debt which is owed to the leaving entity by other members of the group, the amount of the increase in the allocable cost amount is the market value of the asset at the leaving time.

3.47 However, as an integrity rule, where the creation of an asset in a leaving entity before its leaving time would have been a CGT event but for the single entity rule, the amount added to the old group's allocable cost amount is, depending on the

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22 ibid, paragraphs 5 and 6.
23 Division 711 of the ITAA 1997.

circumstances, the incidental costs incurred in relation to the asset, the expenditure incurred in relation to the asset, or the cost base or reduced cost base of the asset.[24]

3.48 The operation of this adjustment to the old group's allocable cost amount was illustrated in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 as follows:

> Within a consolidated group, land with a market value of $10 million is leased to a group entity, Lefco, for 99 years for a rental of $1 per year. The group had a cost base for this land of $2 million.
>
> With this lease as Lefco's only asset, the group sells all of its membership interests in Lefco.
>
> The head company's cost for the groups membership interests in Lefco is set at $2 million, because that is the cost that would be allowed to the group for the CGT event constituted by the terms of the lease of the land to Lefco.[25]

3.49 The purpose of this adjustment to the old group's allocable cost amount is to ensure the liabilities which are not recognised while the leaving entity was a member of the group (because of the single entity rule) are reflected in the allocable cost amount.[26]

3.50 Example 3.4 illustrates the outcome that arises when a leaving entity takes with it an intra-group asset which has been acquired by the consolidated group. The example highlights that the outcome that arises from the disposal of an intra-group asset (see Examples 3.2 and 3.3) may be different to the outcome that arises from the disposal of an entity that holds an intra-group asset.

Example 3.4: Direct acquisition of an intra-group licence

Assume the same facts as in Example 3.2. However, Sub A leaves the consolidated group and takes the licence to use the software with it — that is, Head Co does not dispose of the licence and the licence did not come to an end while in the group. If the licence is the only asset held by Sub A at the leaving time, a third party will pay Head Co the market value of the licence ($5 million) to acquire the membership interests in Sub A.

In these circumstances, Head Co will owe an obligation (a liability) to Sub A which corresponds to the asset (the licence) that Sub A takes with it. Therefore, section 711-40 of the ITAA 1997 will apply so that old group's allocable cost amount

24 Sections 711-20 and 711-40 of the ITAA 1997.

25 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, Example 5.15, pages 146 and 147.

26 Section 711-20 of the ITAA 1997.

for Sub A is increased by the market value of the licence.

Therefore, the consolidated group has paid $5 million to acquire the licence which is reflected in the amount it receives for disposing of the membership interests in Sub A. Assuming that it does not incur any incidental costs, Head Co will not make any capital gain or loss as a result of the disposal of the membership interests in Sub A — that is, the capital proceeds received by Head Co ($5 million) will be equal to the old group's allocable cost amount for Sub A ($5 million).

A similar outcome would arise if the intra-group licence had been acquired indirectly (that is, in the circumstances outlined in Example 3.3).

3.51 The Government has accepted in principle that the operation of section 711-40 of the ITAA 1997 would be modified to:

- restrict the adjustment so that it applies only to accounting liabilities owed by the group to the leaving entity; and
- where the creation of an asset in a leaving entity before its leaving time would have been a CGT event but for the single entity rule, reduce the amount of the adjustment to nil (on the basis that the relevant expenditure would be deductible under the business related costs provisions[27]).[28]

3.52 Broader concerns about the treatment of tax costs in relation to intra-group assets were raised with Treasury during the consultation process relating to the proposed amendment. Therefore, implementation of the proposed amendment has been deferred pending the outcome of this Review.

Question 3.3

The Board seeks stakeholder comment on:

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

(b) In what circumstances, if any, do you consider the taxation outcomes that arise when intra-group assets are acquired or disposed of to be inappropriate? What do you consider the appropriate outcome to be?

27 Section 40-880 of the ITAA 1997.
28 Treasurer's Media Release No 053 of 13 May 2008.

Tax history of intra-group assets

3.53 The entry and exit history rules[29] identify:

- the history that an entity brings with it when it joins a consolidated group; and
- the history that an entity takes with it when it leaves the group.

3.54 This can affect the future tax liabilities of the group or of a subsidiary after it leaves the group.

3.55 When a right arising from an intra-group contract emerges from a consolidated group, either directly or indirectly, it is unclear what facts in respect of the asset also emerge and that may be relevant for the tax purposes of the head company or the leaving entity.

3.56 Under the single entity rule, applying the divisional model, rights arising from an intra-group contract that cease to be owned by a consolidated group are recognised by the tax system when they emerge. In this regard, a note in the income tax law states that:

> In the case of other assets [that is, assets other than those consisting of liabilities owed to the leaving entity by the group], the fact that the [leaving] entity inherits their history under section 701-40 when the entity ceases to be a subsidiary member of the group means that the assets would be treated as having the same cost as they would for the head company at that time. However, assets consisting of liabilities do not have such a history because they are only recognised when the entity ceases to be a subsidiary member and the single entity rule ceases to apply.[30]

3.57 This allows for parity between the income tax outcomes for a consolidated group and for a single entity that operates with divisions.

3.58 However, the ATO Consolidation Symposium paper raises concerns about the identification of tax history in relation to intra-group assets that emerge from a consolidated group, as follows:

> In relation to income tax history matters, it is not entirely clear what factual history in respect of an intra-group asset is available to either the head company or an entity when the asset commences to be recognised by the tax system.[31]

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29 Sections 710-5 and 701-40 of the ITAA 1997. . . The entry and exit history rules are discussed in more detail in Appendix 3.

30 Note to subsection 701-45(3) of the ITAA 1997.

31 Des Maloney and Peter Walmsley, *ATO Perspective on Consolidation – Unravelling the Mysteries of the Single Entity Rule*, page 16.

Question 3.4

The Board seeks stakeholder comment on:

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

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

THE SINGLE ENTITY RULE AND THIRD PARTIES THAT DEAL WITH A CONSOLIDATED GROUP

3.59 The single entity rule does not apply to an entity outside of a consolidated group (that is, a third party) which deals or transacts with a member of the consolidated group.[32]

3.60 Consequently, although a transaction between members of a consolidated group does not give rise to any income tax consequences for the group, the transaction may affect the income tax position of a third party who deals with the group.

3.61 This can occur when a provision of the income tax law requires a taxpayer to have regard to the transactions, assets or liabilities of another party. If the other party is a consolidated group, the taxpayer may recognise transactions, assets or liabilities that are ignored by the group.

3.62 The former government announced that the income tax law would be amended to extend the operation of the single entity rule for the purposes of certain CGT integrity provisions. The Government has accepted this proposal in principle.[33]

3.63 Treasury has advised the Board that submissions received in response to consultation material relating to this announcement suggest that consideration should be given to extending the single entity rule more generally.

3.64 Issues where the affairs of a consolidated group potentially affect a third party that have been identified relate to:

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32 Taxation Ruling TR 2004/11, paragraphs 12 and 38.

33 Treasurer's Media Release No 053 of 13 May 2008.

- CGT event K6 (which happens, broadly, when pre-CGT shares in a company, or pre-CGT units in a unit trust, are sold and the property of the company or trust is predominantly post-CGT property);
- the CGT discount rules;
- distributions by liquidators; and
- the commercial debt forgiveness rules.

3.65 The Board understands that the operation of the single entity rule in these circumstances is causing uncertainty for taxpayers and often results in a lack of symmetry and unfairness. In some cases this uncertainty and lack of symmetry provides favourable outcomes for taxpayers. However, in other cases the outcomes for taxpayers are unfavourable.

CGT event K6

3.66 CGT event K6[34] is an integrity rule that prevents a pre-CGT entity from being used as a repository to hold and dispose of post-CGT assets.

3.67 Broadly, CGT event K6 happens when a shareholder sells pre-CGT shares in a company, or a unit holder sells pre-CGT units in a unit trust, and the market value of the post-CGT property of the company or trust, or the market value of post-CGT property in underlying entities, is at least 75 per cent of the net value of the company or trust.

3.68 If CGT event K6 happens the shareholder or unit holder has a capital gain equal to that part of the capital proceeds from the sale of the pre-CGT shares or units that is reasonably attributable to the amount by which the market value of the post-CGT property exceeds the sum of the cost bases of that property.

3.69 A taxpayer that disposes of pre-CGT shares it holds in the head company needs to determine whether CGT event K6 applies. For the purpose of determining the amount of any capital gain, the shareholder needs to identify:

- the post-CGT property of the consolidated group; and
- the cost bases of that post-CGT property.

3.70 The identification of both the post-CGT property and the cost bases of the property may be distorted by intra-group transactions. For example, an item of pre-CGT property transferred intra-group may be treated as post-CGT property for the third party (but not for the group). The third party may also have regard to the

34 Section 104-230 of the ITAA 1997.

cost base that the post-CGT property would have rather than its tax cost as set under the consolidation tax cost setting rules.

3.71 The Government has accepted in principle that the single entity rule would be extended for the purpose of applying CGT event K6.[35]

CGT discount

3.72 Under the CGT rules, the amount of a capital gain that is included in a taxpayer's assessable income is discounted where an asset has been held for more than 12 months. The level of the discount is 50 per cent for individuals and 33⅓ per cent for complying superannuation entities.

3.73 As an integrity rule, the discount is not available on the disposal of interests in certain companies or trusts if more than half the underlying assets of the entity were acquired within the 12 month period immediately before the CGT event.[36]

3.74 Where a taxpayer sells shares in the head company of a consolidated group that it has held for more than 12 months, the taxpayer needs to ascertain whether more than 50 per cent of the assets of the head company (by cost and by value) have been held for more than 12 months. The assets of the head company will include membership interests in its subsidiary members, and may include other assets that have been transferred to the head company from other members of the group within the 12 month period immediately before the CGT event.

3.75 The single entity rule does not apply to shareholders. Therefore, shareholders may need to have regard to any intra-group assets and transactions of the head company.

3.76 The Government has accepted in principle that the single entity rule would be extended for the purpose of applying the CGT discount rules. [37]

Distributions by liquidators

3.77 Distributions by a liquidator to a shareholder in the course of winding up a company can be deemed to be dividends to the extent they represent income derived by the company.[38] For these purposes, amounts included in the company's assessable income are deemed to be income derived by the company.[39]

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35 Treasurer's Media Release No 053 of 13 May 2008.
36 Section 115-45 of the ITAA 1997.
37 Treasurer's Media Release No 053 of 13 May 2008.
38 Section 47 of the *Income Tax Assessment Act 1936* (ITAA 1936).
39 Section 47(1A) of the ITAA 1936.

3.78 The single entity rule may not apply when determining whether distributions received by a shareholder from the liquidator of a head company represent income derived by the head company for the purposes of applying the provisions relating to distributions by liquidators.[40]

3.79 As a consequence, a shareholder may need to recognise each subsidiary member of the group as a separate notional taxpayer deriving notional assessable income for the purposes of applying the provisions relating to distributions by liquidators.

Commercial debt forgiveness rules

3.80 The commercial debt forgiveness rules[41] apply when a commercial debt is forgiven. The rules are an integrity measure designed to prevent both the debtor and creditor from being allowed deductions in respect of, broadly, what is in substance a single outgoing or loss.

3.81 The commercial debt forgiveness rules may have an effect on companies other than the debtor company when a debt is forgiven. Where the debtor company is a member of a group of related companies, the impact of the debt forgiveness rules may be spread across the group of related companies.[42]

3.82 When the debt being forgiven is between two members of the same consolidated group, consequences do not arise under the commercial debt forgiveness rules for the group because, under the single entity rule, the intra-group debt is not recognised.

3.83 However, the single entity rule does not apply to a related company of the debtor company that is not a member of the group. Therefore, in some circumstances a third party related company may need to recognise the existence of the debt for the purposes of applying the commercial debt forgiveness rules.

3.84 If an intra-group debt is created and forgiven under the single entity rule, the application of the commercial debt forgiveness rules to a third party related company is inappropriate as neither the debtor nor the creditor has been allowed deductions in respect of broadly the same commercial outgoing or loss.

3.85 This problem would not arise if the single entity rule was extend to related third parties for the purpose of applying the commercial debt forgiveness rules (where intra-group debt created under the single entity rule is forgiven).

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40 Draft Taxation Determination TD 2007/D5.

41 Division 245 of Schedule 2C of the ITAA 1936.

42 Subdivision 245-G of Schedule 2C of the ITAA 1936

Question 3.5

The Board seeks stakeholder comment on:

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

(b) Should the single entity rule be extended to all third parties who have dealings with a consolidated group? If so, would any exceptions be required?

(c) Alternatively, should the single entity rule be extended to third parties who are directly related to a consolidated group (such as shareholders)? If so, would any exceptions be required?

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

CHAPTER 4: INTERACTION BETWEEN THE CONSOLIDATION REGIME AND OTHER PARTS OF THE INCOME TAX LAW

4.1 The consolidation provisions operate in conjunction with the general taxation provisions located elsewhere in the income tax law. For example, they work with the ordinary income, general deduction, trust and CGT rules in the income tax law.

4.2 This Chapter examines some areas where issues and uncertainties arise as a result of the interaction between the consolidation regime and other parts of the income tax law. In some circumstances uncertainties may arise because of problems with provisions outside consolidation.

4.3 In some cases these uncertainties provide favourable outcomes for taxpayers. However, in other cases the outcomes for taxpayers are unfavourable.

4.4 The issues and uncertainties included in this Chapter fall into five broad but overlapping categories:

- taxation of trusts;
- consolidation membership rules;
- international tax issues;
- CGT roll-overs; and
- financial arrangements.

4.5 The Board invites comment on the issues outlined in this Chapter and on any others areas of uncertainty or inequity that arise because of the interaction between the consolidation regime and other parts of the income tax law.

4.6 The Board is primarily interested in identifying any systemic issues that arise with consolidation interactions and the most efficient way of preventing similar issues from arising in the future.

TAXATION OF TRUSTS

4.7 Anomalous outcomes may arise when taxing the net income of a trust that joins or leaves a consolidated group part way through an income year.

Current arrangements

4.8 The general provisions for the taxation of trusts are found in Division 6 of Part III of the ITAA 1936. Division 6 uses both trust law concepts and tax law concepts as the basis for determining whether tax liabilities are imposed on beneficiaries or on trustees.

4.9 The beneficiaries of a trust and the trustee are assessed on the trust's net income which is determined under section 95 of the ITAA 1936. The amount on which each beneficiary is assessed depends on the share of the trust's income to which they are presently entitled. The trustee is assessed on any of the trust's net income that is not included in a beneficiary's assessable income or assessed to the trustee on a beneficiary's behalf[43], generally at the highest marginal rate of tax.

4.10 If a trust is a member of a consolidated group for part of an income year, the consolidation core rules require the net income of a trust to be calculated for each period that the trust is not a member of a consolidated group — a non-membership period — as if it were an income year.[44] A trust can have more than one non-membership period in an income year.

4.11 In some cases, the tax outcomes for beneficiaries are only affected by the consolidation core rules. However, if a beneficiary is a member of a consolidated group for part of the income year, the consolidation provisions also modify how the trust's net income is assessed. These rules apportion the trust's assessable income and deductions for an income year between the beneficiary (for its own non-membership period) and the head company (for any period that the beneficiary was a member of the group and the trust was outside the group). [45]

Issues with current arrangements

4.12 A number of issues arise as a result of the interactions between the trust and consolidation provisions. These issues mainly arise because of the way trusts are taxed. Issues also arise because beneficiaries of a trust can join a consolidated group at a different time to the trust or may not join at all.

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43 Sections 99 and 99A of the ITAA 1936.
44 Sections 701-30 and 701-65 of the ITAA 1997.
45 Sections 716-75 to 716-100 of the ITAA 1997.

4.13 The Government has accepted in principle that the tax law would be amended to clarify the taxation outcomes when a trust joins or leaves a consolidated group part way through an income year. [46]

4.14 The announced amendments are intended to ensure that beneficiaries are taxed on an appropriate share of a trust's net income when a trust joins or leaves a consolidated group part way through an income year.

4.15 Since the announcement, other issues have been identified including:

- the application of the single entity rule when calculating the share of a trust's income to which a beneficiary is presently entitled if that entitlement arises in a period when both the beneficiary and trust are members of the same consolidated group;
- the application of the special rules that modify how the trust's net income is assessed to a beneficiary that is a subsidiary member of a consolidated group for part of an income year; and
- the calculation of the trust's allocable cost amount.

4.1 The precise nature of these issues may be affected by the outcome of the appeal to the High Court of the decision in *Bamford*[47].

Calculating the income of a trust for a non-membership period

4.2 Where a trust is a member of a consolidated group for part of an income year, it is unclear how beneficiaries work out the share of trust income to which they are presently entitled. For the purpose of calculating the trust's net income for the non-membership period, the consolidation rules treat the trust's non-membership period as if it were an income year. However, these rules do not modify how the income of a trust (which is different to the trust's net income) is calculated or change the time a beneficiary is presently entitled to the income of the trust.

4.3 If the income of the trust is not calculated over the same period as the trust's net income, beneficiaries may be assessed on a greater or lesser amount than is appropriate. In addition, if a beneficiary has not been assessed on an amount received from the trustee, CGT consequences may arise.

46 Treasurer's Media Release No 053 of 13 May 2008.
47 *Bamford v Commissioner of Taxation* [2009] FCAFC 66.

Recognising a group member's present entitlement to trust income

4.4 When a trust joins a consolidated group, the single entity rule treats both the trust and beneficiaries as part of the head company and intra-group transactions are ignored.

4.5 If the single entity rule prevents a beneficiary's entitlement to trust income from being recognised, the trustee may be assessed on an amount of the trust's net income at the highest marginal tax rate.

Assessing beneficiaries that are not members of a consolidated group

4.6 Beneficiaries that are not members of a consolidated group during an income year may be presently entitled to a share of a trust's income either before it joins a consolidated group or after it leaves a group. If a beneficiary is not a member of the consolidated group, it is unclear how their share of net income is calculated.

4.7 Concerns have been raised that the consolidation core rules that require the net income of a trust to be calculated for each period that a trust is not a member of a consolidated group only apply to the trust. That is, they do not apply for the purposes of working out the tax outcome of a beneficiary.

4.8 If this is the outcome, a beneficiary will be assessed on their share of the trust's net income as if the trust had never been a member of a group. That is, the net income of the trust will be calculated for the whole year instead of being apportioned between the membership period and the non-membership period.

4.9 As a consequence, the trust's net income will need to be reconstructed to include any intra-group transactions that were ignored for consolidation purposes. In addition, the amount the beneficiary is assessed on under the trust provisions will be different to the amount calculated under the consolidation provisions.

4.10 Similar issues also arise when a beneficiary is a member of a consolidated group for part of an income year. In these circumstances, the rules that apportion the trust's assessable income and deductions for an income year between the beneficiary and the head company apply. If the trust is a member of another consolidated group, it is unclear whether the single entity rule is taken into account when applying the apportionment rules. That is, can the beneficiary take into account the fact that the trust does not have assessable income or deductions because the trust is taken to be part of the head company?

4.11 It is also unclear how the apportionment rules interact with the consolidation core rules. The consolidation core rules require the trust's net income to be calculated as if the non-membership period were an income year — that is, on a derived basis. The apportionment rules require amounts to be reasonably attributed to relevant periods. Consequently, beneficiaries could be assessed on amounts that would not be included in the trust's net income that is calculated for the trust's non-membership period.

Question 4.1

The Board seeks stakeholder comment on:

(a) How should the net income for a trust's non-membership period be assessed to beneficiaries and trustees?

(b) Do the current rules need to be amended to achieve an appropriate outcome? For example, are specific provisions needed in the consolidation rules to align the calculation of the income of a trust with the method used for calculating the net income for the trust's non-membership period? If so, is there a simple approach that can be used that produces an appropriate outcome?

(c) Should a single set of rules apply to assess all beneficiaries on a share of the trust's net income for a non-membership period? If so, what should the rules be?

(d) Are there any other issues which are not identified in this Chapter that arise when a trust joins or leaves a consolidated group part way through an income year? What is the best way of resolving these issues?

Calculating the allocable cost amount of a trust when a trust joins a consolidated group part way through the year

4.12 When a consolidated group acquires a trust part way through an income year, it might adjust the price it pays to reflect any tax that the group expects to pay on its share of the net income for the non-membership period. Where this occurs, anomalous outcomes can arise when calculating the allocable cost amount for the trust.

4.13 The allocable cost amount is basically the sum of the cost bases of the head company's membership interests in the joining entity held by members of the joined group and the joining entity's liabilities. A joining entity's liabilities generally include the income tax payable on its taxable income for the period up to the time it joined the consolidated group.

4.14 In the case of a trust, the beneficiaries and the trustee are liable to pay any income tax that is payable on the trust's net income — not the trust. The tax cost setting rules do not include any tax for which the group is liable on the net income of the trust that relates to the non-membership period.

4.15 If the group's liability to pay income tax is not taken into account in the allocable cost amount and the consolidated group discounted the purchase price for the trust, there will be insufficient allocable cost amount to allocate to the trust's assets. This could result in the head company making a greater capital gain than is appropriate if it disposes of any CGT assets that the trust brought into the group.

Question 4.2

The Board seeks stakeholder comment on:

(a) When working out the allocable cost amount for a trust, should the head company recognise its liability for income tax payable on its share of the net income of the trust as a cost of acquiring the joining entity? If yes, do the current cost setting rules need to be amended to achieve this outcome? If so, how?

(b) Are there any other issues which are not identified in this Chapter that arise with the way the cost setting rules apply to trusts when they join or leave a consolidated group? If so, how can these be overcome?

CONSOLIDATION MEMBERSHIP RULES

4.16 There are two types of consolidated groups — ordinary consolidated groups and MEC groups. An ordinary consolidated group consists of an Australian resident head company and all of its Australian resident wholly-owned subsidiaries. A MEC group is a foreign owned group of wholly-owned Australian resident subsidiaries that do not have a single resident head company.

4.17 The subsidiary members of a consolidated group or a MEC group may be companies, trusts or partnerships.

4.18 Issues concerning the application of the consolidation membership rules relate to:

- trusts; and
- non-resident entities that satisfy the foreign hybrid rules.

Application of the membership rules to trusts

4.19 The trust issues arise because of the definition of entity in the income tax law and the inclusion of specific entities in the membership rules contained in the consolidation provisions.

4.20 The consolidation provisions specify that an entity that is a trust can be a member of a consolidated group. However, they do not specify that an entity that is the trustee of a trust can be a member of a consolidated group. This could create difficulties in determining the tax treatment for the net income of the trust and applying the cost setting rules to the trust where the trust is a member of a consolidated group and the trustee remains outside the group.

Current arrangements

4.21 The income tax law uses the term 'entity' throughout the law as a shortcut reference to any kind of individual or body. When an area of the tax law refers to an entity, it refers to all types of legal persons such as individuals, companies and other things that the tax law treats as having a separate identity such as partnerships and trusts.

4.22 The tax law also refers to the trustee of a trust as being an entity consisting of the person who is trustee at any given time. In addition, the tax law recognises that:

- a legal person can have a number of different capacities;
- for each capacity, the person is taken to be a different entity; and
- where a provision refers to an entity of a particular kind, it refers to the entity in that capacity only.[48]

4.23 The membership rules in the consolidation provisions refer to entities of a particular kind — that is, only entities that are companies, trusts and partnerships can become members of a consolidated group.[49]

Issues with current arrangements

4.24 Although a trust is taken to be an entity for tax purposes, under the general law a trust is not a person that is distinct from that of the trustee. A trust represents the relationship between a trustee and a beneficiary where the trustee owns property for the benefit of others.

4.25 It is unclear how the consolidation provisions apply where:

- the trustee is a member of a consolidated group but the trust is not a member of the group;
- the trust is a member of a consolidated group but the trustee is not a member of the group; or
- the trust is a member of a consolidated group but one or more of the beneficiaries are not members of the group.

48 Section 960-100 of the ITAA 1997
49 Section 703-15 of the ITAA 1997

4.26 For example, it is unclear whether a company that operates in two or more capacities is a member of a consolidated group in respect of each of those capacities.

4.27 If the membership rules allow a trust, but not the trustee, to be a member of a consolidated group it is unclear how the single entity rule applies to income tax provisions that operate on the basis of legal ownership. For example:

- deductions for the decline in value of a depreciating asset are available to the holder of the asset which is the trustee company; and
- various CGT provisions that apply to the owner of an asset or specify the trustee.

4.28 Uncertainty arises when applying the cost setting rules to a trust that joins or leaves a consolidated group as the trust's assets and liabilities are those of the trustee but not the trust. It is also unclear how the consolidation rules interact with the general trust provisions, especially where the trust is a member of a consolidated group but the trustee or a debt beneficiary is not.

Question 4.3

The Board seeks stakeholder comment on:

(a) Does a trustee need to be a member of the same consolidated group as the trust? If yes, why? If not, why not?

(b) If a trustee is not a member of the same consolidated group as the trust, do the core rules and other tax rules operate appropriately to deem the income and expenditure of the trust to be that of the head company?

(c) Should a trust be a member of a consolidated group if it has beneficiaries that are not members of the group? If yes, what other issues need to be resolved? If not, why not?

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

Application of the membership rules to non-resident entities that satisfy the foreign hybrid rules

4.29 The foreign hybrid rules may enable certain foreign companies that are treated as partnerships for income tax purposes to be members of a consolidated group, even though they would fail to satisfy the residency test in the consolidation membership rules if they were recognised as a company for income tax purposes.[50]

50 Division 830 of the ITAA 1997.

Current arrangements

4.30 A company or a trust can be a member of a consolidated group only if it is an Australian resident. However no such requirement exists for partnerships. It was considered that residency rules were not required for partnerships as a partnership can only become a member of a consolidated group when all the beneficial interests in the partnership are owned by resident entities.

4.31 The Explanatory Memorandum that accompanied the New Business Tax System (Consolidation) Bill (No. 1) 2002 stated that:

> The broad rationale underlying the rules that limit the types of entities that are eligible to be a member of a consolidated group is to ensure that consolidated groups receive a tax treatment like ordinary Australian resident companies and that relative concessional treatment is neither effectively gained by nor denied to entities by becoming a member of a consolidated group.[51]

4.32 The foreign hybrid rules were introduced in 2004. These rules allow certain non-resident entities that are treated as a partnership for foreign tax purposes to be treated as a partnership for the purposes of applying Australia's income tax law. Apart from limiting deductions for partnership losses, foreign hybrid entities are subject to the same rules that apply to resident partnerships.

4.33 Prior to the introduction of the foreign hybrid rules, these non-resident entities were treated in Australia as non-resident companies and, as such, could not become members of a consolidated group.

4.34 Following the introduction of the foreign hybrid rules, non-resident entities that satisfy the foreign hybrid rules may be eligible to become members of a consolidated group as they are treated as a partnership for all purposes of the income tax law, including the consolidation membership rules.

Issues with current arrangements

4.35 Where non-resident entities that satisfy the foreign hybrid rules are eligible to be members of a consolidated group, the following outcomes arise:

- transactions between resident entities in the group and the non-resident entity are ignored for income tax purposes;
- income received by the non-resident entity is assessable in Australia;
- non-portfolio dividends received by the non-resident entity are exempt from tax;

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51 Explanatory Memorandum to New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 1.21.

- the head company of the consolidated group is entitled to foreign income tax offsets; and
- the head company can claim losses made by the non-resident entity — the loss limitation rules that apply under the foreign hybrid rules do not apply.

4.36 The Board is keen to review whether the current outcomes for non-resident entities that satisfy the foreign hybrid rules are appropriate and gives effect to the policy intent of limiting the types of entities that can become members of a consolidated group.

4.37 Although the foreign hybrid rules were introduced after the consolidation rules, it is unclear whether the consolidation rules were fully considered during the development of the foreign hybrid rules.

Question 4.4

The Board seeks stakeholder comment on:

(a) Should non-resident entities that satisfy the foreign hybrid rules be members of a consolidated group? If yes, how is this consistent with the Government's policy intent that limits the types of entities that become members of a consolidated group?

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

(c) If these entities can become members of a consolidated group, are there any integrity risks that need to be addressed? If so, what are they and what is the best way to resolve them?

(d) If these entities cannot be members of a consolidated group, what is the most efficient way of preventing non-resident entities from being members of a consolidated group?

International tax issues

4.38 The Board understands that concerns have been raised by stakeholders that inequities arise as a result of the interactions between the consolidation regime and the foreign resident CGT rules.

Current arrangements

4.39 When the consolidation regime was introduced, a non-resident entity recognised capital gains and capital losses it made on assets that had the necessary connection with Australia. For example, a non-resident entity included capital gains and capital losses made on land and buildings situated in Australia, shares or units in Australian resident companies or units in Australian resident companies or trusts.

4.40 In 2006 Australia's CGT regime was amended to narrow the range of assets on which a foreign resident recognises a capital gain or capital loss to Australian real property and the business assets (other than Australian real property) of an Australian permanent establishment. Consequently, capital gains and capital losses made on assets that fall outside this definition (non-taxable Australian real property assets) are disregarded for Australian tax purposes.[52]

4.41 To ensure foreign investors could not avoid Australia's CGT provisions by holding Australian assets through interposed entities, the CGT regime was strengthened to capture capital gains and losses made on a foreign resident's direct and indirect interests in the targeted assets.

4.42 For example, a foreign resident may establish a foreign company that invests in Australian assets. Without the integrity rules, the sale of the foreign company by the foreign resident would not be subject to CGT in Australia.

4.43 Consequently, where a foreign resident holds membership interests in a resident entity, the foreign resident can generally disregard any capital gains or losses it makes on the disposal of those interests where the majority of the assets held by the resident entity are non-taxable Australian real property assets.

4.44 The changes to the CGT regime were made to align Australia's domestic law with international practice, to provide greater certainty and reduce compliance costs.

Issues with current arrangements

4.45 The interaction between the consolidation regime and the foreign resident CGT rules enables:

- Australian assets to be moved within a MEC group and disposed of without recognising a capital gain; and
- the cost base of Australian assets to be uplifted where there is no change in the economic ownership of the corporate group and without recognising a capital gain.

Moving Australian assets within a MEC group then disposing of them without recognising a capital gain

4.46 The single entity rule allows consolidated groups to move assets within a group without tax consequences.

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52 Division 855 of the ITAA 1997.

4.47 Prior to the introduction of the foreign resident CGT rules, entities that formed a consolidated group recognised any capital gains made when assets are disposed. Following the introduction of the foreign resident CGT rules, the foreign owner of a MEC group could use the foreign resident CGT rules to indirectly dispose of certain assets to avoid recognising a capital gain.

4.48 As a result, where a non-resident entity owns a consolidated group and a subsidiary member of the group owns an asset which is non-taxable Australian real property, then:

- if the subsidiary member disposes of the asset, the head company of the consolidated group is taken to have disposed of the asset — consequently, the head company must recognise any capital gain or loss made on the disposal of the asset for Australian tax purposes. As the head company is an Australian resident, the foreign resident CGT rules do not apply; or

- if the head company of the consolidated group disposes of the shares in the subsidiary member to a third party, the head company recognises any capital gain or loss for Australian tax purposes as a result of the consolidation tax cost setting rules that apply when a subsidiary member leaves a consolidated group.

4.49 This outcome is consistent with what happens to entities that do not form a consolidated group or MEC group.

4.50 However, a concern has been raised with the Board that a MEC group could use its structure, the flexibility of the consolidation regime and the foreign resident CGT rules to disregard the capital gain or loss on the non-taxable Australian real property asset by, for example, taking the following steps:

- step 1 — a new Australian resident entity that is wholly-owned by the non-resident owner of the group is incorporated;

- step 2 — the new Australian resident entity becomes an eligible tier-1 member of the MEC group (that is, a non-resident company's first tier of investment in Australia);

- step 3 — the non-taxable Australian real property asset is transferred from the subsidiary that originally held the asset to the new Australian resident entity; and

- step 4 — the foreign holding company disposes of the membership interests in the Australian resident entity to the third party that purchases the asset.

4.51 This outcome arises because the consolidation rules allow MEC groups to transfer assets between members of the group without giving rise to any tax consequences. The foreign resident CGT rules allow the foreign owner of a group to dispose of the membership interests in an Australian resident entity without recognising a capital gain where the majority of the Australian residents' assets are non-taxable Australian real property.

Question 4.5

The Board seeks stakeholder comment on:

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

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

4.52 Consolidated groups that are wholly-owned by a non-resident entity could use the consolidation regime and the foreign resident CGT rules to uplift the cost base of Australian assets without recognising a capital gain or loss. This outcome could be achieved where:

- an entity or a group of entities in the group have predominantly non-taxable Australian real property assets;
- the non-resident owner of the group incorporates a new consolidated group that it wholly owns; and
- the non-resident entity disposes of all the shares it owns in a member of the group that has predominantly non-taxable Australian real property assets to the newly formed consolidated group at market value.

4.53 The foreign resident CGT rules allow the foreign owner of the group to disregard any capital gains it makes on the disposal of the membership interests in the Australian resident entity to the new group as the majority of the entity's assets are not taxable Australian real property assets.

4.54 The consolidation tax cost setting rules then allow the newly formed consolidated group to reset the tax cost of the purchased group's assets to their market value.

Question 4.6

The Board seeks stakeholder comment on:

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

CAPITAL GAINS TAX

4.55 The Board understands that anomalous outcomes can arise where CGT assets are rolled over between members of a wholly-owned group and are subsequently sold.

Current arrangements

4.56 The CGT regime generally includes the net capital gains made on CGT assets in a taxpayer's assessable income. Special rules allow entities to roll-over a capital gain or loss made in certain circumstances. The primary effect of a CGT roll-over is to defer the capital gain or loss until a later CGT event happens to the asset.

4.57 Prior to the introduction of the consolidation regime, a CGT roll-over was available when assets were transferred between companies that were members of the same wholly-owned group.[53]

4.58 Following the introduction of the consolidation regime, the scope of the CGT roll-over rules were restricted so that they apply only when, so far as is relevant:

- an asset is transferred from a consolidated group to a foreign resident company that is a member of the same wholly-owned group; or

- an asset is transferred to a consolidated group from a foreign resident company that is a member of the same wholly-owned group.

4.59 CGT event J1[54] broadly operates to end the deferral that happened under the roll-over. Generally, CGT event J1 happens where a CGT asset is rolled over between two companies that are members of the same wholly-owned group, and the company that owns the CGT asset after the roll-over stops being a wholly-owned member of that group.

Issues with current arrangements

4.60 When the consolidation regime was introduced, CGT event J1 was modified so that it would not apply if the recipient company that holds an asset that was rolled over prior to joining a consolidated group ceases to be a subsidiary member of a consolidated group.[55]

4.61 In these circumstances, the consolidation tax cost setting rules that apply when an entity leaves a consolidated group use the cost bases of the leaving entity's assets to determine whether a capital gain or loss is made on the disposal of the membership interests. As a result, the deferred capital gain or loss is brought to account.

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53 Subdivision 126-B of the ITAA 1997

54 Section 104-175 of the ITAA 1997.

55 Section 104-182 of the ITAA 1997.

4.62 As the modification applies only when a subsidiary member leaves a consolidated group, the Board understands that concerns have been raised by stakeholders about the appropriateness of the outcomes when:

- an eligible tier-1 company (that is, a non-resident company's first tier of investment in Australia) leaves a MEC group;
- a subsidiary member leaves a MEC group; or
- the head company of a consolidated group leaves the group.

Eligible tier-1 company leaves a MEC group

4.63 When an eligible tier-1 company leaves a MEC group, the capital gain or loss on the membership interests is calculated by reducing the capital proceeds by the reset cost base amount of the membership interests sold. The reset cost base of the membership interests is calculated using a formula based on the cost bases of the pooled interests the top company holds in the eligible tier-1 entities that are members of the MEC group. This amount may be different to the amount that would have been brought to account had the consolidation provisions not applied.

4.64 In certain circumstances, CGT event J1 may also apply to include any capital gain or loss made up to that point in time on any rolled-over assets of the leaving eligible tier-1 company.

4.65 Concerns have been expressed that the capital gain or loss on the rolled-over asset may not be brought to account appropriately in all cases when an eligible tier-1 company leaves a MEC group.

Subsidiary member leaves a MEC group

4.66 When a subsidiary member leaves a MEC group, the capital gain or loss on the disposal of the membership interests is calculated using the tax cost setting rules that apply when an entity leaves a group. In addition, CGT event J1 may also apply to include a capital gain or loss made on the rolled over asset.

4.67 Consequently, the capital gain or loss on the rolled over asset may be included in taxable income twice.

Head company of a consolidated group leaves the group

4.68 CGT event J1 could also create uncertainty and possible inequities where an asset is rolled-over to the head company of a consolidated group that is owned by a non-resident and the head company leaves the group. This could happen, for example, if the non-resident sells the head company of the consolidated group to another non-resident.

4.69 If the rolled-over assets are all of the membership interests in a resident entity, the single entity rule applies so that the membership interests cease to be recognised for income tax purposes during the period that the entity is a member of the consolidated group. It is unclear whether CGT event J1 can apply to the membership interests when the non-resident entity disposes of its interests in the head company of the consolidated group.

4.70 If the membership interests cannot be recognised, CGT event J1 will not apply. Consequently, any capital gain on the rolled-over membership interests would not be assessed when the membership interests in the head company are disposed of.

Alternatively, if the membership interests can be recognised, and CGT event J1 applies, issues arise when calculating the cost base of the membership interests. When an entity leaves a consolidated group, the cost base of the membership interests of the entity is recalculated based on the net assets the entity takes with it. No such calculation applies when a non-resident sells the head company of the consolidated group. Therefore it is unclear what the cost base is in this situation. If Division 711 is used to calculate the cost base, it will bear no relationship to the cost base of the membership interest when the roll-over occurred.

Question 4.7

The Board seeks stakeholder comment on:

(a) Are there circumstances in which CGT event J1 produces undesirable outcomes? If so, how can the income tax law be amended to overcome these concerns?

(b) Are there situations that CGT event J1 does not apply to but should? If so, what are they?

Financial arrangements

4.71 Issues may also arise as a result of the interaction between the consolidation regime and the provisions relating to:

- foreign currency gains and loss; and
- the taxation of financial arrangements.

Current arrangements

4.72 Division 775 of the ITAA 1997 ensures gains and losses arising from foreign currency exchange rate fluctuations are brought to account in a taxpayer's assessable income.

4.73 Following the introduction of the consolidation regime, various issues have been raised in relation to the operation of the foreign currency gains and loss provisions for consolidated groups. Although a number of issues have been dealt with by the ATO, it is not clear to the Board whether there are any outstanding issues.

4.74 Division 230 of the ITAA 1997, which was inserted into the income tax law in 2009, contains the new regime for the taxation of financial arrangements. Division 230 defines what is meant by a 'financial arrangement' for income tax purposes and includes various methods that can be used to bring the gains and losses from these arrangements to account for income tax purposes.

4.75 The taxation of financial arrangements rules generally apply to income years commencing on or after 1 July 2010. However, taxpayers can elect to apply the rules to income years commencing on or after 1 July 2009.

4.76 Although the interactions between the taxation of financial arrangements regime and the consolidation regime were considered at the time the former rules were being developed, it is unclear whether additional interaction issues have been identified by stakeholders following the introduction of the regime.

Question 4.8

The Board seeks stakeholder comment on:

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

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

OTHER ISSUES

4.77 The issues outlined in this Chapter are the primary areas of concern that have been brought to the Board's attention where issues are arising in relation to the operation of other parts of the income tax law for consolidated groups.

4.78 The Board invites comment on any other areas of concern that are not examined in this Chapter and that arise as a result of the interaction of specific legislative provisions with the consolidation regime.

Question 4.9

The Board seeks stakeholder comment on any other areas of concern that arise as a result of the interaction between the consolidation regime and other provisions in the income tax law? If so, what are the issues and how can they be resolved?

Chapter 5: Review of the inherited history rules

5.1 The inherited history rules, which consist of the entry history rule and the exit history rule, are core rules that support the operation of the single entity rule.[56] These rules identify the income tax history that an entity brings with it into a consolidated group or takes with it when it leaves a group.

5.2 When the consolidation regime was being developed, a clean slate approach was considered. Under a clean slate approach, an entity would not bring any income tax history with it when it joins a consolidated group. Similarly, an entity that leaves a consolidated group would not take any income tax history with it.[57]

5.3 Treasury has advised the Board that, at the time the consolidation regime was being developed, business and professional groups involved in the consultation process primarily focused on the impact for existing wholly-owned groups that were proposing to form consolidated groups — that is, formation cases.

5.4 The clean slate approach was abandoned in favour of an inherited history approach because business and professional groups raised concerns that the clean slate approach created significant compliance costs, particularly in formation cases.

5.5 As the consolidation regime has matured, business and professional groups representing large businesses are now more focused on acquisition cases and have made representations suggesting that the inherited history model should be reviewed to determine whether a deemed acquisition model, supported by clean slate rules, would be more effective going forward.[58]

5.6 The Board is seeking comments on the difficulties that arise under the inherited history approach, in particular, in the context of current legislative amendments clarifying the use of the tax cost of an asset that is set under the tax cost setting rules.[59]

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56 See Appendix 3 for an outline of the inherited history rules.

57 See Appendix 3 for an outline of the clean slate rules.

58 See the 2009-10 Pre-Budget Submission by the Institute of Chartered Accountants in Australia of 16 January 2009 and the Minerals Council of Australia submission to the Australia's Future Tax System Review of November 2008.

59 Section 701-55 specifies how the tax cost of an asset that is set under the tax cost setting rules is used when applying other provisions in the income tax law. . . Subsections 701-55(2) to (5B) specify the use of the tax cost under particular provisions (such as the capital allowance provisions and the CGT provisions). . . Amendments to clarify the operation of subsection 701-55(6), which specifies

5.7 In particular, the Board would like to consider whether it would be preferable to:

- modify the inherited history approach to address particular problems, if any, that arise; or
- develop a clean slate approach with appropriate exceptions.

5.8 In this regard, the clean slate model in the 2002 exposure draft legislation was not fully developed. Therefore, that model would need to be reviewed. It is apparent that exceptions would be needed to make it workable. For example, under the clean slate rule proposed in the original consolidation model, an exception was proposed to retain the pre-CGT status of pre-CGT assets.[60]

5.9 Significant transitional issues would arise if the clean slate approach was adopted. Given the complexity of the consolidation regime, this could require a substantive review of the whole regime to ensure that the clean slate approach operates effectively. In addition, difficulties could arise for existing wholly-owned groups (particularly in the small business sector) that have not yet formed consolidated groups. Issues could also arise where a consolidated group acquires all the membership interests in a joining entity over a period of time.

5.10 Finally, it is not clear how the adoption of a clean slate approach would impact on the compliance costs of consolidated groups. Therefore, the Board is seeking comments on the compliance cost implications of moving to a clean slate approach.

5.11 The Board acknowledges that this Chapter raises questions of policy. However, given that mergers and acquisitions are an essential part of Australia's capital market, it is important for the effective and robust operation of the consolidation regime that it deals readily with the acquisition case as well as the formation case.

Question 5.1

The Board seeks stakeholder comment on:

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

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

(c) Alternatively, should the consolidation regime adopt a deemed acquisition

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the use of the tax cost when a specific provision does not apply, have been announced by the Government (see Treasurer's Media Release No 053 of 13 May 2008) and are expected to be introduced into Parliament in the first half of 2010.

60 See paragraph 2.42 of the Explanatory Material to the Exposure Draft of the New Business Tax System (Consolidation) Bill 2002, which is available on the Board's website.

model, using clean slate rules?

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

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

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

CHAPTER 6: OPERATION OF THE CONSOLIDATION REGIME FOR SMALL BUSINESSES

6.1 The Board has noted that many eligible small business groups have not elected into the tax consolidation regime. While a focus on consolidation and small business is not required by the terms of reference, the Board considers this low take-up is an issue worth investigating. Accordingly, the Board seeks comment on whether there are any aspects of the consolidation regime that are causing particular difficulties for small businesses.

6.2 In this regard, the Board notes that the Review of Business Taxation recommended:

> 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 arrangement.[61]

6.3 Despite this recommendation, the consolidation regime does not include any shortcuts or more flexible arrangements for small businesses. Consequently, the consolidation rules apply in the same way to small business and to large corporate groups. In addition, small business groups that have not consolidated have also lost access to specific grouping rules that previously applied to wholly-owned corporate groups but are no longer available.

6.4 In Australia, small businesses operate through various business structures, including as sole traders, companies and trusts. Many small businesses are unable to form a consolidated group because they do not use corporate group structures. Treasury has advised the Board that less than 30 per cent of small businesses (that is, entities that carry on a business and satisfy the $2 million aggregated turnover test in the income tax law) use a corporate group structure.

6.5 Nevertheless, a significant number of small businesses do use corporate group structures and therefore are potentially eligible to form consolidated groups. However, as Diagram 6.1 demonstrates, despite the intended advantages of the consolidation regime, only a relatively small proportion of small business corporate groups have actually formed a consolidated group.

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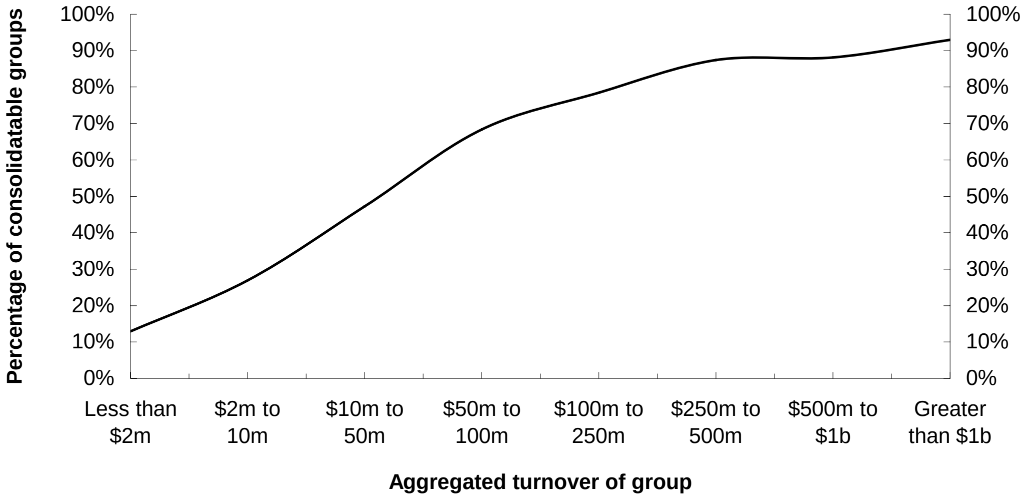
61 Review of Business Taxation, *A Tax System Redesigned*, July 1999, Recommendation 15.6, page 529.

Diagram 6.1: Degree of consolidation by aggregated turnover[62]



6.6 The Board notes two factors that that may discourage small business corporate groups from forming consolidated groups.

6.7 First, anecdotal evidence suggests that the complexity of the consolidation legislation and cost of keeping up-to-date with the provisions makes access to the consolidation regime very difficult for many accounting and tax professionals that advise small business corporate groups.

6.8 Much of the complexity associated with the consolidation regime arises under the tax cost setting rules that apply when an entity joins or leaves a consolidated group. These rules impose a significant compliance burden on taxpayers. In recognition of the significant compliance costs, when the consolidation regime was introduced transitional rules provided some relief from the tax cost setting rules for corporate groups that entered the consolidation regime. These transitional rules allowed entities that joined a consolidated group before 1 July 2004 to retain the historical asset cost bases of assets — that is, the tax costs of the assets did not have to be reset.

6.9 Second, if the membership interests in an entity that joins a consolidated group are pre-CGT assets, the provisions that currently apply when the entity leaves the group can result in an erosion of the pre-CGT status of those membership interests.

6.10 The former government announced that the income tax law would be amended to modify the taxation outcomes that arise when the membership interests in a subsidiary member of a consolidated group are pre-CGT assets to overcome these concerns. The Government has accepted this proposal[63] and relevant amendments are expected to be introduced into Parliament in the first half of 2010.

62 Source: ATO statistics as at 6 October 2009.

63 Treasurer's Media Release No 053 of 13 May 2008.

6.11 However, the Board also seeks comment on whether there are any aspects of the consolidation regime that are causing particular difficulties for small businesses.

Question 6.1

The Board seeks stakeholder comment on:

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

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

APPENDIX 1: DISCUSSION PAPER QUESTIONS

CHAPTER 2: BACKGROUND

Question 2.1

The Board seeks stakeholder comment on:

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

(b) For those corporate groups that have elected into the consolidation regime, has the introduction of the consolidation regime reduced the ongoing tax compliance costs associated with carrying on the group's business? If not, what are seen as the key impediments to achieving reduced compliance costs?

(c) For those corporate groups that have not yet elected to consolidate, what are the key concerns that are keeping corporate groups out of the consolidation regime

CHAPTER 3: OPERATION OF THE SINGLE ENTITY RULE

Question 3.1

The Board seeks stakeholder comment on:

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

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

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

Question 3.2

The Board seeks stakeholder comment on:

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

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

(c) Does section 701-85 of the ITAA 1997, which sets out the approach to the interpretation of the core consolidation provisions, increase uncertainty in the application of the single entity rule? If so, how can this uncertainty be alleviated?

Question 3.3

The Board seeks stakeholder comment on:

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

(b) In what circumstances, if any, do you consider the taxation outcomes that arise when intra-group assets are acquired or disposed of to be inappropriate? What do you consider the appropriate outcome to be?

Question 3.4

The Board seeks stakeholder comment on:

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

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

Question 3.5

The Board seeks stakeholder comment on:

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

(b) Should the single entity rule be extended to all third parties who have dealings with a consolidated group? If so, would any exceptions be required?

(c) Alternatively, should the single entity rule be extended to third parties who are directly related to a consolidated group (such as shareholders)? If so, would any exceptions be required?

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

Chapter 4: Interaction between the consolidation regime and other parts of the income tax law

Question 4.1

The Board seeks stakeholder comment on:

(a) How should the net income for a trust's non-membership period be assessed to beneficiaries and trustees?

(b) Do the current rules need to be amended to achieve an appropriate outcome? For example, are specific provisions needed in the consolidation rules to align the calculation of the income of a trust with the method used for calculating the net income for the trust's non-membership period? If so, is there a simple approach that can be used that produces an appropriate outcome?

(c) Should a single set of rules apply to assess all beneficiaries on a share of the trust's net income for a non-membership period? If so, what should the rules be?

(d) Are there any other issues which are not identified in this Chapter that arise when a trust joins or leaves a consolidated group part way through an income year? What is the best way of resolving these issues?

Question 4.2

The Board seeks stakeholder comment on:

(a) When working out the allocable cost amount for a trust, should the head company recognise its liability for income tax payable on its share of the net income of the trust as a cost of acquiring the joining entity? If yes, do the current cost setting rules need to be amended to achieve this outcome? If so, how?

(b) Are there any other issues which are not identified in this Chapter that arise with the way the cost setting rules apply to trusts when they join or leave a consolidated group? If so, how can these be overcome?

Question 4.3

The Board seeks stakeholder comment on:

(a) Does a trustee need to be a member of the same consolidated group as the trust? If yes, why? If not, why not?

(b) If a trustee is not a member of the same consolidated group as the trust, do the core rules and other tax rules operate appropriately to deem the income and expenditure of the trust to be that of the head company?

(c) Should a trust be a member of a consolidated group if it has beneficiaries that are not members of the group? If yes, what other issues need to be resolved? If not, why not?

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

Question 4.4

The Board seeks stakeholder comment on:

(a) Should non-resident entities that satisfy the foreign hybrid rules be members of a consolidated group? If yes, how is this consistent with the Government's policy intent that limits the types of entities that become members of a consolidated group?

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

(c) If these entities can become members of a consolidated group, are there any integrity risks that need to be addressed? If so, what are they and what is the best way to resolve them?

(d) If these entities cannot be members of a consolidated group, what is the most efficient way of preventing non-resident entities from being members of a consolidated group?

Question 4.5

The Board seeks stakeholder comment on:

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

Question 4.6

The Board seeks stakeholder comment on:

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

Question 4.7

The Board seeks stakeholder comment on:

(a) Are there circumstances in which CGT event J1 produces undesirable outcomes? If so, how can the income tax law be amended to overcome these concerns?

(b) Are there situations that CGT event J1 does not apply to but should? If so, what are they?

Question 4.8

The Board seeks stakeholder comment on:

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

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

Question 4.9

The Board seeks stakeholder comment on any other areas of concern that arise as a result of the interaction between the consolidation regime and other provisions in the income tax law? If so, what are the issues and how can they be resolved?

Chapter 5: Review of the inherited history rules

Question 5.1

The Board seeks stakeholder comment on:

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

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

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

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

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

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

CHAPTER 6: OPERATION OF THE CONSOLIDATION REGIME FOR SMALL BUSINESSES

Question 6.1

The Board seeks stakeholder comment on:

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

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

APPENDIX 2: A COMPENDIUM OF ATO VIEWS THAT ADDRESS SINGLE ENTITY RULE ISSUES[64]

Ruling Number	Question	Answer
TD 2004/33	Income tax: consolidation: capital gains: does a CGT event happen to the head company of a consolidated group if a debt is created within the consolidated group and later transferred to a non-group entity?	No. The transfer of the debt in these circumstances is effectively the borrowing of money or obtaining of credit by the head company from a non-group entity. A CGT event does not happen when a taxpayer borrows money or obtains credit from another entity.
TD 2004/34	Income tax: consolidation: capital gains: does section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where an option granted within the consolidated group is later transferred to a non-group entity?	Yes. CGT event A1 will happen to the head company where the head company of a consolidated group transfers the option or where the option is transferred by a subsidiary member of that consolidated group.
TD 2004/35	Income tax: consolidation and capital gains tax: does section 104-10 (CGT event A1) of the *Income Tax Assessment Act 1997* apply to the head company of a consolidated group where a licence granted within the consolidated group is later transferred to a non-group entity for no capital proceeds?	Yes, section 104-10 (CGT event A1 about the disposal of a CGT asset) of the *Income Tax Assessment Act 1997* (ITAA 1997) will happen to the head company where the head company of a consolidated group transfers the licence or where the licence is transferred by a subsidiary member of that consolidated group. The capital proceeds are deemed to be the market value of the licence at the time of the CGT event under the market value substitution rule in section 116-30 of the ITAA 1997.
TD 2004/37	Income tax: consolidation: are intra-group money lending transactions or dealings taken into account in determining if the head company of a consolidated group is carrying on business as a money lender?	No. Intra-group money lending transactions or dealings are not taken into account in determining whether the head company of a consolidated group is carrying on business as a money lender for income tax purposes.
TD 2004/40	Income tax: consolidation: capital gains: does CGT event A1 in section 104-10 of the *Income Tax Assessment Act 1997* happen to the head company of a consolidated group when a contract is made to sell a membership interest in a subsidiary member of the group to a purchaser outside the group?	Yes. The timing rule for CGT event A1 in paragraph 104-10(3)(a) of the *Income Tax Assessment Act 1997* (ITAA 1997) applies so that the time of the event is when the contract is made to dispose of the membership interest.

64 Des Maloney and Peter Walmsley, *ATO Perspective on Consolidation – Unravelling the Mysteries of the Single Entity Rule*, Appendix 1.

Ruling Number	Question	Answer
TD 2004/41	Income tax: consolidation: capital gains: can membership interests in a subsidiary member of a consolidated group be recognised for the purpose of applying the market value substitution rule in section 116-30 of the *Income Tax Assessment Act 1997* if CGT event A1 happens to the group's head company when a contract is entered into to dispose of the interests?	Yes. The membership interests of a consolidated group can be recognised at the time the contract was entered into (that is, before the subsidiary leaves the group as a result of the disposal of the interests).
TD 2004/45	Income tax: consolidation: capital gains: how does the controlling individual condition in paragraph 152-110(1)(c) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business 15 year exemption in Subdivision 152-B) apply to the head company of a consolidated group in respect of the sale of an asset brought into the group by a subsidiary member?	Under the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) the controlling individual condition in paragraph 152-110(1)(c) of the ITAA 1997 is applied to the head company of the consolidated group.
TD 2004/46	Income tax: consolidation: capital gains: is the controlling individual condition in paragraph 152-305(2)(b) of the *Income Tax Assessment Act 1997* (one of the conditions for the small business retirement exemption) applied to the head company of a consolidated group?	Yes. The effect of the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) is that the controlling individual condition in paragraph 152-305(2)(b) of the ITAA 1997 is applied to the head company of the consolidated group.
TD 2004/47	Income tax: consolidation: capital gains: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* affect the application of the controlling individual test in paragraph 152-10(2)(a) when a CGT event happens to a share or trust interest that is a membership interest in a subsidiary member (company or trust) of a consolidated group?	No. The single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) does not prevent recognition of the company or trust to determine that the controlling individual test is not passed.
TD 2004/48	Income tax: consolidation: capital gains: for the purposes of Subdivision 125-C of the *Income Tax Assessment Act 1997*, can the head company of a consolidated group meet the requirements of a demerging entity in subsection 125-70(7) where a subsidiary member is demerged from the group?	Yes. The head company of the consolidated group can satisfy the requirements of a demerging entity in subsection 125-70(7) of the *Income Tax Assessment Act 1997* (ITAA 1997).
TD 2004/50	Income tax: consolidation: capital gains: if a subsidiary member of a consolidated group acquires shares in a company outside the group (the original company) under a scrip-for-scrip arrangement, is the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* relevant in determining the eligibility for rollover of shareholders in the original company?	No. The single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) is not relevant in determining the eligibility for rollover of the shareholders of the original company.

Ruling Number	Question	Answer
TD 2004/68	Income tax: consolidation: Division 7A: if a private company that is a head company or subsidiary member of a consolidated group makes a payment or a loan, or forgives a debt to a shareholder (or shareholder's associate) external to the consolidated group, does the single entity rule apply to the calculation of the distributable surplus under section 109Y of the *Income Tax Assessment Act 1936*?	No. Only the accounts of the private company (that is the head company or the subsidiary member), that is treated as having paid a dividend under Division 7A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) to the shareholder (or shareholder's associate) external to the consolidated group, are relevant in calculating the distributable surplus under section 109Y of the ITAA 1936.
TD 2004/81	Income tax: consolidation: capital gains: does the deregistration of a subsidiary member of a consolidated group cause a 'new event' to happen under paragraph 170-275(1)(a) of the *Income Tax Assessment Act 1997* if, before the subsidiary joined that group, a transfer of shares in it was a 'deferral event' under section 170-255 and the group's head company is the 'originating company' for the deferral event?	Yes. Subdivision 170-D of the *Income Tax Assessment Act 1997* (ITAA 1997) disregards a capital loss or deduction that arises if a company (the 'originating company') that is a member of a 'linked group' disposes of a CGT asset to another member of that group. A disposal in these circumstances is referred to as a 'deferral event'. The disregarded loss or deduction (the 'deferred loss') may be recognised subsequently as a loss of the originating company if either the asset, or the originating company, leaves that linked group. These events are referred to as 'new events': section 170-275 of the ITAA 1997.
TD 2004/82	Income tax: consolidation: capital gains: can the exemption in section 152-125 of the *Income Tax Assessment Act 1997* apply to a payment made by the head company of a consolidated group to a CGT concession stakeholder of the head company in respect of a capital gain made on the disposal of an asset legally owned by a subsidiary member of the group for which disposal the head company obtained the small business 15 year exemption?	Yes. The exemption in section 152-125 of the *Income Tax Assessment Act 1997* (ITAA 1997) can apply in those circumstances.
TD 2004/83	Income tax: can the assignment of an intra-group debt or income stream to an entity that is not a member of the consolidated group give rise to a debt interest for the head company of the group under Division 974 of the *Income Tax Assessment Act 1997*?	Yes. Where a member of a consolidated group assigns a debt or an income stream owed to it by another member to an entity that is not a member of the group, the scheme will generally satisfy the definition of a 'financing arrangement' under section 974-130 of the *Income Tax Assessment Act 1997* (ITAA 1997) for the purposes of applying the debt test contained in section 974-20 of the ITAA 1997. Applying the single entity rule in section 701-1 of the ITAA 1997, the head company is taken to issue the interest at the time the member assigns the debt or income stream to the entity that is outside the group. Whether the other requirements of the debt test are satisfied is determined by reference to the facts and circumstances of each case.

Ruling Number	Question	Answer
TD 2004/84	Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where the principal of an intra-group loan is assigned by a member of the group to a non-member?	Yes. Where a member of a consolidated group assigns the principal of a loan owed to it by another member to a third party which is not a member of the group, the arrangement is treated as the issue by the head company of a 'security' under subsection 159GP(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). Applying the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997), the head company will be taken to be the issuer of the security once the member assigns the right to the principal to an entity outside of the group. The head company will be entitled to claim deductions on an annual accruals basis in relation to the discount or deferred interest component of the security under Division 16E of Part III (Division 16E) of the ITAA 1936 if the security satisfies the conditions for a 'qualifying security' under subsection 159GP(1) of the ITAA 1936 at the time of the deemed issue by the head company and the conditions under section 159GT of the ITAA 1936 are otherwise satisfied.
TD 2004/85	Income tax: can Division 16E of Part III of the *Income Tax Assessment Act 1936* apply to a head company of a consolidated group where an intra-group income stream is assigned by a member of the group to a non-member?	Yes. Where a member of a consolidated group assigns an income stream owed to it by another member to a third party which is not a member of the group, the arrangement will be treated as the issue by the head company of a 'security' under subsection 159GP(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). Applying the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) the head company will be taken to be the issuer of the security once the member assigns the right to the income stream to an entity outside of the group. The head company will be entitled to claim deductions on an annual accruals basis under Division 16E of Part III (Division 16E) of the ITAA 1936 if the security satisfies the conditions for a 'qualifying security' under subsection 159GP(1) of the ITAA 1936 at the time of the deemed issue by the head company and the conditions under section 159GT of the ITAA 1936 are otherwise satisfied.

Ruling Number	Question	Answer
TD 2006/36	Income tax: consolidation: can the profit received on the disposal of membership interests in a subsidiary member of a consolidated group be income according to ordinary concepts?	Yes, the profit received on the disposal of membership interests in a subsidiary member of a consolidated group can be income according to ordinary concepts, depending on the facts of the particular case. The views expressed in the Taxation Determination apply equally to a multiple entry consolidated (MEC) group where appropriate.
TR 2007/2[65]	Income tax: Does the same business test apply in the context of determining whether deductions are available to the head company of a consolidated group in respect of prior year losses, bad debts, net capital losses or foreign losses?	Yes. Under the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997), subsidiary members of a consolidated group are taken for the purposes of the same business test (section 165-10) (among other purposes) to be parts of the head company. In this context, the principles set out in TR 1999/9 in respect of the application of the same business test to a single company apply equally to the head company of a consolidated group.
Draft TD 2007/D5	Income tax: consolidation: does the single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* apply in determining whether distributions by the liquidator of a head company represent 'income derived' by the head company for the purposes of section 47 of the *Income Tax Assessment Act 1936*?	No. The single entity rule in section 701-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) applies only for the head company core purposes and entity core purposes described in that section. For other purposes of the income tax law, such as the application of section 47 of the *Income Tax Assessment Act 1936* (ITAA 1936) to determine the income tax liability of a shareholder of a head company, the single entity rule does not apply.

65 Note that the description of the question and answer has been modified from the original source so that it reflects the actual content of TR 2007/2.

APPENDIX 3: OUTLINE OF THE INHERITED HISTORY RULES AND THE CLEAN SLATE RULES

INHERITED HISTORY RULES

A3.1 The inherited history rules are core rules which support the operation of the single entity rule. These rules, which consist of the entry and exit history rules, identify the income tax history that an entity brings with it into a consolidated group or takes with it when it leaves a group.

Entry history rule

What is the entry history rule?

A3.2 The entry history rule[66] identifies the income tax history that the head company inherits from an entity that joins a consolidated group. On entry, everything that happened in relation to an entity before it became a subsidiary member of the consolidated group is taken to have happened in relation to the head company for the purposes of calculating the head company's income tax liabilities or losses during its membership of the consolidated group. The head company only inherits the history in respect of things that affect taxable income or could affect future taxable income.

What are the implications of the entry history rule?

A3.3 The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 outlines the primary implications of the entry history rule as follows:

> As a consequence of the entry history rule a head company may be entitled to certain deductions for expenditure incurred by a joining entity prior to it joining the group. Examples are entitlements to deductions for expenditure on borrowing expenses, gift deductions (where the entitlement to the deduction is spread), water facilities, connecting power or telephone lines, certain business related costs and expenditure allocated to a project pool. A head company may also be entitled to a deduction for a debt that is brought into a consolidated group which subsequently goes bad.
>
> A head company may also need to include assessable income as a consequence of something that happened to a joining entity prior to consolidation. For example, an entity may have received a prepayment for which the assessable income is included over the period of the provision of the services. A head company may also be assessable on the receipt of a recoupment of expenditure made by a subsidiary member prior to its entry

66 Section 701-5 of the ITAA 1997.

into the group. Also an entity before joining a group may have elected to defer tax on the profit from the disposal or death of livestock or elected to defer the inclusion of the profit on a second wool clip.[67]

A3.4 The Explanatory Memorandum also states that:

> Only history in respect of things that affected taxable income or could affect a later taxable income of the head company is inherited. Consequently history in relation to franking credits and foreign tax credits would not be inherited.[68]

A3.5 The head company becomes the holder of several tax attributes for a consolidated group. These include losses, franking credits, foreign income tax offsets and conduit foreign income. Specific provisions operate to transfer these tax attributes to the head company and retain them. For example, the head company does not inherit history relating to franking credits as these do not affect the calculation of taxable income.

A3.6 A significant consequence of the entry history rule is that the pre-CGT status of assets that are brought into a consolidated group by a joining entity is inherited by the head company.

A3.7 In addition, private income tax rulings issued to an entity before it becomes a member of a consolidated group will apply to the head company insofar as the relevant facts have not changed either by reason of consolidation (for example, because they relate to intra-group transactions, which are ignored during consolidation) or otherwise.

A3.8 The entry history rule is modified to reach an appropriate tax outcome in some situations.

A3.9 In some cases these modifications override the entry history rule. For example, the tax costs of assets that a head company acquires when an entity joins a consolidated group are set at the joining time at their tax cost setting amounts. This tax cost is used by the head company for future tax purposes and overrides the historical costs of the assets.

A3.10 In addition, the consolidation loss provisions override the inherited history rules in relation to the transfer and utilisation of losses. The joining entity may transfer its losses to a consolidated group only if the entity satisfies certain tests. The consolidation loss rules then apply an ongoing utilisation rate based on relative market value of the joining entity. Any unused losses do not leave with an entity when it leaves a consolidated group.

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67 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.32 and 2.34.

68 ibid, paragraph 2.35.

A3.11 In other cases the modifications provide support for the entry history approach. For example, specific provisions ensure that:

- in respect of a depreciating asset, the head company retains the same depreciation method for working out the decline in value as the joining entity; and
- franking credits of the joining entity are transferred to the head company.

Exit history rule

What is the exit history rule?

A3.12 The exit history rule[69] specifies the income tax history that a leaving entity inherits from the head company. The leaving entity takes the income tax history in relation to any assets, liabilities and businesses that the leaving entity has when it ceases to be part of the head company.

A3.13 The history in relation to a business includes the entitlements and obligations in respect of carrying on a business (such as a primary production business) or the carrying on of particular activities. The leaving entity also takes the previously inherited history as a consequence of the entry history rule in respect of an asset, liability or business that the leaving entity has when it ceases to be part of the head company.

What are the implications of the exit history rule?

A3.14 The implications of the exit history rule are outlined in the Explanatory Memorandum as follows:

> The history that is inherited by an entity that leaves a consolidated group is the history relating to:
>
> - any assets;
> - any liabilities, including anything that is treated as a liability according to generally accepted accounting concepts; and
> - any businesses,
>
> that the entity takes when it leaves the group.
>
> The meaning of liabilities in this context is broader than the meaning of liability in the context of the cost setting rules (i.e. step 2 of working out the allocable cost amount).

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69 Section 701-40 of the ITAA 1997.

> The history in relation to a business covers such things as the entitlements and obligations in respect of carrying on a business (such as a primary production business) or the carrying on of particular activities.[70]

A3.15 The Explanatory Memorandum also points out that:

> The history that is inherited by an entity when it leaves a consolidated group may relate to the history in respect of an asset, liability or business from the period before that asset, liability or business became part of the head company as a consequence of the entry history rule.[71]

A3.16 Significant consequences of the exit history rule are that a leaving entity will inherit:

- the tax cost setting amounts allocated to assets that the leaving entity takes with it; and

- the pre-CGT status of assets that a leaving entity takes with it.

A3.17 In addition, private income tax rulings that relate to particular assets, liabilities or businesses that a leaving entity takes out of a group will apply to the leaving entity insofar as the relevant facts have not changed either by reason of the entity ceasing to be a member of a consolidated group or otherwise.

CLEAN SLATE RULES

A3.18 The original consolidation model contained clean slate rules.[72] Under the clean slate rules proposed by that model, subsidiary members would lose their individual tax identity on consolidation. When an entity joins a consolidated group, the head company would be taken to have acquired its assets and businesses. The income tax history of the subsidiary member would not be taken into account for the purposes of working out:

- the income tax liability or losses of the group for any income year during which the subsidiary is a member; or

- the income tax liability or losses of the subsidiary member for any income year after it leaves the group.

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70 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.40 to 2.42.

71 ibid, paragraph 2.44.

72 The description of the clean slate rules is based on the Explanatory Material to the Exposure Draft of the New Business Tax System (Consolidation) Bill 2002.

A3.19 The proposed clean slate rules consisted of the entry clean slate rule and the exit clean slate rule.

Entry clean slate rule

What is the entry clean slate rule?

A3.20 Under the entry clean slate rule proposed in the original consolidation model[73], when an entity joins a consolidated group it would not bring its income tax history into the group. That is, nothing that happened to an entity before it became a subsidiary member of the consolidated group would be taken to have happened in relation to the head company for the purposes of calculating the head company's income tax liabilities or tax losses.

A3.21 On entry to a consolidated group:

- a deemed payment for the acquisition of assets of the joining entity would happen with a new acquisition date (the joining time); and
- the value of the deemed payment would be determined under the consolidation tax cost setting rules which apply when an entity joins a consolidated group.

What are the implications of the entry clean slate rule?

A3.22 Subject to certain exceptions, under the entry clean slate rule an entity would not bring its income tax history into a group for the purposes of calculating the income tax liabilities or losses of the head company. The cost setting rules would treat the acquisition of an entity by a consolidated group as the acquisition of the assets of that entity.

A3.23 The entry clean slate rule would make it clear that amounts are not included in the assessable income of the head company for events that related purely to the subsidiary before it joined the group. Similarly, the head company could not deduct amounts in respect of events that relate purely to the subsidiary before it joined the group.

A3.24 The head company would be entitled to tax deductions for the tax cost setting amount allocated to assets, whether through capital allowances, the cost of trading stock, the cost base of capital assets, or on the deemed cost of equity where it is re-created when an entity leaves a consolidated group.

A3.25 It would therefore be necessary, for example, to ensure that the head company would not be allowed a deduction purely because of something the subsidiary did

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73 See paragraphs 2.37 to 2.39 of the Explanatory Material to the Exposure Draft of the New Business Tax System (Consolidation) Bill 2002.

before it became a member (e.g. incurring borrowing expenses), in addition to its entitlements based on the cost of acquiring the subsidiary. Without this rule, the head company would be allowed a deduction for an outgoing it did not incur.

A3.26 A significant consequence of an entry clean slate rule is that, without specific modification, the pre-CGT status of assets that are brought into a consolidated group by a joining entity would not be inherited by the head company.

A3.27 Generally, the mere act of consolidation does not change the character of transactions involving assets dealt solely under the CGT provisions, where those assets continue to be held by a consolidated group in the same manner as held by a member of the group prior to consolidation.

A3.28 A consequence of the entry clean slate rules, in conjunction with the acquisition of assets by the head company, could be to change the character of transactions involving some revenue assets. That is, similar to when the assets of a business are acquired directly, the character of certain revenue assets and transactions occurring post-consolidation would change. Some consequences could be:

- to deny a deduction to the head company for bad debts written-off in respect of trade debts of the joining entity acquired by the head company at the joining time (a capital loss would be allowed in respect of the write-off); and
- to deny a deduction to the head company for repairs to remedy defects that existed at the joining time (the cost of repairs would be included in the cost base of the asset).

A3.29 However, as is the situation under current law, it would be relevant to consider the nature of a transaction undertaken by a subsidiary member of a consolidated group in the context of the activities of the group as a whole, in order to determine the character of a particular act or transaction in an assessment of the consolidated group. Therefore, the tax character of a transaction undertaken by a consolidated group would continue to be a question of fact to be determined in the light of all the circumstances.

A3.30 Finally, as a result of an entry clean slate rule, private income tax rulings issued to an entity before it becomes a member of a consolidated group may not apply to the head company.

A3.31 A pure asset acquisition model would deem the transfer of the assets of a joining entity to the head company without the transfer of losses, franking credits and any other tax attributes. This would clearly result in practical barriers to the consolidation regime. Therefore, the model would need to be modified to ensure that it is commercially realistic.

A3.32 The entry history rule and the entry clean slate rule are on two opposite ends of the wide spectrum of income tax history. As a result, the modifications made to the entry history rule would not necessarily apply to the entry clean slate rule.

Exit clean slate rule

What is the exit clean slate rule?

A3.33 Under the exit clean slate rule proposed in the original consolidation model[74], when an entity leaves a consolidated group the head company would be deemed to have acquired the membership interests in the leaving entity for a payment that reflects the group's cost of the net assets of the leaving entity. This would be determined under the consolidation tax cost setting rules which apply when an entity leaves a consolidated group.

A3.34 The assets and liabilities of a leaving entity may be different from its assets and liabilities when it entered the group or when it was created by the group. For this reason, a leaving entity would be treated as a completely new entity for income tax purposes.

A3.35 Under the exit clean slate rule, the leaving entity would not take any history that happened to it before it joined the consolidated group or while it was a member of a group for the purposes of calculating its liability to income tax or tax loss in respect of the period after it leaves the group.

What are the implications of the exit clean slate rule?

A3.36 Under the exit clean slate rule, the leaving entity would not be entitled to deductions on the basis of things that happened to it (or any other entity) before it joined the group or while it was a member of the group.

A3.37 In addition, the leaving entity would not inherit the tax costs of the assets that it takes with it. Therefore, a modification would be required to ensure that the leaving entity would be taken to have acquired its assets on leaving the group for a payment for each asset that, if it had been received by the group, would have resulted in a tax-neutral disposal by the group.

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74 See paragraphs 2.40 and 2.41 of the Explanatory Material to the Exposure Draft of the New Business Tax System (Consolidation) Bill 2002.