Australian Government

The Board of Taxation

POST-IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE CONSOLIDATION REGIME

Position Paper

the board of taxation
www.taxboard.gov.au

The Board of Taxation
October 2010

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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.

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

The Board's intention in undertaking post-implementation reviews is to focus on whether the consolidation legislation is operating as intended, and in light of feedback received from relevant industry participants, whether its implementation and operation can be improved.

The Board expresses its gratitude to those that have provided submissions and participated in consultations and looks forward to the further involvement of stakeholders in this post-implementation review.

Richard Warburton AO
Chairman, Board of Taxation

CHAPTER 1: INTRODUCTION

BACKGROUND TO THE REVIEW

1.1 The consolidation regime, which was introduced with effect from 1 July 2002, applies primarily to wholly-owned groups of Australian resident entities that choose to form a consolidated group.

1.2 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 by forming a multiple entry consolidated group (MEC group). Unless otherwise specified, references in this Position Paper to a consolidated group include a MEC group.

1.3 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.

1.4 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.

1.5 On 3 June 2009, the Government announced that the Board of Taxation would undertake a post-implementation review of certain aspects of the consolidation regime.

1.6 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'.[1]

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1 The Charter of the Board of Taxation.

Scope of the review

1.7 As it is not feasible to review the whole of the consolidation regime, the Board of Taxation was 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.

1.8 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 also considered the effectiveness of the consolidation regime for these small business groups.

The review team

1.9 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), Chris Jordan AO (Deputy Chairman), Keith James and Curt Rendall. Geoffrey Lehmann continues to be 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.

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

Review process

1.11 Following the announcement of the review, the Board conducted some targeted consultations with key stakeholders. Drawing on these consultations and other information, the Board developed a Discussion Paper, which was released on 9 December 2009.[2] The paper canvassed issues that were brought to the attention of the Board and posed questions to be addressed as part of the consultation process.

1.12 Following the release of the Discussion Paper, the Board conducted further consultation forums in Sydney and Melbourne in February 2010 as an additional

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2 The Discussion Paper can be accessed from the Board's website. See: www.taxboard.gov.au.

mechanism for obtaining views and to assist stakeholders in preparing written submissions.

1.13 The Board received 12 submissions in respect of the issues raised in the Discussion Paper. A list of submissions, other than confidential submissions, is provided in Appendix A.[3]

OUTCOMES OF THE CONSULTATION PROCESS

1.14 The overall consensus from stakeholders is that the existing framework behind the consolidation regime is working effectively in the majority of circumstances. This has lead to overall increased business efficiency and integrity of the tax system, as well as a reduction in ongoing tax compliance costs experienced by consolidated groups.

1.15 However, stakeholders suggested that the operation of the regime is often overly complex. This is primarily due to the focus of the regime on formation cases, where the measures operate to ensure taxpayers achieve appropriate outcomes when no change in the economic ownership of the group has occurred.

1.16 The incidence of formation cases has clearly declined since the consolidation regime was introduced in 2002. As acquisition cases are now the more common transaction being undertaken by consolidated groups, stakeholders suggested that significant improvement could be made by adjusting the current policy framework for the consolidation regime.

1.17 In addition, stakeholders highlighted that the operation of the consolidation regime could be improved by resolving the issues that were raised in the Board's Discussion Paper.

1.18 Given the breadth and complexity of issues associated with this review, the Board considers that stakeholders should be given an opportunity to comment on the positions reached before making final recommendations.

1.19 Therefore, this Position Paper sets out the Board's considered views on the issues raised in the Discussion Paper and in stakeholder submissions. In this regard:

- Chapter 2 considers the policy framework for the consolidation regime (including the operation of the inherited history rules);
- Chapter 3 considers issues relating to the operation of the single entity rule;

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3 Submissions are provided in full on the Board's website. See: www.taxboard.gov.au.

- Chapter 4 considers issues relating to interactions between the consolidation regime and other parts of the income tax law; and
- Chapter 5 considers the operation of the consolidation regime for small business corporate groups.

1.20 Appendix B contains a list of the Board's positions and questions on which feedback is being sought. The Board will settle on final recommendations arising from the review after receiving submissions on the Position Paper.

MAKING SUBMISSIONS

1.21 The Board welcomes submissions on the issues raised in this Position Paper. The closing date for submissions is 26 November 2010. It is not expected that each submission will necessarily address all of the proposed positions and questions raised. 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

1.22 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. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

1.23 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: Policy framework for the consolidation regime

2.1 Treating wholly-owned corporate groups as a single entity for income tax purposes is the cornerstone principle of the consolidation regime.

2.2 Following a choice to consolidate, the members of a consolidated group 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;
- 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.[4]

2.3 In addition to the single entity rule, supporting provisions determine the treatment of assets when an entity joins a consolidated group, including what history is relevant to the consolidated group, and re-create the tax cost of membership interests when an entity leaves a consolidated group. These supporting provisions provide the framework within which the single entity rule is applied to consolidated groups.

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

FRAMEWORK OF THE CONSOLIDATION REGIME

Design principles

2.4 The consolidation regime was developed based on the following six framework design principles[5]:

- Principle 1 — Consolidation to be optional, but if a group decides to consolidate, all of its wholly owned Australian resident group entities must consolidate;
- Principle 2 — Consolidated groups to be treated as a single entity;
- Principle 3 — Current grouping provisions to be repealed;
- Principle 4 — Individual entity losses and franking account balances able to be brought into the consolidated group;
- Principle 5 — Carry-forward losses and franking balances to remain with the consolidated group on an entity's exit; and
- Principle 6 — Provisions to be established for determining the cost bases on exit.

Asset-based model

2.5 In relation to Principle 6, an asset-based model was ultimately adopted. The asset-based model allows assets to move freely within a consolidated group with no income tax consequences and removes the need for complex value shifting rules and loss duplication rules for intra-group transactions.

2.6 The asset-based model, in effect, tracks the costs to a consolidated group of acquiring a joining entity through to the time that the entity leaves the group, and was originally described in the following terms:

> The asset-based model dispenses entirely with tax recognition of group entities in consolidation. Upon the entry of an entity into consolidation, the group's cost base for its equity in the entity is transferred to the assets the entity brings with it ... The cost base for the equity, when transferred to the individual assets, replaces existing asset cost bases. Where a group sells equity, the group's cost base for that equity is reconstructed equal to the sum of the cost bases of the assets that go with it.
>
> The intuition underlying this approach is that on entry to the consolidation regime the equity cost base is transferred to the assets of the entity as a representation of the actual cost on consolidation of the assets to the overall group. On exit from the group

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5 Commonwealth of Australia, *Tax Reform: Not a new tax, a new tax system*, August 1998, pages 122-123; Review of Business Taxation, *A Platform for Consultation*, February 1999, pages 545—567.

the process is reversed and the cost base of the equity is derived from the assets of the entity at that time, as this is what is actually being taken out of consolidation.[6]

2.7 These key elements of the asset-based model are reflected in the income tax law by the single entity rule and the tax cost setting rules.

Inherited history rules

2.8 As highlighted in the Board's Discussion Paper, the asset-based model was originally developed using an asset acquisition approach, with clean slate rules. Under the clean slate rules, an entity would not bring any income tax history with it when it joins a consolidated group. Similarly, an entity would not take any income tax history with it when it leaves the group.

2.9 The clean slate approach was subsequently replaced with an inherited history approach, which is reflected by the entry history and exit history rules (inherited history rules). The inherited history approach identifies the income tax history that an entity brings with it when it joins a consolidated group or takes with it when it leaves the group

2.10 Consequently, while the asset-based model resets the tax values of a subsidiary member's assets when it joins a consolidated group, the inherited history rules apply to determine the history that the group can take into account when determining the tax consequences of subsequent transactions relating to those assets.

2.11 The Board understands that the clean slate approach was replaced with the inherited history approach to overcome concerns that the clean slate approach created significant compliance costs, particularly in formation cases. In particular, concerns were raised that the clean slate approach may have resulted in certain assets and expenditure changing character from being on revenue account to capital account simply because a consolidated group was formed.

2.12 Although the consolidation regime broadly applies the inherited history approach, the Board notes that a number of modifications have been made to ensure certain outcomes are achieved. The tax treatment of a joining entity's depreciating assets is one example where a modified approach has been utilised, primarily to ensure inappropriate outcomes do not arise on the initial formation of a consolidated group.[7]

2.13 Therefore, in practice, the consolidation regime applies a 'hybrid' approach. In this regard, the submission from Deloitte Touche Tohmatsu (Deloitte) states:

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6 Review of Business Taxation, *A Platform for Consultation*, February 1999, pages 574—575.

7 Appendix C discusses the current treatment of depreciating assets held by an entity that joins a consolidated group

> ... in our view, the current model is not a pure inherited history model as there are significant elements of an acquisition model scattered throughout the provisions.

VIEWS IN EXPRESSED SUBMISSIONS

2.14 The general consensus in submissions received by the Board was that the existing framework behind the consolidation regime is, for the most part, working effectively and has lead to increased business efficiency and integrity within the tax system for consolidated groups.

2.15 However, stakeholders suggested that the operation of the regime is often overly complex. This is primarily due to the focus of the regime on formation cases, where the measures operate to ensure taxpayers achieve appropriate outcomes when no change in the economic ownership of the group has occurred.

2.16 The consolidation provisions were introduced with effect from 1 July 2002. Eight years on, the incidence of formation cases has clearly declined, with the more common transaction now undertaken by consolidated groups being acquisition cases.

2.17 Unlike formation cases, acquisition cases require some degree of change in the economic ownership of the entity being acquired, i.e. the consolidated group could be acquiring as much as 100 per cent of the joining entity or, alternatively, the last remaining membership interests in the joining entity in order for it to become eligible to join the group.

2.18 In light of the increased incidence of acquisition cases, business and professional groups have questioned whether the current policy framework behind the consolidation regime remains the most appropriate model going forward.

2.19 In this regard, some submissions suggested that adoption of a clean slate model, as originally proposed in the 2002 Exposure Draft, may be a simpler or more intuitive framework, at least in relation to acquisition cases. For example, the supplementary joint submission from the Corporate Tax Association/Minerals Council of Australia (CTA/MCA) stated:

> … the principle concern back in 2002 was the potentially dramatic implications of adopting a system which would immediately disregard the history related to every asset owned by major corporate groups in Australia when determining subsequent tax outcomes. These concerns were compounded by the fact that many groups intended to utilise the transitional option whereby the pre-existing tax bases of assets of nominated subsidiaries could be retained….
>
> These factors are understood to be the major reason why, ultimately, a decision was made to utilise an entry history rule approach rather than the CSR [clean slate rule].

> Therefore, eight years on these particular compliance factors that led to the decision not to adopt the CSR are no longer relevant.

2.20 The Deloitte submission highlighted that, as a result of the current framework, differences remain which can impact on whether a consolidated group chooses to acquire or dispose of an individual asset, or the entity holding the asset:

> An inherited history model provides for a different outcome as compared to an acquisition model. This difference can sometimes influence whether an entity chooses to dispose of the underlying assets or the membership interests relating to those underlying assets.[8]

2.21 This concern was also raised in the CTA/MCA submission, which stated:

> From the perspective of corporate groups the asset cost setting rules had the potential to address the income tax bias against a share acquisition as compared to an asset acquisition, where the target entity held, in particular, depreciating assets.
>
> In certain respects the current system does not consistently address this design objective. The tax cost of assets is reset but other relevant income tax attributes of those assets are subject to an inherited history rule and this may on one view conflict with the objective described above.

2.22 In light of these issues, the CTA/MCA submission urged the Board to take the opportunity to re-examine the framework behind the current regime, with a view to further clarifying the 'basic policy outcomes that the Consolidation Regime should in future be seeking to replicate'.

ALTERNATE POLICY APPROACHES

2.23 Clear evidence exists which suggests that the more common transaction today, and going forward, is the acquisition by, rather than formation of, a consolidated group.

2.24 In light of this evidence and having regard to the views expressed in submissions, particularly in relation to the treatment of depreciating assets, the Board considers that there is some merit to examining a shift from the current inherited history approach.

2.25 In this regard, the Board has considered the following options:

- adopting an acquisition approach; or

8 The reference to an 'acquisition model' in this quote is taken to be a reference to the 'asset acquisition approach'.

- adopting an asset acquisition approach.

2.26 Broadly, both these alternate models adopt as the base case the acquisition of an entity, rather than the formation of a consolidated group.

2.27 In this regard, the acquisition approach replicates as closely as possible, outcomes that would arise under a direct acquisition of the underlying assets and liabilities of the joining entity for their market value.

2.28 In light of concerns expressed in certain submissions as to additional complexity or transitional issues that could arise from adopting an alternate framework, the asset acquisition approach attempts to replicate direct acquisition outcomes, but only in relation to assets. Where such outcomes are not possible or would require major changes to the current legislative framework, the asset acquisition approach articulates a clear policy principle as to the tax treatment afforded by the consolidation regime.

2.29 The key impacts from adopting these alternate approaches are discussed more fully below. Appendix D contains a high level comparison of these two approaches and the existing inherited history approach.

Acquisition approach

Objective

2.30 The objective of the acquisition approach would be to replicate, as closely as possible, the outcomes that would arise if there was a direct acquisition or disposal of the underlying assets and liabilities of an entity by a consolidated group, rather than the acquisition or disposal of membership interests in the entity.

2.31 Under the acquisition approach, the history of a joining entity's assets and liabilities would be irrelevant to the consolidated group going forward. Therefore, the inherited history rules would be removed.

2.32 The joint CTA/MCA submission outlined the objectives of the acquisition approach as follows:

> The objectives of the asset transaction model [that is, the acquisition approach in this Paper] would be that in the context of an entity acquisition or disposal to replicate, as closely as possible, the tax outcomes in respect of assets that would have arisen if the transaction had been undertaken as a direct acquisition or disposal of the underlying assets (and liabilities) of the relevant subsidiary.
>
> The conceptual underpinning of an asset transaction model approach would be to reflect the economic substance of a group's acquisition of 100 per cent of the shares in a joining entity, being that the group is economically acquiring full ownership of the

underlying assets of the joining entity, and that this should be recognised for all go-forward income tax purposes in respect of such assets.

Therefore, the asset transaction model is totally consistent with, and in effect further supports, the operation of the single entity rule. However, the asset transaction model would render redundant the entry history rule, because in the context of a direct asset acquisition the past history of the asset in the hands of the vendor is of no relevance to the purchaser.[9]

Entity joining a consolidated group

2.33 Under the acquisition approach, when an entity joins a consolidated group, the group would be taken to acquire all the assets and liabilities of the joining entity at the joining time.

2.34 Key implications that would arise are:

- pre-capital gains tax (CGT) assets held by the joining entity at the joining time would become post-CGT assets[10];
- assets held by the joining entity that become intra-group assets of the group would come to an end at the joining time for a payment equal to the allocable cost amounts allocated to the assets[11];
- liabilities held by the joining entity would be assumed by the group based on their market value at the joining time;
- non-asset tax attributes of the joining entity (such as undeducted business related expenditure and other inherited deductions) would not be transferred to the group — this would simplify the calculation of the allocable cost amount for the joining entity as the step 7 adjustment for inherited deductions could be removed; and
- consistent with the high level design principles on which the consolidation regime is based, tax losses and franking credits held by a joining entity would continue to be transferred to the group.

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9 There are some very limited exceptions, the two principle ones being where assets are acquired from an associate or related party, and where assets are acquired from a Government agency

10 Under the inherited history approach, this change in status of pre-CGT assets is likely to arise in an acquisition (as opposed to formation) case due to the operation of Division 149 of the *Income Tax Assessment Act 1997* (ITAA 1997), which changes the status of pre-CGT assets when there is a change in the majority underlying ownership of an entity.

11 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

2.35 Modifications could be made to alter these outcomes if necessary, having regard to other policy considerations.[12]

Operating as a consolidated group

2.36 Under the acquisition approach, the tax outcomes that arise in relation to an asset held by a consolidated group would be determined solely by the group's treatment of the asset, on the basis that the group has directly acquired the asset at the joining time. Therefore, as the joining entity's history in relation to the asset would be irrelevant, the entry history rule would be removed.

2.37 Key implications that would arise are:

- asset-based deductions (such as capital allowances) would be determined on the basis that the consolidated group acquired the asset at the joining time for an amount equal to its tax cost setting amount — as a consequence, for example, the effective life of an asset for capital allowance purposes would be determined at the joining time;
- the capital/revenue character of the amount received on the disposal of an asset would be determined on the basis of the consolidated group's treatment of the asset;
- intra-group assets that emerge from the group would be taken to be created at the time they emerge[13];
- the consolidated group could deduct trade debts held by a joining entity that are written-off as bad only if the group is a money lender[14]; and
- the consolidated group could not rely on private binding rulings issued to a joining entity prior to the joining time to the extent that those rulings relate to the assets and liabilities of the joining entity.

2.38 Modifications could be made to alter these outcomes if necessary, having regard to other policy considerations.[15]

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12 For example, modifications may be required for the treatment of pre-CGT assets and depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

13 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

14 A consequential amendment may be required to ensure that trade debts are not retained cost base assets.

15 For example, modifications may be required for the treatment of depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

Leaving a consolidated group

Implications for the consolidated group

2.39 Under the acquisition approach, when an entity leaves a consolidated group, the consolidated group would be taken to dispose of the assets and liabilities that the leaving entity takes with it at the leaving time. The calculation of the allocable cost amount for the leaving entity would be simplified as the step 2 adjustment for inherited deductions could be removed.

2.40 In addition, the capital/revenue character of any gain or loss made by the group on the disposal of the membership interests in the leaving entity would need to reflect the character of the underlying assets. As a result, a leaving entity's assets would need to be valued prior to it leaving a consolidated group.

2.41 Alternatively, to reduce compliance costs and complexity, a proxy could be developed. For example, a percentage approach could be used. However, the use of such a proxy would not necessarily reflect the current values and gains made on the assets. That is, if the revenue/capital split was determined using the cost bases of the assets, the outcome would not reflect the actual gains or losses made on the assets.

2.42 Therefore, additional compliance costs would arise under the acquisition approach when an entity leaves a consolidated group. In this regard, the Deloitte submission states:

> If a pure acquisition model were to be used in an exit scenario, we agree that the Division 711 calculation would split the gain between revenue and capital gains. While this may, theoretically, provide a neutral outcome, there are significant practical problems associated with adopting such a model on exit.
>
> That is, in order for such a proposition to work, the sales proceeds for the shares would need to be matched to the underlying sale of assets. This would require a thorough identification of assets, irrespective of whether they have a tax cost. This is because an asset with a nil tax cost may have some value and may be a revenue asset as compared to a capital asset. This identification of assets would greatly increase the level of compliance, as currently taxpayers only need to identify assets with a tax cost.

2.43 In addition, consistent with the high level design principles on which the consolidation regime is based, tax losses and franking credits held by the consolidated group would continue to be retained by the group.

Implications for the leaving entity

2.44 Under the acquisition approach, the leaving entity would be taken to acquire all the assets and liabilities that it takes with it at the leaving time. Therefore, as the prior history of the asset would be irrelevant, the exit history rule would be removed.

2.45 Key implications that would arise (assuming that the leaving entity does not join another consolidated group) are:

- the leaving entity would be taken to acquire all the assets that it takes with it (including CGT assets and depreciating assets) at the leaving time;
- asset-based deductions (such as capital allowances) would be determined on the basis that the leaving entity acquired the asset at the leaving time for an amount equal to its terminating value — as a consequence, for example, the effective life of an asset for capital allowance purposes would be determined at the leaving time;
- the capital/revenue character of the amount received on the disposal of an asset would be determined on the basis of the leaving entity's group's treatment of the asset;
- liabilities that the leaving entity takes with it would be assumed by the leaving entity based on their market value at the leaving time; and
- non-asset tax attributes of the consolidated group (such as undeducted business related expenditure and other inherited deductions) would not be transferred to the leaving entity.

Advantages and disadvantages of the acquisition approach

2.46 A key advantage of the acquisition approach is that it would offer a clear policy benchmark against which the outcomes of the consolidation regime can be compared. That is, outcomes from entering into the regime would replicate as closely as possible outcomes that would arise under a direct asset acquisition.

2.47 As a result, the acquisition approach would reduce tax induced distortions in the decision making process of a consolidated group and increase efficiency in the tax system.

2.48 However, the acquisition approach would represent a significant change to the existing consolidation framework and would be likely to lead to greater complexity and compliance costs for consolidated groups. For example, when an entity leaves a consolidated group, it would be necessary to determine the characterisation of any gain or loss made on the disposal of the entity.

2.49 In addition, difficulties would arise as to the market value of liabilities that would need to be determined when an entity joins or leaves a consolidated group. At present the entry and exit process recognises liabilities at their accounting value. While new legislative measures, for example the taxation of financial arrangements (TOFA)

provisions[16] and the foreign currency gains and losses (FOREX) provisions[17], have introduced a concept of requiring liabilities to be market valued for certain purposes, the Board recognises that requiring groups to undertake this process for all liabilities would increase compliance costs that arise when entity leaves a consolidated group.

Asset acquisition approach

Objective

2.50 The objective of the asset acquisition approach would be similar to the acquisition approach for assets. That is, the outcomes for assets would broadly replicate the outcomes that would arise if there was a direct acquisition or disposal of the underlying assets of an entity by a consolidated group, rather than the acquisition or disposal of membership interests in the entity.

2.51 Under the asset acquisition approach, the inherited history rules would be retained. However, a modification would be made to specifically exclude assets from the scope of those rules.

2.52 In addition, in light of the difficulties with valuing liabilities, a key difference (compared to the acquisition approach) is that the existing treatment of liabilities would be maintained.

Entity joining a consolidated group

2.53 Key implications that would arise under the asset acquisition approach when an entity joins a consolidated group are:

- when an entity joins a consolidated group, the group would be taken to acquire all the assets of the joining entity at the joining time;
- pre-CGT assets held by the joining entity at the joining time would become post-CGT assets[18];
- assets held by the joining entity that become intra-group assets of the group would come to an end at the joining time for a payment equal to the allocable cost amounts allocated to the assets[19];

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16 Division 230 of the ITAA 1997.

17 Division 775 of the ITAA 1997.

18 Under the inherited history approach, this change in status of pre-CGT assets is likely to arise in an acquisition (as opposed to formation) case due to the operation of Division 149, which changes the status of pre-CGT assets when there is a change in the majority underlying ownership of an entity.

19 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

- the entry history rule would be retained so that liabilities would be transferred to the group at the leaving time based on their accounting value;
- non-asset tax attributes of the joining entity (such as undeducted business related expenditure and other inherited deductions) would be aligned with the treatment of tax losses and franking credits and therefore transferred to the group — the entry history rule would achieve this outcome; and
- consistent with the high level design principles on which the consolidation regime is based, tax losses and franking credits held by a joining entity would continue to be transferred to the group.

2.54 Modifications could be made to alter these outcomes if necessary, having regard to other policy considerations.[20]

Operating as a consolidated group

2.55 Under the asset acquisition approach, the tax outcomes that arise in relation to an asset held by a consolidated group would generally be determined by the group's treatment of the asset, on the basis that the group has directly acquired the asset at the joining time. However, the joining entity's history would be relevant for the purposes of transferring the joining entity's liabilities to the group, usually at their accounting value.

2.56 Key implications that would arise are:

- asset-based deductions (such as capital allowances) would be determined on the basis that the consolidated group acquired the asset at the joining time for an amount equal to its tax cost setting amount — as a consequence, for example, the effective life of an asset for capital allowance purposes would be determined at the joining time;
- the capital/revenue character of the amount received on the disposal of an asset would be determined on the basis of the consolidated group's treatment of the asset;
- intra-group assets that emerge from the group would be taken to be created at the time they emerge[21];

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20 For example, modifications may be required for the treatment of pre-CGT assets and depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

21 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

- the consolidated group could deduct trade debts held by a joining entity that are written-off as bad only if the group is a money lender[22]; and
- the consolidated group could not rely on private binding rulings issued to a joining entity prior to the joining time to the extent that those rulings relate to the assets of the joining entity.

2.57 Modifications could be made to alter these outcomes if necessary, having regard to other policy considerations.[23]

Leaving a consolidated group

Implications for the consolidated group

2.58 Under the asset acquisition approach, when an entity leaves a consolidated group, the consolidated group would be taken to dispose of the membership interests held in the leaving entity — that is, the outcomes that currently apply when an entity leaves a consolidated group would be retained. Consequently, in most circumstances the consolidated group would make a capital gain or loss on the disposal of the membership interests held in the leaving entity, as those membership interests would usually be held on capital account.

2.59 However, consistent with the treatment of tax losses and franking credits, non-asset tax attributes of the joining entity (such as undeducted business related expenditure and other inherited deductions) would not be transferred to the leaving entity. Consequently, the calculation of the allocable cost amount for the leaving entity would be simplified as the step 2 adjustment for inherited deductions could be removed.

2.60 In addition, consistent with the high level design principles on which the consolidation regime is based, tax losses and franking credits held by the consolidated group would continue to be retained by the group.

Implications for the leaving entity

2.61 Key implications that would arise when an entity leaves a consolidated group under the asset acquisition approach (assuming that the leaving entity does not join another consolidated group) are:

- the leaving entity would be taken to acquire all the assets that it takes with it (including CGT assets and depreciating assets) at the leaving time;

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22 A consequential amendment may be required to ensure that trade debts are not retained cost base assets.

23 For example, modifications may be required for the treatment of depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

- asset-based deductions (such as capital allowances) would be determined on the basis that the leaving entity acquired the asset at the leaving time for an amount equal to its terminating value — as a consequence, for example, the effective life of an asset for capital allowance purposes would be determined at the leaving time;
- the capital/revenue character of the amount received on the disposal of an asset would be determined on the basis of the leaving entity's treatment of the asset; and
- the exit history rule would be retained so that liabilities would be transferred to the leaving entity at the leaving time, usually based on their accounting value.

Advantages and disadvantages of the asset acquisition approach

2.62 The asset acquisition approach would significantly clarify the policy benchmark against which the outcomes of the consolidation regime can be compared. That is, outcomes from entering into the regime for assets would substantially replicate as closely as possible outcomes that would arise under a direct asset acquisition.

2.63 As a result, the asset acquisition approach may reduce tax induced distortions in the decision making process of a consolidated group and increase efficiency in the tax system.

2.64 Although the asset acquisition approach would represent a change to the existing consolidation regime, in practical terms that change would be relatively insignificant (compared to the acquisition approach). That is, the fundamental change would be to ensure that:

- the assets of a joining entity are acquired by the consolidated group at the joining time for an amount equal to the tax cost setting amounts allocated to the assets; and
- the assets that a leaving entity takes with it are acquired by the leaving entity at the leaving time for an amount equal to the terminating values of the assets.[24]

2.65 A key advantage of the asset acquisition approach is that it would substantially retain:

- the existing treatment of liabilities; and
- the consequences that arise for a consolidated group when an entity leaves the group (as distinct from the consequences that arise for the leaving entity).

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24 In technical terms, this would primarily involve an amendment to section 701-55 of the ITAA 1997. However, it would also require numerous consequential amendments.

THE BOARD'S VIEW

2.66 The current inherited history framework underlying the consolidation regime is working effectively in the majority of cases to achieve the primary objectives of the consolidation regime.

2.67 One of the primary drivers behind the introduction of the consolidation regime was to reduce compliance costs for corporate groups in undertaking their tax affairs.

2.68 As highlighted in the Deloitte submission, the consolidation regime has required a significant investment of time and resources from both advisors and taxpayers. In this regard, familiarity with the operation of the regime is beginning to result in decreased compliance costs over time. This investment could be jeopardised if radical changes are made to the operation of the regime:

> While we agree that the tax consolidation regime has contributed to an improvement in the business efficiency and integrity of the tax system, we also consider that it has resulted in significant compliance costs for taxpayers over the period of introduction. We note that such compliance costs are reducing over time as groups become more familiar with the operation of the provisions.

2.69 Therefore, the Board considers that a fundamental change to the existing consolidation model could be justified only if the case for change is compelling and is strongly supported by the business community.

2.70 In this regard, the current inherited history framework was developed in an environment where the focus of stakeholders was on formation cases. The consolidation regime has now matured so that, at least for large businesses, the focus has now shifted to acquisition cases.

2.71 The Board acknowledges that the acquisition approach offers a clear policy benchmark against which the outcome of the consolidation regime can be compared. That is, outcomes from entering into the regime would replicate as closely as possible outcomes that would arise under a direct asset acquisition. However, the acquisition approach would give rise to increased compliance costs, particularly in relation to the treatment of liabilities and the consequences that arise when an entity leaves a consolidated group.

2.72 In relation to liabilities, the Board notes that the historical value of liabilities is generally used throughout the income tax law, with the notable exceptions of the recently introduced TOFA and FOREX provisions. Therefore, the Board considers that a broader review of the treatment of liabilities in the income tax law would be required

before the acquisition approach (requiring market valuation of liabilities) could be adopted.[25]

2.73 As acquisition cases are now the primary focus of consolidation, the Board considers that the adoption of the asset acquisition approach would be a significant improvement for the consolidation regime. This would provide greater consistency between the treatment of assets acquired directly or indirectly. However, the existing treatment of liabilities and the consequences that arise for a consolidated group when an entity leaves the group would be retained.

2.74 Therefore, the Board considers that the asset acquisition approach should be adopted.

2.75 However, the Board notes that the application of the asset acquisition approach may need to be modified in some cases to ensure that the income tax law applies consistently to consolidated groups and other taxpayers having regard to the policy underlying other parts of the law.

2.76 For example, adopting the asset acquisition approach in formation cases, or in cases where there is a change in ownership of a joining entity, would cause different outcomes to arise for consolidated groups and other taxpayers in some cases. Therefore, although the proposals outlined in Chapter 5 of this Position Paper will significantly address these concerns, the Board seeks stakeholder comments on whether the asset acquisition approach should be modified in some cases.[26]

Position 2.1

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

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25 An acquisition approach is currently adopted for TOFA liabilities that are subject to certain elections. That approach could be extended to a broader range of TOFA liabilities and to FOREX liabilities.

26 For example, modifications may be required for the treatment of pre-CGT assets and depreciating assets (including pre-July 2001 mining rights) in formation cases, or in cases where there is a change in ownership of a joining entity.

Question 2.1

The Board seeks stakeholder comment on:

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

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

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

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

Chapter 3: Operation of the single entity rule

3.1 The single entity rule operates to treat a wholly-owned corporate group as a single taxpayer. The objective of the single entity rule was specified in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 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 organisational structures based more on commercial rather than tax considerations; and
> - promote equity by improving the integrity of the tax system.[27]

Views expressed in submissions

3.2 Submissions generally supported the view advanced in the Board's Discussion Paper that, in most cases, the single entity rule works effectively and produces appropriate outcomes.

3.3 The joint submission received from the ICAA/TIA contained the following:

> On the whole, we consider that the SER [single entity rule] does operate to simplify compliance, reduce compliance costs and enhance the efficiency and integrity of the tax system. This is clearly the case for groups which have all of their dealings with third parties (i.e. non-group members) and have limited intra-group assets (other than for instance membership interests in subsidiary members).

3.4 In addition, the submission received from CPA Australia states:

> The single entity rule and the inherited history rules have increased business efficiency in that they have removed tax impediments to business, and have reduced

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

> the need to consider the tax implications of group reorganisations and other transactions within groups. In relation to the integrity of the tax system, the treatment of consolidated groups as a single entity for certain purposes has removed opportunities to cascade losses in a chain of group companies, as well as the double taxation and loss duplication that previously occurred on the disposal of assets followed by a disposal of equity interests.
>
> However, the rules have also given rise to uncertainty, particularly in the context of various issues identified in the Discussion Paper such as the application of the SER to intra-group assets, and the interaction between the SER and inherited history rules and other areas of the income tax laws. This uncertainty has reduced the overall business efficiency gains that would otherwise have resulted from the introduction of the consolidation rules.

3.5 The CPA Australia submission highlights a common concern that was raised in submissions received by the Board. That is, although the single entity rule has gone some way to achieving its stated policy objectives, the ability of the regime to achieve these objectives has been hampered by the significant uncertainty and delay associated with providing resolution to key issues surrounding the application of the single entity rule.

3.6 Further, the Deloitte submission acknowledged that:

> Broadly, we believe that the single entity rule operates appropriately and as intended in the majority of cases. However, there are a number of cases where the single entity rule does not appear to operate appropriately.

3.7 In this regard, the primary areas of uncertainty associated with the operation of the single entity rule relate to:

- intra-group assets;
- intra-group liabilities;
- integrity issues; and
- dealings by third parties with a consolidated group.

Intra-group assets

3.8 Intra-group assets primarily relate to contractual rights between group members. These assets are disregarded by the head company under the single entity rule. Broadly, there are three types of intra-group assets:

- membership interests in subsidiary members of the group;

- rights relating to intra-group debt interests; and
- rights relating to intangible intra-group assets (e.g. options, rights or licences).

3.9 Intra-group assets that constitute membership interests are appropriately dealt with specifically under the tax cost setting processes that apply when an entity joins or leaves a consolidated group.[28] Accordingly, this Chapter focuses on intra-group assets other than intra-group membership interests.

3.10 Intra-group assets (other than membership interests) can either be:

- created within the group;
- brought into the group through the direct acquisition of the asset; or
- brought into the group through the acquisition of the membership interests in the entity holding the asset (that is, an indirect acquisition).

3.11 An intra-group asset acquired under a direct acquisition does not have its tax cost reset under the consolidation rules. Nevertheless, a real cost is often incurred by the head company of the consolidated group to bring the asset into the group.

3.12 Where an indirect acquisition of an intra-group asset occurs, the tax cost setting process applies to set a tax cost for the asset.

3.13 The contractual rights that give rise to an intra-group asset (other than a membership interest) will usually have associated obligations. Therefore, where a consolidated group holds an intra-group asset, it will usually have a corresponding liability. In some cases this corresponding liability will not be recognised as an accounting liability.

Current divisional company model

3.14 The ATO currently adopts a 'divisional company' model for dealing with intra-group assets (other than membership interests). This model has been adopted because the ATO considers that it best achieves the intent of the consolidation regime.

3.15 Under the divisional company model, the following outcomes arise.

- If both the rights and obligations relating to an asset are held within the group, the asset becomes an intra-group asset and is no longer recognised for income tax purposes.[29]

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28 Divisions 705 and 711 of the ITAA 1997.
29 Taxation Ruling TR 2004/11, paragraph 8.

- If an intra-group asset (other than an intra-group debt interest) is disposed of to a third party, it is treated for income tax purposes as a disposal of an asset and CGT event A1 applies. However, only incidental costs associated with the asset's disposal are included in the asset's cost base.[30]
- If an intra-group asset is disposed of indirectly as part of an entity disposal, the tax cost setting rules that apply when an entity leaves a consolidated group operate to re-create the tax cost of the leaving entity's membership interests for the head company.[31]

3.16 However, at the 2009 Consolidation Symposium, the ATO acknowledged that, in some cases, the divisional company model creates issues when applying the single entity rule.[32] These issues usually arise where an equivalent transaction cannot be undertaken by 'divisions' within a consolidated group.

3.17 The ATO departs from the divisional company model for their treatment of intra-group debts. Where an intra-group debt is transferred to a non-group entity, the transfer is treated, in substance, as the equivalent to borrowing money or obtaining credit (i.e. the creation of a loan). As such, no CGT event occurs to the consolidated group. In effect, the ATO applies an 'ending/creation model' to intra-group debt interests and a 'disposal model' to other intangible intra-group assets.

3.18 Stakeholders have criticised this dual approach as it creates uncertainty and there is no legislative basis for treating of intra-group assets differently. Stakeholders also question whether the divisional company model is the most appropriate model for dealing with intra-group assets.

3.19 On this point, the Deloitte submission says:

> … we question whether ... the treatment of debt like instruments is an exception, or is in fact the way such arrangements should be seen under the single entity rule. That is, if there is an intra-group option that is disposed of to a third party, it is questioned whether the single entity rule in fact results in CGT event A1, or instead results in a creation of a new asset. In our view, the inconsistent treatment of intra-group arrangements results in a fundamental question as to whether the ATO view is indeed technically correct, giving rise to uncertainty of application.

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30 Taxation Ruling TR 2004/11, paragraph 11. Taxation Determinations TD 2004/34 (about intra-group options) and TD 2004/35 (about intra-group licences).

31 Division 711 of the ITAA 1997.

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

Ending/creation model

3.20 A number of submissions received by the Board suggested an ending/creation model may be a more appropriate model for determining the tax treatment of intra-group assets. Under an ending/creation model, intra-group assets would be treated as effectively coming to an end when they come into the group and re-created when they emerge from the group.

3.21 Stakeholders submitted that this treatment accords with both an asset acquisition approach and the operation of the single entity rule, as assets are deemed to have been acquired by the head company at the joining time and cease to be recognised when they become intra-group assets.

3.22 The CTA/MCA submission said:

> Prima facie, the ATM [asset transaction model] would deal directly with this issue by regarding the ACA [allocable cost amount] allocated to an intra-group asset as being a payment made by the joined group to terminate the intra-group asset. … Such an approach would reflect the economic reality that from the group's perspective the acquisition of the joining entity has had the result of negating the commercial and legal obligations associated with the intra-group asset owned by the joining entity.[33]

3.23 This approach would also mirror the tax treatment that applies to intra-group membership interests under the consolidation regime, as membership interests cease to exist when an entity joins a consolidated group and are re-created, with their tax cost reset, when an entity leaves a consolidated group.

3.24 Practically, under the ending/creation model, when an entity joins a consolidated group, the cost incurred to acquire an intra-group asset would be deemed to be a payment made by the head company to terminate the asset. However, when an intra-group asset leaves the group, the asset would be 're-created', as opposed to being 'disposed of' (as is the case under the current divisional company model, apart from intra-group debt interests).

The Board's view

3.25 The Board considers that the consolidation regime could be improved by making the treatment of intra-group assets more consistent and certain.

3.26 In determining the most appropriate treatment for dealing with intra-group assets, the Board considered the following questions:

- should the tax costs of intra-group assets be recognised for tax purposes?

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33 Note the reference to an asset transaction model in this submission refers to the acquisition approach, as outlined in Chapter 2.

- when should the tax costs of intra-group assets be recognised?
- what history, if any, is relevant for intra-group assets?

3.27 In this regard, the tax costs of intra-group assets include:

- if the intra-group asset is acquired directly by the consolidated group, the actual cost of the asset and any other outlays or expenditure incurred to third parties in acquiring or holding the asset; or
- if the intra-group asset is held by an entity that becomes a member of a consolidated group (and therefore is acquired indirectly by the group), the tax cost setting amount for the asset and any other outlays or expenditure incurred to third parties in relation to holding the asset.

Should the tax costs of intra-group assets be recognised for tax purposes?

3.28 The taxation outcomes that arise when intra-group assets are recognised by the head company of a consolidated group depend on whether the asset is:

- acquired or disposed of directly by the consolidated group, including where the asset is brought to an end within the consolidated group; or
- acquired or disposed of indirectly by the consolidated group, because the consolidated group acquires an entity (thereby creating an intra-group asset) or an entity leaves the group taking the intra-group asset with it.[34]

Intra-group assets acquired or disposed of directly by a consolidated group

3.29 An asset acquired by a consolidated group directly from a third party entity may become an intra-group asset. This could happen, for example, if the head company of a consolidated group acquires rights from a third party entity that arise under a contract between the third party entity and a subsidiary member of the group.

3.30 An asset acquired under a direct acquisition does not have its tax cost reset under the consolidation rules. Nevertheless, a real cost is often incurred by the head company of the consolidated group to bring the asset into the group.

3.31 In addition, a consolidated group may incur economic outlays in relation to an intra-group asset during the period that it is held within the group or when it is disposed of or comes to an end (for example, third party legal expenses or stamp duty).

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34 An ATO discussion paper titled *What is the income tax treatment of expenditure incurred by a consolidated group to acquire an asset that becomes an intra-group asset which is then disregarded due to the single entity rule?* was released to the National Tax Liaison Group Consolidation Sub-group on 23 November 2006. The paper, which compared the economic and tax effects of the differing disposal options for a consolidated group, sought to determine the tax cost that should be recognised for intra-group assets.

3.32 In the Board's view, actual economic outlays to third parties that relate to intra-group assets directly acquired, or disposed of, by a consolidated group should be recognised for income tax purposes. Recognition of these outlays ensures that the tax outcome mirrors the economic cost to the group from acquiring or disposing of an asset, thereby reducing any disparity in outcomes that arise to the group.

Intra-group assets acquired indirectly by a consolidated group

3.33 When a consolidated group acquires a subsidiary entity, it indirectly acquires the subsidiary entity's assets. Any of those assets which arise under contractual arrangements with another member of the group will become intra-group assets that are acquired indirectly by the group.

3.34 Where an intra-group asset is acquired indirectly, the tax cost of the asset is reset under the consolidation tax cost setting rules. However, due to the operation of the single entity rule, the tax cost of an intra-group asset acquired indirectly by a consolidated group is not recognised for income tax purposes.[35]

3.35 However, it is apparent that for the tax outcome to mirror the true economic position of the consolidated group, the tax cost setting amount allocated to an asset that is acquired indirectly should be recognised for income tax purposes.

3.36 Therefore, the Board considers that the tax cost setting amount allocated to these intra-group assets should be recognised for income tax purposes.

When should the tax costs of intra-group assets be recognised?

3.37 Under the divisional company model, the fact that the single entity rule commences to apply to an intra-group asset is not sufficient to trigger income tax recognition of the tax cost of that asset. Accordingly, the head company cannot recognise the tax cost of the asset until the group disposes of the asset.

3.38 In contrast, submissions received by the Board argued that a consolidated group should be able recognise the tax cost associated with an intra-group asset when the single entity rule commences to apply to the asset, i.e. when the asset comes into the group and becomes an intra-group asset. This is consistent with the treatment that would arise under an ending/creation model.

3.39 Although there are valid reasons for recognising the tax costs associated with intra-group assets when the assets are brought into the group, adopting such a model would have the effect of bringing forward the point of recognition of such tax costs. This could have an adverse impact on the revenue if the asset remains in the group indefinitely.

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35 Section 701-58 of the ITAA 1997

3.40 The Board acknowledges that, where recognition of the tax cost of an intra-group asset is deferred until the asset subsequently emerges from the group or lapses intra-group, the consolidated group would be required to 'track' the asset and tag it with its tax cost.[36] This is contrary to policy intent underlying the consolidation regime (which results in intra-group assets ceasing to be recognised) and therefore would impose additional compliance costs.

3.41 However, the Board notes that these assets continue to exist within the consolidated group up until the time they are disposed of or lapse.

3.42 Therefore, the Board considers that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or the asset lapses, provided that there is no corresponding accounting liability for the asset that has been taken into account elsewhere in the consolidated group. In this regard, if another member of the group recognises an accounting liability which corresponds to the intra-group asset and that was taken into account under the tax cost setting rules that applied when that other member joined the group, the accounting liability effectively increases the tax costs of the other member's assets that are now taken to be held by the head company of the group.[37]

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

3.43 Under the asset acquisition approach proposed by the Board in Chapter 2, a consolidated group would be taken to acquire all the assets at the joining time. Therefore, the capital/revenue character of the amount received on the disposal of the asset would be determined on the basis of the consolidated group's treatment of the asset. As a result, the income tax history that an intra-group asset had prior to coming into the consolidated group would be irrelevant when it is subsequently disposed of or lapses.

3.44 This outcome is broadly consistent with views expressed in submissions made to the Board, which stated that, depending on the nature of the transaction being undertaken between the two contracting parties, the tax treatment of the payment made by the head company of the group (i.e. the tax cost) to acquire/terminate the asset should be determined in accordance with the ordinary provisions of the income tax law.

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36 Paragraph 3.27 outlines the tax costs of intra-group assets.

37 Accounting liabilities of a joining entity increase the allocable cost under step 2 of section 705-60 of the ITAA 1997.

Position 3.1:

The Board considers that:

(a) the tax cost of an intra-group asset[38] that does not have a corresponding accounting liability which is recognised elsewhere in the consolidated group should be recognised for income tax purposes;

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

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

Question 3.1

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

INTRA-GROUP LIABILITIES

3.45 When an entity leaves a consolidated group, the allocable cost amount for the leaving entity is adjusted to reflect intra-group liabilities — that is liabilities owed by members of the old group to the leaving entity.[39]

3.46 The Government announced that the income tax law would be amended so this intra-group liability adjustment applies to accounting liabilities.[40] Submissions received by the Board highlighted significant stakeholder concerns with the proposal to restrict the operation of the adjustment to accounting liabilities.

3.47 Both stakeholders and the ATO consider that there may be situations involving intra-group assets where there is no corresponding liability owed by members of the old group to the leaving entity.

3.48 The problems experienced by consolidated groups which undertake indirect disposals of intra-group assets could be compounded if the intra-group liability adjustment is restricted to accounting liabilities.

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38 Paragraph 3.27 outlines the tax costs of intra-group assets.

39 Section 711-40 of the ITAA 1997.

40 Media release No. 053 of 13 May 2008 issued jointly by the Treasurer and the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs

3.49 However, if an adjustment could be made for a corresponding liability, situations can arise where recognising the market value of that liability could result in a gain not being recognised for tax purposes. This outcome would also seem inappropriate.

3.50 Accordingly, the Board considers that the Government should give further consideration to amending the intra-group liability adjustment so that:

- the adjustment is triggered when an intra-group asset that does not have a corresponding liability owed to it by a member of the old group leaves a consolidated group with a leaving entity; and
- the adjustment applies to liabilities and to other similar types of obligations.

Position 3.2

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

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

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

Question 3.2

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

INTEGRITY ISSUES RESULTING FROM INTRA-GROUP TRANSACTIONS

3.51 The Board had been advised that integrity issues can arise from the use of intra-group transactions that could lead to inappropriate tax outcomes.

3.52 In particular, ignoring the taxation consequences of intra-group dealings may result in some value shifts not being recognised by the tax system. This could occur where rights are created in respect of an asset (the encumbered asset) of the consolidated group and the parties to the rights agreement are members of the same consolidated group (that is, the rights are created intra-group).

3.53 As the rights agreement is an intra-group dealing, there are no tax consequences when the rights are created because of the operation of the single entity rule.

3.54 If the market value of the encumbered asset is diminished because of the rights that have been created, the cost base of the asset will be unaffected and an accounting liability might not arise in relation to the right.[41]

3.55 In addition, the encumbered asset could then be disposed of with the potential for the following outcomes.

- direct disposal of the asset — the group makes a capital loss or reduced capital gain on disposal and may maintain economic use of the asset (via the right); and
- indirect disposal of the asset by disposal of the entity holding the asset:
  - the group makes a capital loss or reduced capital gain on disposal of the membership interests and may maintain economic use of the asset (via the right); and
  - the cost base (undiminished by the encumbrance) of the asset is included in the tax costs of the membership interests in the entity and there may not be any accounting liability recognised in relation to the leaving entity's obligations under the right created in favour of the old group member.

3.56 If the rights agreement results in an asset consisting of a non-accounting liability owed to a member of the consolidated group by the leaving entity, then the head company is given a market value cost base for the right.[42] Consequently, a permanent difference to the revenue would arise (as the capital loss or reduced capital gain on the disposal of the membership interests would not be recouped if the asset created by the rights agreement was subsequently disposed of by the head company).

3.57 The Board notes that for non-consolidated groups, the general value shifting rules would generally apply to impact the value shift generated by creating the encumbrance over the asset.

3.58 Therefore, the Board considers that additional integrity provisions are required so that, if an intra-group asset or liability is taken out of a consolidated group, any value shift effected intra-group is appropriately reflected:

- in the case of a direct disposal of the asset or liability, in working out the amount of capital gain or capital loss made by the group; or
- in the case of an indirect disposal of the asset or liability, under the tax cost setting rules that apply when an entity leaves a consolidated group.

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41 Where no accounting liability is created, the allocable cost amount worked out when an entity leaves a consolidated group will not be reduced by the value of the accounting liability (as only accounting liabilities are recognised at step 4 of tax cost setting process that applies when an entity leaves a consolidated group).

42 Section 701-20 of the ITAA 1997.

Position 3.3

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

Question 3.3

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

EXTENSION OF THE SINGLE ENTITY RULE TO THIRD PARTIES THAT DEAL WITH CONSOLIDATED GROUPS

3.59 The single entity rule does not apply to an entity outside of a consolidated group (a third party) which deals or transacts with a member of the consolidated group. In these circumstances, the single entity rule can cause uncertainty for third parties where the income tax position of the third party is affected by the transaction, but the income tax position of the consolidated group is not.

3.60 The Government has announced that the income tax law will be amended to extend the operation of the single entity rule for the purposes of certain CGT integrity provisions.[43]

3.61 Therefore, the Board's Discussion Paper sought views on whether the single entity rule should be extended to third parties in a broader range of circumstances. The Board also sought comments on whether the extension of the single entity rule should be reflected in a general principle or determined on a case by case basis.

Views expressed in submissions

3.62 Stakeholders who responded to this issue were unanimous in the view that the single entity rule should be extended to third parties in a broader range of circumstances than currently proposed. However, a 'broad-brush' approach to extend the single entity rule to all third parties who transact with a consolidated group was not supported.

3.63 In particular, a number of stakeholders were concerned that a blanket extension of the rule would place additional and onerous obligations on consolidated groups in ensuring that all third parties who transact with the group are fully informed of the correct tax status of the group. Further, it was generally acknowledged that a blanket

43 Media release No. 053 of 13 May 2008 issued jointly by the Treasurer and the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs.

extension of the single entity rule to all third parties may not produce an appropriate outcome in all circumstances.

3.64 Accordingly, the majority of submissions were in favour of an extension of the single entity rule on a case by case basis, having regard to the specific circumstances and operation of the income tax legislation.

3.65 The operation of the single entity rule and the inherited history rules is already extended to third parties for the purposes of applying the conduit foreign income rules[44], the value shifting rules[45] and the loss integrity provisions[46].

3.66 Some submissions expressed concerns that further extending the single entity rule on a case by case basis may create additional uncertainty and complexity for taxpayers when applying the consolidation legislation. This uncertainty may arise, for instance, where the legislation is not clear on the specific circumstances in which third parties can rely on the single entity rule in determining their tax affairs. Also, there were concerns that additional complexity may result where provisions extending the operation of the single entity rule are scattered throughout the consolidation legislation rather than centralised in one specific place.

3.67 To address this uncertainty, the Deloitte submission proposed:

> As Division 701 contains the single entity rule, it would seem logical that an extension to the single entity rule to third party dealings and other provisions should be contained in Division 701 (e.g. section 701-100).
>
> In our view, the provision would require two parts. The first part would identify relevant provisions of the Tax Act requiring an extension of the single entity rule outside core purposes. Essentially this section would contain a list of provisions where it is considered necessary to extend the operation of the single entity rule (e.g. Division 115, Division 152, Division 974, etc). Expansion of this list could be done via amendment or by regulations. The second part would then be needed to turn on the single entity rule in respect of all provisions contained in the first part.

3.68 Stakeholders generally agreed that the single entity rule should be extended to third parties transacting with a consolidated group in the circumstances outlined in the

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44 Section 715-875 of the ITAA 1997.

45 Section 715-410 of the ITAA 1997.

46 Section 715-75 and section 715-215 of the ITAA 1997.

Board's Discussion Paper.[47] Some stakeholders identified other areas where the extension of the single entity rule could be considered.[48]

The Board's view

3.69 It is clear that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who transact with a consolidated group in a broader range of circumstances than those announced by the Government.

3.70 The Board considers that it would be preferable to develop a principle that could be applied to extend the single entity rule to third parties who transact with a consolidated group to third parties, rather than dealing with the issues purely on a case by case basis.

3.71 In this regard, a clear principle that emerges from the examples raised is that the single entity rule should be extended to third parties who are:

- shareholders of the head company of a consolidated group; and
- liquidators appointed to the head company of a consolidated group.

3.72 In both these scenarios the third party clearly sees the group as a single entity. Therefore, the Board considers that the single entity rule should be extended to these third parties and invites stakeholder comments on whether any exceptions are required.

3.73 The Board also considers that there may be a case for extending the single entity rule so that it applies to the dealings of a related third party with a consolidated group. The Board seeks stakeholder comments on whether this would be appropriate.

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47 The issues covered in the Board's Discussion Paper were CGT event K6, the CGT discount rules, distributions by liquidators and the commercial debt forgiveness rules.

48 These included the dividend imputation system, the small business CGT concessions, the debt/equity provisions, private company distributions and qualifying securities.

Position 3.4

The Board considers that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who are:

(a) shareholders of the head company of a consolidated group; or

(b) liquidators appointed to the head company of a consolidated group.

Consideration should also be given to extending the single entity rule (together with other parts of the consolidation provisions) so that it applies to the dealings of a related third party with a consolidated group.

Question 3.4

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

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

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

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

4.1 Chapter 4 of the Discussion Paper identified areas where issues and uncertainties arise as a result of the interaction between the consolidation regime and other parts of the income tax law. The Board asked stakeholders to comment on the issues identified and to advise on any other areas of uncertainty or inequity that arise as a result of such interactions.

4.2 The issues and uncertainties fall into five broad but overlapping categories:

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

TAXATION OF TRUSTS

4.3 Issues relating to the interactions between the trust provisions and the consolidation provisions mainly arise because of the way trusts are taxed. These issues relate to:

- determining how much of a trust's net income is assessed to each beneficiary and/or trustee when the trust is a member of a consolidated group for part of an income year; and
- calculating the allocable cost amount of a trust that joins a consolidated group part way through an income year.

Determining the net income of a trust that is a member of a consolidated group for part of an income year

4.4 Several issues arise when determining the amount of a trust's net income that should be assessed to beneficiaries and/or trustees where the trust is a member of a consolidated group for part of an income year.

4.5 The Government announced a new tax regime for managed investment trusts in the 2010-11 Budget.[49] The new regime is to commence on 1 July 2011. These changes may overcome some of the interaction issues that arise when a managed investment trust is a member of a consolidated group for part of an income year. Consequently, the Board considers that the consolidation interactions relating to managed investment trusts should be considered during the development of the new regime.

4.6 In addition, as the Board recommended that a broader review be undertaken on the way other trusts are taxed,[50] alternative models for determining the net income for other trusts during the non-membership period have not been considered as part of this review.

4.7 The Board has, however, considered the trust interaction issues using the existing framework[51] for taxing beneficiaries and trustees, taking into account the following principles included in Deloitte's submission:

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

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49 Assistant Treasurer's media release No 086 of 7 May 2010, in response to the Board's Report on its Review of the Tax Arrangements Applying to Managed Investment Trusts.

50 See Recommendation 48 in the Board's Report on its Review of the Tax Arrangements Applying to Managed Investment Trusts.

51 Division 6 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936).

Calculating the trust's net income and trust law income for a non-membership period

4.8 Stakeholders agree that the income tax law should be clarified to provide certainty on how the trust's net income and trust law income should be calculated when a trust joins or leaves a consolidated group part way through an income year.

4.9 In this regard it is clear that:

- the net income and trust law income should be worked out appropriately for each non-membership period; and
- the trust's exempt income and non-assessable non-exempt income should be allocated appropriately between the periods.

4.10 To address these issues, the Board considers that the net income and trust law income should be apportioned between the membership and non-membership periods using similar principles to those currently used to allocate the income and deductions of a trust between the head company and a beneficiary when a beneficiary is a subsidiary member of a consolidated group for part of the year.[52]

4.11 That is, the trust's net income for the non-membership period should be calculated by reference to the income and expenses that are reasonably attributed to the period and a reasonable proportion of such amounts that are not attributable to any particular period within the income year.

4.12 In addition, to the extent income and expenses are apportioned in calculating the trust's net income for the non-membership period, similar adjustments may be appropriate when calculating the trust law income.

4.13 The Board acknowledges that taxpayers would need to be aware of the terms of the trust deed when determining the trust law income for the non-membership period. For example, some trust deeds may define income as equating to, or calculated by reference to, the trust's net income for tax purposes.

4.14 However, as noted in the Deloitte submission, it is unclear if these clauses automatically modify the calculation of trust law income for the purposes of the deed and how they apply to trusts that have more than one non-membership period in an income year.

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52 See Subdivision 716-A of the ITAA 1997.

Position 4.1

The Board considers that:

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

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

Question 4.1

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

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

4.15 The Board considers that beneficiaries of a trust who have benefited from the trust law income during the non-membership period should be assessed on their share of the net income calculated for that period. Therefore, to overcome the uncertainty and issues that currently arise, the share of net income should be determined by taking into account events that happen after a trust joins or leaves a consolidated group.

4.16 For example, assume a trust and its two beneficiaries join a consolidated group part way through an income year. The income of the trust for the income year is $10,000 — $4,000 relates to the non-membership period and $6,000 for the membership period. Disregarding the single entity rule, each beneficiary becomes presently entitled to 50 per cent of the income of the trust — that is, $5,000 at the end of the income year.

4.17 Provided the beneficiaries' entitlements relate to the income of the trust derived during the non-membership period, they should be presently entitled to $2,000 of the income of the trust during the non-membership period. The amount of the trust's net income the beneficiaries are assessed on is based on their percentage of the entitlement to the income of the trust. If the trust's net income is the same as the income of the trust, each beneficiary should be assessed on $2,000.

4.18 In coming to this view, the Board acknowledges that this proposal could have a compliance impact on taxpayers as they would need to determine whether a beneficiary's income entitlement relates to the trust income derived during the non-membership period or to some other period.

Position 4.2

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

Question 4.2

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

Calculating the allocable cost amount of a trust that joins a consolidated group part way through an income year

4.19 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 trust's non-membership period.

4.20 Currently, the tax cost setting rules do not recognise the tax for which the group may be liable on the net income of the trust's non-membership period as a cost to the group of acquiring the trust. It is only the trust's liabilities that are taken into account in calculating its allocable cost amount at the joining time. This can result in anomalous outcomes.

4.21 The Board agrees with stakeholder views that the group's tax liability in relation to the net income of a trust's non-membership period should be included as a liability in working out the allocable cost amount when the trust joins a consolidated group. However, the adjustments required to the tax cost setting calculations to reflect this change will depend on how the net income relating to the trust's non-membership period is determined.

Position 4.3

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

Question 4.3

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

CONSOLIDATION MEMBERSHIP RULES

4.22 The Board's Discussion Paper considered the application of the consolidation membership rules as they relate to:

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

Applying the consolidation membership rules to trusts

Membership of a consolidated group — the trustee

4.23 In relation to the membership requirements of trusts, stakeholders were of the view that it was not necessary for the trustee to be a member of the same consolidated group as the trust.

4.24 In this regard, the CTA/MCA submission said :

> ... many trusts employ external trustees and many trustees act as trustees for more than one trust and as such it would not be possible for many trusts to form part of a tax consolidated group. Further, individuals can be trustees of trusts and as such any such trusts would not be eligible to be part of a tax consolidated group.
>
> … changing trustees would also likely lead to significant integrity risk as trusts could be taken in and out of tax consolidated groups with no economic change of ownership.
>
> Therefore, … it would be inappropriate to require the trustee to be a member of the same consolidated group as the trust.

4.25 Although stakeholders considered it was unnecessary for the trustee to be a member of the same consolidated group as the trust as a condition of the trust's membership, they agreed that the technical issues identified in the Board's discussion paper can arise when this is not the case. For example, it is unclear how the tax cost setting rules apply to a trust when it joins or leaves a consolidated group as the trust's assets are those of the trustee — not the trust.

4.26 Although stakeholders suggested some alternative approaches to address these issues, the Board considers that requiring the trustee, in its capacity of trustee, to be a member of the same group as the trust is a systemic and straight forward method resolving the issues. In this regard, provided the trustee is only a member of a consolidated group in its capacity as trustee for that trust, the concerns raised by stakeholders should be overcome.

Position 4.4

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

Question 4.4

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

Membership of a consolidated group — beneficiaries

4.27 Stakeholders generally agreed that a trust should qualify as a member of a consolidated group only if all of its beneficiaries are members of the group.

4.28 However, BDO suggested that debt beneficiaries (that is, beneficiaries whose interests in the trust are classified as debt interests) should be excluded from the membership requirements. That is, a trust should qualify as a member of a consolidated group if all of its beneficiaries, other than debt beneficiaries, are members of the group.

4.29 In contrast, CPA Australia and Deloitte's recognised that difficulties could arise if debt interests in trusts are outside the group. For example, it is unclear how the net income of the trust would be allocated between the consolidated group and the debt beneficiaries outside the group as the trust does not have any net income for tax purposes once it joins the group.

4.30 Consequently, the Board considers that all beneficiaries, including debt beneficiaries, unit holders or objects of a trust must be subsidiary members of the consolidated group for the consolidation rules to work as intended.

Position 4.5

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

Question 4.5

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

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

4.31 Prior to the introduction of the foreign hybrid rules, a foreign hybrid entity was effectively treated for foreign tax purposes as a partnership (i.e. the partner or member is subject to tax) but was taxed in Australia as a non-resident company. As a result, they could not become members of a consolidated group.

4.32 The foreign hybrid rules allow these non-resident entities to be treated as a partnership for Australian tax purposes. As a result, these entities could become members of a consolidated group.

4.33 Stakeholders were of the view that non-resident entities that satisfy the foreign hybrid rules should be entitled to become members of a consolidated group.

4.34 As the changes to allow foreign hybrids to be treated as partnerships are relatively new, it is unclear if there are any risks associated with allowing these entities to become members of a consolidated group.

4.35 Therefore, the Board considers that foreign hybrids should be eligible to become members of a consolidated group. However, this should be reviewed if evidence suggests that integrity risks arise as a result of this outcome.

Position 4.6

The Board considers that:

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

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

Question 4.6

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

INTERNATIONAL TAX ISSUES

4.36 The Board's Discussion Paper outlined concerns that 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.

4.37 The Discussion Paper included some simplified examples to highlight situations where the interaction of the consolidation regime with the non-resident CGT rules produce outcomes that, when viewed from the perspective of the overall outcome, are detrimental to the revenue.

4.38 Stakeholders were of the view that the general anti-avoidance rules[53] would apply to the arrangements outlined in these examples. They were also concerned that additional integrity measures may inhibit genuine commercial transactions.

4.39 The ATO agree that, in respect of the examples presented in the Discussion Paper, the general anti-avoidance rules could apply to strike down the tax benefit identified. However, commercial transactions are more sophisticated than the examples shown and it is unclear whether these rules could apply in all situations.

4.40 In this regard, Justice Richard Edmonds noted in his article in Lawyer's Weekly:

> It is not in the interests of the ATO to have to fall back, as a matter of last resort, on Part IVA and taxpayers certainly don't embrace such resort. Part IVA cases are never easy and the outcome is, in many cases, tinged with uncertainty.[54]

4.41 The Board is keen to ensure that the tax law operates efficiently, is easy to interpret and apply with certainty for both taxpayers and the ATO and produces equitable outcomes, having regard to the overall policy objectives of both the consolidation and the foreign resident CGT rules.

4.42 The consolidation rules allow consolidated groups, including MEC groups, to transfer assets between members of the group without giving rise to any tax consequences.

4.43 The foreign resident CGT rules, which limit Australia's CGT tax base to real property held by non-residents, were introduced as part of an ongoing process to ensure that Australia has a competitive international tax system.

4.44 The Board recognised in its review of the foreign source income anti-deferral regime's that, as a net capital importer, Australia needs to have an international tax regime that gives better access to international markets. If Australia's taxation treatment is less generous or flexible than that of other countries, this could reduce the competitiveness of our companies. The Board also acknowledged that international

53 Part IVA of the ITAA 1936.
54 Justice Richard Edmond, Lawyer's Weekly — Law's taxing sham, 12 March 2010, pages 14 and 15.

competitiveness needs to be considered in the context of our domestic revenue raising requirements.

4.45 Viewed in isolation, the policy of allowing tax-free movements of assets within a consolidated group and MEC group and limiting Australia's CGT tax base to real property held by non-residents is justifiable — it's the interaction of these policies that creates distortions.

4.46 Therefore, to assess the merits of the outcomes that arise as a result of the interactions between the consolidation regime and the foreign resident CGT rules, the Board considered the following objectives:

- ensure foreign owned entities do not have a comparative advantage over Australian owned entities that cannot be justified;
- ensure Australia remains an attractive place to do business;
- as far as possible, minimise the economic distortions of commercial choices; and
- ensure the revenue does not bear an unacceptable level of risk.

4.47 The Board is also of the view that, as far as possible, similar entities should be taxed consistently. The extent to which the taxation treatment favours particular types of entities has an impact on horizontal equity. This allows certain entities to receive benefits at a cost to the taxation revenue and can create inappropriate investment distortions.

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

4.48 The policy objectives underlying the foreign resident CGT rules have an impact on horizontal equity when comparing the tax treatment of resident entities and non-resident entities. However, the ability of MEC groups to move taxable CGT assets within the group, and then dispose of them without tax consequences, provides MEC groups with a further comparative advantage over other taxpaying entities — including other consolidated groups that are wholly-owned by a foreign resident.

4.49 Wholly-owned resident entities that form a consolidated group, and Australian resident entities that do not form a consolidated group, must recognise any gain or loss on the disposal of non-taxable Australian real property assets for Australian income tax purposes regardless of whether the asset is disposed of directly to a third party or indirectly through the disposal of the membership interests in the subsidiary that holds the asset.

4.50 However, a MEC group can use its structure to move assets within the group so that capital gains and losses made on assets that are non-taxable Australian real

property are disregarded. The difficulty arises because, when an entity (including an eligible-tier-1 company) leaves a MEC group, the principal asset test in Division 855[55] focuses solely on the leaving entity.

4.51 This gives foreign owned entities that form a MEC group an advantage over Australian owned entities and foreign owned entities that form a consolidated group and increases distortions in commercial choices as the current CGT exemption may create incentives for entities to modify their structures to take advantage of the current rules.

4.52 Therefore, to overcome these concerns, the Board considers that all the assets of a MEC group or consolidated group (rather than only the assets of the leaving entity) should be taken into account for the purpose of applying the principal asset test in Division 855.

Position 4.7

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

Question 4.7

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

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

4.53 The Board also considers that the interaction between the consolidation regime and the foreign resident CGT rules is inequitable to the extent that it allows consolidated groups that are wholly-owned by a non-resident entity and MEC groups to uplift the cost base of Australian assets without recognising a capital gain and without changing the underlying beneficial ownership of assets.

4.54 In this regard, the consolidation tax cost setting rules were developed to prevent double taxation — that is, tax payable by the vendor on the disposal of membership interests and on the unrealised gains on assets of the joining entity by the consolidated group or MEC group. Where a vendor is not taxable on the disposal of membership interests, an uplift in the joining entity's assets is not justified.

55 See section 855-30 of the ITAA 1997.

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

Position 4.8

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

Question 4.8

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

CAPITAL GAINS TAX

4.56 Anomalous outcomes arise when CGT assets are rolled over between members of a wholly owned group and subsequently sold. Stakeholders have raised concerns about the appropriateness of the outcomes that arise when:

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

Subsidiary member leaves a MEC group

4.57 Stakeholders raised concerns that capital gains or capital losses made on the disposal of rolled over assets are effectively double counted when a subsidiary member leaves a MEC group. The tax cost setting rules that apply when an entity leaves a consolidated group capture any deferred capital gains or capital losses made on rolled over assets when a subsidiary member leaves a MEC group. In addition, CGT event J1[56] may also apply to include the deferred capital gain or capital loss in taxable income.

4.58 Blake Dawson pointed out that CGT event J1 does not apply when a subsidiary company leaves a consolidated group with a rolled over asset. In their view, this modification should also apply when subsidiary members leave a MEC group.

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56 CGT event J1 broadly operates to end the deferral that happened under the roll-over.

4.59 The Board agrees that the current provisions create inequities and could result in capital gains or capital losses being included twice in taxable income. Consequently, CGT event J1 should not apply when subsidiary members leave a MEC group with assets that were rolled over prior to the entity joining the group.

Position 4.9

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

Question 4.9

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

Eligible tier-1 company leaves a MEC group

4.60 The Deloitte and joint CTA/MCA submissions raised concerns that double taxation may arise when an eligible tier-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group because of the pooling rules.

4.61 The pooling rules apply when an eligible tier-1 company leaves a MEC group. These rules indirectly capture some or all of the deferred capital gains or capital losses made on rolled over assets when an eligible tier-1 company leaves a MEC group. CGT event J1 may also apply to include the deferred capital gain or capital loss in taxable income.

4.62 Although the CTA/MCA submission included several examples to demonstrate that double taxation arises, they acknowledged that further consideration is needed to develop a solution.

4.63 The Board agrees that double taxation may arise when an eligible tier-1 company leaves a consolidated group with assets that were rolled over prior to the entity joining a consolidated group because of the pooling rules. However, as stakeholders have highlighted, there is no clear solution to address these concerns. Therefore, the Board is seeking stakeholder views on a potential solution.

Position 4.10

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

Question 4.10

(a) Do stakeholders agree with Position 4.10? If not, why not?

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

Head company of a consolidated group leaves the wholly-owned group

4.64 CGT event J1 arises when, broadly, a company ceases to be a member of a wholly-owned group following a CGT roll-over. However, the operation of the provision is uncertain and may result in inequitable outcomes where the membership interests in a subsidiary are rolled over to the head company of a consolidated group that is owned by a non-resident and the head company subsequently leaves the wholly-owned group.

4.65 Stakeholders are generally of the view that CGT event J1 should apply in these circumstances. However, it is unclear if 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. This is because the membership interests cease to be recognised for income tax purposes under the single entity rule.

4.66 In addition, the cost base of the membership interests in the subsidiary member is difficult to determine. However, further work is needed to determine how the cost base of the membership interests in the subsidiary member should be calculated.

Position 4.11

The Board considers that:

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

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

Question 4.11

(a) Do stakeholders agree with Position 4.11? If not, why not?

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

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

Other changes to the operation of CGT event J1

4.67 Submissions included other examples where anomalous outcomes arise when CGT assets are rolled over between members of a wholly-owned group and are subsequently sold.

4.68 The CTA/MCA submission suggested that the issues could be overcome if CGT event J1:

- included a time limit (for example it would only apply if the relevant break-up time occurred within three years);
- exempted minority interest divestments (for example, CGT event J1 would not apply if less than 10 per cent of the membership interests are disposed of); and
- allowed the sub-group break-up exemption to apply where less than 100 per cent of the interests in the sub-group is disposed of to non-group entities.

4.69 The Board is of the view that these suggestions involve broader changes to the CGT rules. However, because of the significance and the uncertainty that current exists with CGT event J1, the Board is interested in stakeholders views on whether these suggestions could reduce the anomalies and compliance costs that currently arise.

Question 4.12

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

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

OTHER ISSUES

4.70 The Board's Discussion Paper sought views on issues that arise as a result of the interaction between the consolidation regime and the provisions relating to FOREX and TOFA.

4.71 Stakeholders were also asked to submit any other areas of concern that arise a result of the interaction between the consolidation regime and other provisions in the income tax law that were not included in the Discussion Paper.

4.72 Some of these issues are discussed below. Other issues are outside the scope of this Review. However, some of these other issues are currently being considered outside the Board's process. A list of these issues, and the processes for dealing with them, are outlined in Appendix E.

4.73 In relation to issues not included as part of this Review or currently being considered by another process, the Board considers that Treasury and the ATO take the necessary action to consider and, where appropriate, resolve these issues as soon as practicable.

Consideration of consolidation interactions during the development of new measures

4.74 A number of stakeholders raised concerns about the interaction between the consolidation regime and recently introduced legislation (for example, the TOFA provisions and the managed investment trust provisions). Although the Board is aware that the interaction issues raised are being dealt with by Treasury and the ATO outside the Review process, the Board considers that interaction issues are important and should be taken into account as part of the initial design process.

4.75 The Board also acknowledges the complexities involved in developing new regimes and the time needed to identify issues and develop views. In some cases, interaction issues can only be identified and dealt with after the new regime has been settled. Therefore, the Board considers that stakeholders have a critical role in assisting Treasury to identify consolidation interaction issues when new policy proposals that affect the taxation of companies are being developed.

Interactions between the consolidation regime and double tax agreements

4.76 Double tax agreements relieve double taxation by allocating taxing rights between the country of residence and the country of source. The main methods of allocation are either:

- the country of residence is granted sole taxing rights, or

- both countries are given the right to tax the income, with the country of residence providing relief for tax paid in the country of source.

4.77 It is unclear how Australia's double tax agreements apply to consolidated groups. In particular, it is not clear whether:

- Australia's double tax agreements apply to a consolidated group, its head company, subsidiary members or a combination of these (a treaty interpretation issue); and

- for double tax agreement purposes, the single entity rule applies to attribute the actions of subsidiary members of a consolidated group to the head company of the group (a single entity rule interpretation issue).

4.78 In view of these uncertainties, the Board considers that Treasury and the ATO should undertake a review to clarify how Australia's double tax agreements apply to a consolidated group.

Position 4.12

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

Question 4.13

Do stakeholders agree with Position 4.12? If not, why not?

Deferred tax assets and liabilities

4.79 When an entity joins or leaves a consolidated group, deferred tax assets and liabilities impact on the allocable cost amount calculation and allocation process.

4.80 Deferred tax assets and deferred tax liabilities are accounting concepts that measure a future tax asset or liability. Accounting Standard AASB 112 prescribes the accounting treatment of income taxes, including the recognition and measurement of deferred tax assets and deferred tax liabilities.

4.81 Deferred tax assets represent the amount of income tax recoverable in future periods on temporary differences between what a company can deduct for income tax purposes and what can be expensed, depreciated or otherwise written off before tax for accounting purposes. They can also result from carry forward unused tax losses and unused income tax credits.

4.82 Deferred tax liabilities represent the amount of income tax payable by an entity in future periods on temporary differences between accounting and tax.

4.83 The ATO released a discussion paper on the inclusion of deferred tax assets and liabilities in the allocable cost amount and the tax cost setting process to the National Tax Liaison Group Consolidation Sub-group on 26 February 2009. The paper raised a number of issues, complexities and inequities that arise as a result of the current treatment.

4.84 To overcome these issues, the paper included three options:

- amend the tax law to deal with specific circumstances where policy objectives are not met or where inappropriate outcomes arise;
- remove deferred tax liabilities from the consolidation tax cost setting process; and
- remove both deferred tax assets and deferred tax liabilities from the consolidation tax cost setting process.

4.85 The Board has not reached a view on the best approach for dealing with this issue at this stage.

4.86 However, the Board is keen to reduce compliance costs associated with the consolidation regime and to reduce complexity where possible. Therefore, the Board is seeking stakeholder's views on the above options, together with any other suggestions that will simplify the current treatment of deferred tax assets and deferred tax liabilities.

Question 4.14

The Board seeks stakeholder's comments on:

(a) Whether the inclusion of deferred tax assets and deferred tax liabilities in the tax cost setting process results in unnecessary complexity?

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

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

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

Chapter 5: Operation of the consolidation regime for small business corporate groups

5.1 Stakeholders have confirmed that many small business and medium sized corporate groups which are eligible to form a consolidated group have elected to remain outside the consolidation regime.

5.2 The Board's Discussion Paper identified two primary factors that have contributed to the low take-up of the consolidation regime by small business and medium sized corporate groups.

5.3 First, anecdotal evidence suggests that the cost and complexity associated with acquiring the requisite knowledge to confidently apply the consolidation legislation was too high to justify, from the perspective of both the small business and medium sized corporate groups and their usual accounting and tax advisors.

5.4 Second, small business and medium sized corporate groups have been concerned about the operation of the rules aimed at preserving the pre-CGT status of membership interests of an entity that joins a consolidated group. These rules have recently been amended to ensure that the pre-CGT status of these membership interests is not eroded when the entity subsequently leaves the consolidated group.[57]

Views expressed in submissions

5.5 The Board's Discussion Paper sought stakeholder feedback on aspects of the existing regime that are viewed as particularly problematic for small business corporate groups and suggestions on changes that could be made to encourage a greater take-up of consolidation within the smaller business sector.

5.6 All submissions received by the Board that addressed small business issues suggested that, from a small business perspective, any potential benefits that could be achieved under the regime were, on the whole, outweighed by the costs associated with the uptake of the regime. In particular, submissions focused on:

- the structure of small business groups;
- the operation of the tax cost setting rules; and

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57 See *Tax Laws Amendment (2010 Measures No 1) Act 2010*.

- the consolidation transitional concessions.

Structure of small business groups

5.7 Submissions suggested that small business groups have significantly different needs to larger corporate groups. Consequently, the structure of small business and closely-held groups tends to differ to that of larger business groups. These differences impact on the ease with which small business groups can enter into the consolidation regime. They also highlight that the benefits associated with the consolidation regime are often not as relevant to these groups in conducting their tax affairs.

5.8 In this regard, the CPA Australia submission states:

> Many SME's have very small corporate groups (as few as 2 or 3 entities) with limited intra-group transactions. The compliance cost savings that might be achieved through the treatment of those groups as a single entity for tax purposes often have not outweighed the additional compliance costs involved in considering the consolidation rules, performing entry and exit calculations, calculating available fractions, etc.

5.9 The BDO submission highlights the following points of differentiation between smaller and larger business groups:

> Two of the most compelling reasons as to why larger groups elect to consolidate are:
>
> - the ability to ignore intra-group transactions (such as asset transfers) and to pool losses, franking credits and foreign tax credits. Many small business groups are structured in a manner which does not require frequent access to these benefits. For example, assets are often held in separate entities for asset protection and succession planning purposes. The requirements to transfer assets between entities arises infrequently, if at all; and
>
> - in relation to tax losses, subject to the satisfaction of certain tax loss and anti-avoidance rules, small business groups are able to utilise the benefits of discretionary trusts to distribute profits among the group.

Operation of the tax cost setting rules

5.10 A key feature of the consolidation regime is that, when an entity becomes a subsidiary member of a consolidated group, the tax costs of the subsidiary entity's assets are generally reset under the tax cost setting rules. The tax cost setting rules ensure that, broadly, the group's cost of acquiring the subsidiary entity is pushed down into the tax costs of the underlying assets of the joining entity.

5.11 Concerns were raised that the tax cost setting rules cause difficulty for many small business groups, particular on the formation of a consolidated group. In this regard, the submission from Blake Dawson states:

> In our experience, the consolidation regime is generally unattractive to small business because its benefits are outweighed by the compliance costs of (for example) preparing entry and exit 'allocable cost amount' calculations.
>
> These costs are more than usually significant for small business because their usual tax and accounting advisors often need to call on the help of specialist advisors to handle consolidation issues. Such specialist advice is often considerably more expensive, per hour, than their usual advisor's fees. The client therefore finds it difficult to see the 'value proposition'.

5.12 A similar view was expressed by CPA Australia in their submission:

> The complexity of, and uncertainty associated with, the rules has, in many instances, outweighed the benefits. The need to perform complex entry and exit calculations, uncertainty around the interaction between the consolidation rules and other areas of the law such as Division 152, anomalous outcomes that arose under the rules designed to preserve the pre-CGT status of membership interests are some examples of reasons why SMEs chose not to form consolidated groups. Although this meant the loss of the ability to transfer intra-group losses, SMEs have, to an extent, overcome this through management services arrangements.

5.13 Further, the submission from MGI Melbourne Pty Ltd states that:

> The tax cost setting rules are complex and many in the SME and larger family business sector cannot afford to pay advisors to advise on the impact of these rules.
>
> Of particular concern for many groups in the SME and larger family business sector which have been in existence for a long period of time is the detrimental impacts that the tax cost setting process can have to the tax cost of the underlying assets. This is particularly an issue where their shares in the relevant subsidiaries were acquired a long time ago and have a low cost base, compared to the value of the underlying assets (goodwill). On formation of a consolidated group, in some circumstances this may result in the tax cost of assets being eroded, and even a capital gain being made.

5.14 Several submissions highlighted that these detrimental outcomes under the tax cost setting rules typically arise for small business groups which have utilised CGT roll-overs to restructure their business to form a corporate group. This detriment arises because of the difference between the market value of the shares in the relevant companies and the cost base of those shares (which is determined under the relevant CGT roll-over provisions).

5.15 Another issue raised in submissions is that the tax cost setting rules utilise concepts, such as accounting standards, which may not be applicable to smaller business groups. This results in smaller groups experiencing higher compliance costs when applying the consolidation regime, as opposed to larger groups who are more familiar with these types of concepts.

5.16 In this regard, the ICAA/TIA submission states:

> In particular, we highlight the fact that small proprietary companies are not generally required to prepare financial statements in accordance with the accounting standards. A choice to consolidate by SME corporate groups may therefore require them to prepare accounts which comply with accounting standards when this would not otherwise be the case. This of itself results in additional complexity and compliance costs.

5.17 Finally, concerns were also raised that the valuation requirements under the tax cost setting rules are onerous and costly for small business groups.

Consolidation transitional concessions

5.18 When the consolidation regime was introduced, transitional concessions allowed wholly-owned groups that elected to consolidate the choice to retain the existing tax costs of a joining entity's assets (rather than apply the tax cost setting process to reset the tax costs of those assets). Additional concessions applied to simplify the rules for the utilisation of a joining entity's losses. These concessions ceased to apply from 31 December 2005.

5.19 These transitional concessions significantly reduced the compliance burden experienced by groups, particularly on formation of a consolidated group. For example, the option to retain the existing tax values of an entity's assets largely alleviated the need for costly valuations to be undertaken on formation of a consolidated group.

5.20 The transitional concessions were a temporary measure because they did not align with the broader policy objectives of the consolidation regime. In particular, the consolidation regime was introduced as a means to address key integrity issues inherent in the taxation of wholly-owned groups, which included the ability of groups to cascade losses through multiple ownership layers, as well as the potential duplication of taxable gains and tax losses within such groups. Requiring groups to undertake the tax cost setting process is an integral step in achieving these outcomes.

5.21 Many submissions suggested the re-introduction of these transitional concessions, at least for a temporary period, would assist small business and medium sized corporate groups to transition into the consolidation regime. The submissions suggested that the re-introduction of these measures could be justified in light of the significant complexity and uncertainty that has surrounded the operation of the consolidation provisions since their introduction.

5.22 In this regard, the CPA Australia submission states:

> ... many SME's adopted a 'wait and see' approach and, therefore, missed out on the transitional concessions that were initially available...

> In summary, the reintroduction of a transitional period for SMEs from say, 1 July 2011, might provide them with an incentive to form consolidated groups. The concessions would be the same as those originally offered (e.g. stick and spread, COT concessional loss treatment, value and loss donor rules, etc).

THE BOARD'S VIEW

5.23 The Board is concerned that the upfront cost and complexity associated with entering into the consolidation regime discourages wholly-owned small business and medium sized corporate groups from forming a consolidation group. In some cases, this is compounded by the adverse outcomes that can arise under the tax cost setting process that applies when an entity becomes a member of a consolidated group.

5.24 To address these concerns, the Board considers that on-going formation concessions, which are broadly similar to the original transitional concessions, should be introduced for wholly-owned small business and medium sized corporate groups that elect to form a consolidation group.

5.25 The Board also considers that these concessions should be open to all wholly-owned corporate groups that are consolidatable groups at the time of announcement for a limited period of time.

5.26 However, these concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

Formation concessions for eligible corporate groups

5.27 Stakeholder feedback and ATO statistical analysis clearly demonstrates that a significant proportion of potentially eligible wholly-owned corporate groups have chosen to remain outside of the regime.

5.28 The Board is concerned that many of these groups are small businesses that are closely-held and have grown to a stage that they would benefit from forming a consolidated group. By forming a consolidated group, a wholly-owned corporate group can move assets around the group and rationalise its structure with minimal tax consequences. In addition, consolidation facilitates better utilisation of group losses.

5.29 However, the Board appreciates that the costs associated with forming a consolidated group, together with adverse outcomes that can sometimes arise under the tax cost setting rules in formation cases, operate as a barrier to the group consolidating.

5.30 Therefore, the Board considers that on-going concessions should be introduced for wholly-owned small business and medium sized corporate groups that wish to

form consolidated groups. However, the concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

5.31 These formation concessions will provide eligible wholly-owned corporate groups a relatively low-cost alternative on formation of a consolidated group and achieves the objectives of simplicity and reduced compliance costs for these groups. The Board expects that the introduction of these concessions would also boost participation by these groups in the consolidation regime.

Key features of the formation concessions

5.32 The Board proposes to allow eligible corporate groups to elect to access the formation concessions, but only upon the initial formation of a consolidated group. The tax cost setting rules will continue to apply when an entity joins or leaves the consolidated group after the initial formation.

Election to apply the formation concessions

5.33 A significant criticism of the consolidation regime is that specialist skills are required to undertake the tax cost setting process when a consolidatable group forms. The Board considers that eligible wholly-owned corporate groups that elect to apply the formation concessions should be able to remain with their usual accounting and tax advisors, thereby removing a key barrier which currently discourages these groups from entering the consolidation regime.

5.34 Consequently, if a wholly-owned corporate group elects to access the formation concessions, the Board proposes that the election will apply to all of the members of the group.

5.35 The Board acknowledges that an election to apply the original transitional consolidation concessions was made on an entity-by-entity basis. However, the primary drivers for introduction of the proposed formation concessions are simplicity and reduced compliance costs associated with forming a consolidated group. If an entity-by-entity election was available, most groups would need to undertake tax cost setting calculations to determine the most advantageous outcome. This would result in additional complexity and cost, and therefore is not the Board's preferred option.

Eligible corporate groups

5.36 The Board considers that the formation concessions should be available to wholly-owned corporate groups with an aggregated turnover of less than $100 million and assets of less than $300 million in an income year (the threshold test). This is

consistent with the small and medium sized business threshold contained in the TOFA provisions.[58]

5.37 However, to ensure that groups do not inadvertently exceed the threshold test without taking advantage of the concessions, a wholly-owned corporate group should be able to access the concessions provided that it forms a consolidated group by the end of the income year following the income year that it exceeds the threshold test.

5.38 This threshold test will allow wholly-owned groups to experience a significant level of growth prior to their entry into the consolidation regime, thereby providing a clear path and opportunity to form a consolidated group at minimal cost.

Nature of concessions

5.39 The Board considers that the formation concessions should allow eligible wholly-owned groups to:

- retain the existing tax cost bases of assets for all subsidiary members; and
- allow losses held by subsidiary members that are transferred to the consolidated group to be utilised over three years.[59]

5.40 Therefore, a key simplification benefit of the proposed formation concessions is that eligible wholly-owned groups will be able to avoid the cost and complexity associated with the tax cost setting process on formation of a consolidated group by electing to retain the existing tax costs of a subsidiary member's assets.

5.41 In addition, the proposed concessions will allow certain losses held by a joining entity that are transferred to the consolidated group to be utilised over three years. This will allow eligible wholly-owned groups that elect to apply the concessions to avoid the complex 'available fraction' calculations that apply to regulate the utilisation of transferred losses.

5.42 The Board notes that the original transitional consolidation concessions provided a broader range of concessions in relation to, for example, foreign interposed entities, foreign loss treatment and value donor and loss donor rules.

5.43 The Board considers that many of these concessions would not be applicable to smaller, relatively simple group structures. In addition, concessions such as loss and value donor rules are extremely complex and are inconsistent with the objectives of simplicity and reducing compliance costs underlying the on-going concession. Therefore, it is not proposed to replicate these features in the proposed formation concessions.

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58 Section 230-5 of the ITAA 1997.

59 Similar to the loss utilisation treatment under the original transitional concessions.

Position 5.1

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

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

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

- the existing tax costs of assets for all subsidiary members should be retained; and
- losses held by subsidiary members that are transferred to the consolidated group should be able to be utilised over three years.

Question 5.1

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

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

Extension of the formation concessions to all wholly-owned groups for a limited period of time

5.44 In addition to the low take-up of the consolidation regime by wholly-owned small business and medium sized groups, the Board understands that many larger consolidatable corporate groups have not yet elected into the consolidation regime.

5.45 While reasons for the decision to remain outside of the consolidation regime may vary, the Board understands that many groups have resisted entry into the regime due to significant uncertainty with its operation and concerns about inequitable outcomes that can arise under the tax cost setting rules in certain circumstances.

5.46 Following the recent enactment of *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, many of the identified problems which resulted in business groups choosing to remain outside of the consolidation regime have been legislatively resolved. In addition, as the consolidation regime has been operating for several years, many uncertainties relating to the operation of the regime have also been resolved.

5.47 Accordingly, the Board considers that all consolidatable groups which have chosen to remain outside of the regime should be given the opportunity to take advantage of the proposed formation concessions for a specified period of time — that is, for, say, a 12 month period. However, the concessions should not apply to foreign owned corporate groups that elect to form MEC groups.

5.48 As an additional integrity measure, the Board considers that this concession should be available only to those groups which are eligible to form a consolidated group at the date of any announcement of this proposal. This would prevent corporate groups from restructuring following the announcement to gain access to the formation concessions.

5.49 In making this proposal, the Board acknowledges that affected consolidatable groups will need to choose to apply the concessions or adopt the normal tax cost setting rules. This will increase the complexity of the consolidation regime for, and impose additional compliance costs on, those groups.

Position 5.2

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

Question 5.2

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

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

APPENDIX A: LIST OF SUBMISSIONS

The following is a list of submissions, excluding confidential submissions, made to the Board as part of the post-implementation review of certain aspects of the consolidation regime. Submissions can be viewed in full on the Board's website at www.taxboard.gov.au.

Table A.1: List of organisations providing public submissions

Organisation
BDO (Australia) Ltd
Blake Dawson
Corporate Tax Association and Minerals Council of Australia
Corporate Tax Association and Minerals Council of Australia (supplementary submission)
CPA Australia Ltd
Deloitte Touche Tohmatsu Ltd
Group of 100 Inc
MGI Melbourne Pty Ltd
PricewaterhouseCoopers
The Institute of Chartered Accountants in Australia and Taxation Institute of Australia

APPENDIX B: POSITIONS AND QUESTIONS

CHAPTER 2: POLICY FRAMEWORK FOR THE CONSOLIDATION REGIME

Position 2.1

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

Question 2.1

The Board seeks stakeholder comment on:

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

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

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

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

CHAPTER 3: OPERATION OF THE SINGLE ENTITY RULE

Position 3.1

The Board considers that:

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

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

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

Question 3.1

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

Position 3.2

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

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

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

Question 3.2

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

Position 3.3

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

Question 3.3

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

Position 3.4

The Board considers that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who are:

(a) shareholders of the head company of a consolidated group; or

(b) liquidators appointed to the head company of a consolidated group.

Consideration should also be given to extending the single entity rule (together with other parts of the consolidation provisions) so that it applies to the dealings of a related third party with a consolidated group.

Question 3.4

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

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

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

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

Position 4.1

The Board considers that:

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

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

Question 4.1

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

Position 4.2

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

Question 4.2

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

Position 4.3

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

Question 4.3

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

Position 4.4

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

Question 4.4

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

Position 4.5

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

Question 4.5

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

Position 4.6

The Board considers that:

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

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

Question 4.6

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

Position 4.7

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

Question 4.7

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

Position 4.8

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

Question 4.8

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

Position 4.9

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

Question 4.9

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

Position 4.10

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

Question 4.10

(a) Do stakeholders agree with Position 4.10? If not, why not?

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

Position 4.11

The Board considers that:

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

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

Question 4.11

(a) Do stakeholders agree with Position 4.11? If not, why not?

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

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

Question 4.12

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

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

Position 4.12

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

Question 4.13

Do stakeholders agree with Position 4.12? If not, why not?

Question 4.14

The Board seeks stakeholder's comments on:

(a) Whether the inclusion of deferred tax assets and deferred tax liabilities in the tax cost setting process results in unnecessary complexity?

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

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

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

CHAPTER 5: OPERATION OF THE CONSOLIDATION REGIME AND SMALL BUSINESS CORPORATE GROUPS

Position 5.1

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

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

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

- the existing tax costs of assets for all subsidiary members should be retained; and
- losses held by subsidiary members that are transferred to the consolidated group should be able to be utilised over three years.

Question 5.1

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

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

Position 5.2

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

Question 5.2

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

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

APPENDIX C: DEPRECIATING ASSETS

Submissions raised concerns that the policy underlying the inherited history rules has been compromised in some cases. The prime example relates to the treatment of depreciating assets.

Under the current regime, the entry history rule is effectively overridden for depreciating assets held by an entity that becomes a subsidiary member of a consolidated group.[60] The depreciating assets of a subsidiary are taken to be acquired by the head company of a group at the joining time for their tax cost setting amount, consistent with an asset acquisition approach. However, specific rules reinstate history in certain circumstances.

Table C.1, which is based on a table in the CTA/MCA submission, summarises the current outcomes.

Table C.1: Current treatment of depreciating assets

Nature of depreciating asset of joining entity	Treatment accords with inherited history approach	Treatment accords with asset acquisition approach
Rate of depreciation based on effective life		
Prime cost method		
(a) Asset's tax cost not increased under cost setting rules; or	Asset's effective life retained	
(b) Asset's tax cost increased under cost setting rules		Asset's effective life determined at the joining time
Diminishing value method	Asset's effective life retained	
Accelerated rates of depreciation[61]		
(a) Asset's tax cost not increased under cost setting rules; or	Accelerated rate continues to apply	
(b) Asset's tax cost increased under cost setting rules		Accelerated rate ceases to apply

60 Subsection 701-55(2) of the ITAA 1997

61 Generally, accelerated rates of depreciation applied to assets acquired before 21 September 1999.

Table C.1: Current treatment of depreciating assets (continued)

Nature of depreciating asset of joining entity	Treatment accords with inherited history approach	Treatment accords with asset acquisition approach
Privatised assets		
(a) asset held by an earlier consolidated group for at least 24 months and the head company of that earlier group is not an associate of the head company of the joined group; or		Depreciable value limitations cease to apply
(b) otherwise	Depreciable value limitations apply	

The Board understands the policy rationale for this approach is that the asset acquisition approach applies to the depreciating assets of the subsidiary. However, exceptions apply where, broadly:

- the outcomes from applying the asset acquisition approach are inequitable; or
- the outcomes from applying the asset acquisition approach are inconsistent with broader policy objectives[62].

62 For example, in the case of privatised assets, the inherited history approach operates as an integrity measure to maintain the objectives of the privatised asset provisions (which is, broadly, to prevent inappropriate tax benefit transfers).

APPENDIX D: HIGH LEVEL COMPARISON OF POLICY FRAMEWORK OPTIONS

Table D.1: Alternative consolidation approaches

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
1. Objective			
	Future tax outcomes of assets and liabilities based on history.	Replicate the outcomes that would arise if the consolidated group had acquired the assets and liabilities of the joining entity. Disregard history for all purposes.	Replicate the outcomes that would arise if the consolidated group had acquired the assets of the joining entity. Retain existing treatment of liabilities and inherited history rules.
2. Entity joining a consolidated group			
CGT assets[63]	Acquired by the group at the time the joining entity acquired the asset — therefore pre-CGT status is retained	Acquired by the group at the joining time — therefore all assets are post-CGT assets	Acquired by the group at the joining time — therefore all assets are post-CGT assets
Intra-group assets[64]	Absorb allocable cost amount	Allocable cost amount for the asset taken to be a payment to terminate the asset	Allocable cost amount for the asset taken to be a payment to terminate the asset

63 Modifications may be required for the treatment of pre-CGT assets in formation cases, or in cases where there is a change in ownership of a joining entity.

64 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

Table D.1: Alternative consolidation approaches (continued)

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
2. Entity joining a consolidated group (continued)			
Liabilities	Transferred to the group based on accounting value	Assumed by the group based on market value at the joining time	Transferred to the group based on accounting value
Other non-asset tax attributes (eg, undeducted business related expenditure and other inherited deductions)	Transferred to the group Allocable cost amount reduced for inherited deductions	Not transferred to the group Allocable cost amount not reduced for inherited deductions	Transferred to the group Allocable cost amount reduced for inherited deductions
Tax losses[65]	Transferred to the group if certain tests satisfied	Transferred to the group if certain tests satisfied	Transferred to the group if certain tests satisfied
Franking credits[66]	Transferred to the group	Transferred to the group	Transferred to the group

65 Consistent with design principles of the consolidation regime

66 Consistent with design principles of the consolidation regime

Table D.1: Alternative consolidation approaches (continued)

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
3. Operating as a consolidated group			
Asset-based deductions (eg, capital allowances)[67]	Based on a hybrid of inherited history and asset acquisition outcomes	Based on asset acquisition outcomes — therefore effective life reset	Based on asset acquisition outcomes — therefore effective life reset
Capital/revenue status of assets	History of joining entity relevant to determine capital/revenue character of an asset	Capital/revenue character based on group's treatment of an asset	Capital/revenue character based on group's treatment of an asset
Intra-group assets[68]	Tax costs recognised when an asset emerges from the group in some circumstances	Assets taken to be created when they emerge from the group	Assets taken to be created when they emerge from the group
Pre-joining trade debt written off as bad	Deductible based on assessable history	Deductible only if the group is a money lender	Deductible only if the group is a money lender
Status of prior tax rulings of the joining entity	Generally continue to apply	To the extent they relate to assets and liabilities, they would cease to apply	To the extent they relate to assets, they would cease to apply

67 Modifications may be required for the treatment of depreciating assets in formation cases, or in cases where there is a change in ownership of a joining entity.

68 Note that the treatment of intra-group assets is discussed in Chapter 3. In Position 3.1, the Board proposes that the tax cost of an intra-group asset should be recognised when the consolidated group disposes of the asset or when the asset lapses intra-group.

Table D.1: Alternative consolidation approaches (continued)

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
4. Entity leaving a consolidated group			
Allocable cost amount for leaving entity	Tax values of leaving assets plus non-asset deductions (eg, undeducted business related expenditure)	Tax values of leaving assets	Tax values of leaving assets
Nature of gain/loss made by group on disposal of leaving entity	Based on revenue/capital status of membership interests held in the leaving entity (generally all shares given capital status)	Revenue/capital split based on the status of underlying assets.	Based on revenue/capital status of membership interests held in the leaving entity (generally all membership interests given capital status)
Other non asset tax attributes (eg, undeducted business related expenditure and other inherited deductions)	Transferred to the leaving entity	Retained by old group	Retained by old group
Tax losses[69]	Retained by old group	Retained by old group	Retained by old group
Franking credits[70]	Retained by old group	Retained by old group	Retained by old group
CGT assets taken by the leaving entity	Acquired by the leaving entity at the time the joining entity acquired the asset, therefore pre-CGT status is retained	Acquired by the leaving entity at the leaving time	Acquired by the leaving entity at the leaving time

69 Consistent with design principles of the consolidation regime

70 Consistent with design principles of the consolidation regime

Table D.1: Alternative consolidation approaches (continued)

	Inherited history approach (Current approach)	Acquisition approach	Asset acquisition approach
4. Entity leaving a consolidated group (continued)			
Asset-based deductions (eg, capital allowances)	Based on a hybrid of inherited history and asset acquisition outcomes	Based on asset acquisition outcomes — therefore effective life reset	Based on asset acquisition outcomes — therefore effective life reset
Capital/revenue status of assets taken by leaving entity	History of joining entity relevant to determine capital/revenue character of an asset	Capital/revenue character based on leaving entity's treatment of an asset	Capital/revenue character based on leaving entity's treatment of an asset
Liabilities	Transferred to the leaving entity based on accounting value	Assumed by the leaving entity based on market value at the leaving time	Transferred to the leaving entity based on accounting value

Appendix E: Interaction between the consolidation regime and other parts of the income tax law — Additional issues

The Board's Discussion Paper sought views on issues that arise as a result of the interaction between the consolidation regime and the provisions relating to FOREX and TOFA.

Stakeholders were also asked to submit any other areas of concern that arise a result of the interaction between the consolidation regime and other provisions in the income tax law that were not included in the Discussion Paper.

Many of the issues raised are outside the scope of this Review. However, a number of these other issues are currently being considered outside the Board process.

Issues currently being dealt as part of another process

Issues raised by stakeholders that are currently being dealt with outside the review process, and the process for dealing with them, are outlined in Table E.1 below.

Table E.1: Issues and processes outside the review

Issue	Process for dealing with issue
Interactions with the new managed investment trust regime	Consolidation issues are being considered as part of the new managed investment trust regime announced in the 2010-11 Budget
Practical issues that arise when a public trading trust or a corporate unit trust becomes the head company of a consolidated group	Consolidation issues are being considered as part the amendments to remove the corporate unit trust rules
Clarification of the treatment of amounts paid under earnout arrangements in the entry allocable cost amount calculation	Consolidation issues are being considered as part of the amendments to the treatment of earnout arrangements announced in the 2010-11 Budget
Interactions with FOREX and TOFA provisions	The ATO National Tax Liaison Group Finance and Investment Subgroup is prioritising issues relating to these provisions
Treatment of intra-group transactions that straddle the time an entity joins or leaves a consolidated group	The ATO is considering whether recent amendments relating to transactions that straddle the time an entity joins or leaves a consolidate group apply to intra-group transactions

ISSUES TO BE CONSIDERED OUTSIDE THE REVIEW PROCESS

Issues raised by stakeholders that are outside the Review process and which are not currently being dealt with under another process are:

- various issues relating to MEC groups including:
  - the treatment of transfers-up and transfers-down of eligible tier-1 companies;
  - MEC pooling rules relating to functional currency;
  - interaction between MEC groups and loss rules including issues relating to the available fraction;
  - deemed failure of the continuity of ownership test for MEC groups where there is no actual change in majority beneficial ownership; and
  - interaction with the thin capitalisation rules;
- access to the Subdivision 126-B CGT roll-over by a foreign resident with more than one wholly-owned entry point company in Australia that has not formed a MEC group;
- application of CGT event L5 to subsidiary members that are deregistered;
- allowing the modified tax cost setting rules in Subdivision 705-C to apply in additional cases where a consolidated group is acquired;
- clarification of whether the foreign hybrid tax cost setting rules contained in Division 830 apply before or after the cost setting rules in Division 705;
- inclusion of a principle in the tax law to allow inconsistent elections to be cancelled or ignored when an entity joins a consolidated group;
- clarification of how the consolidation rules apply to intangible economic assets (that is, non-CGT assets such as customer relationships, know-how and similar assets); and
- disclosure of Division 7A amounts on income tax returns.

The Board considers that Treasury and the ATO take the necessary action to consider and, where appropriate, resolve these issues as soon as practicable.