



Australian Government

The Board of Taxation

POST IMPLEMENTATION REVIEW OF CERTAIN ASPECTS OF THE CONSOLIDATION TAX COST SETTING PROCESS

Discussion Paper

the **board** of **taxation**
www.taxboard.gov.au

The Board of Taxation
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FOREWORD

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

The Board of Taxation commenced a *post-implementation review of certain aspects of the consolidation regime* in June 2009. During the course of this review, the Board was requested to undertake a *review of the consolidation rights to future income and residual tax cost setting rules* in March 2011. The Board finalised this review and provided a report to the Government in May 2011. The Board's report recommended that the Government investigate two further aspects of the consolidation regime: the tax treatment of liabilities in the consolidation regime; and whether the tax cost setting amount of assets should be capped.

On 25 November 2011, the Government requested that the Board include these two aspects in its *consolidation post-implementation review*.

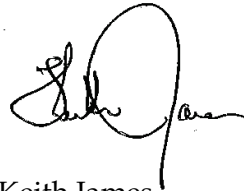
In this context, the Board split the *consolidation post-implementation review* into two stages. The first stage focused on the policy framework for the consolidation regime, the operation of the single entity rule, interactions between the consolidation regime and other parts of the law, and the operation of the consolidation regime for small business corporate groups. The Board has completed its consideration of these issues and provided its report to the Assistant Treasurer in June 2012. The timing for release of the Board's report to the public is a matter for the Government to decide. In line with past practice, it is expected that the report will be available at the time the Government releases its response to the report.

In the second stage of the post-implementation review, the Board is reviewing the tax treatment of liabilities and the capping of the tax cost setting amount of assets in the consolidation regime. The Board is also looking further into some issues that were raised in the first stage of the post-implementation review that remain outstanding, including the treatment of deferred tax liabilities and the interaction between the consolidation regime and certain parts of the CGT rules.

This discussion paper is intended to facilitate public consultation and the preparation of written submissions to the Board on these aspects of the consolidation regime.

A handwritten signature in black ink, appearing to read 'Chris Jordan', with a stylized flourish at the end.

Chris Jordan AO
Chairman, Board of Taxation

A handwritten signature in black ink, appearing to read 'Keith James', with a large loop at the end.

Keith James
Chair of the Working Group

CHAPTER 1: INTRODUCTION

BACKGROUND

1.1 On 3 June 2009 the Government asked the Board of Taxation to undertake a post-implementation review of certain aspects of the consolidation regime.¹

1.2 During the course of this review, on 30 March 2011, the Government requested that the Board conduct a review of the consolidation rights to future income and residual tax cost setting rules.² The Board concluded this review and provided its findings to the Government in a report dated 31 May 2011.³

1.3 In its report on the consolidation rights to future income and residual tax cost setting rules, the Board recommended, among other things, that the Government investigate the following two aspects of the tax consolidation rules:

- the treatment of liabilities held by an entity joining a tax consolidated group; and
- whether the tax cost setting amount allocated to any asset held by a joining entity should be capped at the greater of its market value or terminating value.

1.4 The Government announced its response to the Board's *review of the consolidation rights to future income and residual tax cost setting rules* on 25 November 2011.⁴ As part of this announcement, the Government requested that the Board include the two areas it identified for further investigation into its post-implementation review of certain aspects of the consolidation regime.

1.5 The Board's 2010 post-implementation review into certain aspects of the consolidation regime⁵ Position Paper also identified a number of issues and

¹ Media Release No 058 of 3 June 2009 issued by the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs.

² Media Release No 045 of 30 March 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

³ Board of Taxation, *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules* (May 2011)

⁴ Media Release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

⁵ Board of Taxation, *Post-Implementation Review Into Certain Aspects of the Consolidation Regime* (October 2010).

uncertainties that arise as a result of the interaction of the consolidation regime and other parts of the income tax law, including certain parts of the CGT regime.

1.6 The Board has developed this discussion paper to facilitate the public consultation process on these aspects of the tax consolidation rules.

1.7 Depending on the issues raised during consultation, the Board expects to present its recommendations to Government for consideration by the end of 2012.

SCOPE OF THE REVIEW

1.8 As stated above, the Board is investigating the following aspects of the consolidation regime:

- the treatment of certain types of liabilities held by an entity joining a tax consolidated group;
- whether the tax cost setting amount allocated to any asset held by a joining entity should be capped at the greater of its market value or terminating value; and
- the interaction between the consolidation regime and certain parts of the CGT regime.

1.9 The Board notes that some of the issues raised in different parts of this paper are inter-related and raise complex interactions. The Board will further consider these interactions to ensure that the outcomes are coherent before finalising its recommendations.

THE REVIEW TEAM

1.10 The Board has appointed a Working Group of its members to oversee the review. The members of the Working Group are Keith James (Chairman of the Working Group, and Deputy Chairman of the Board), Chris Jordan AO (Chairman of the Board), Teresa Dyson and Curt Rendall.

1.11 Alexis Kokkinos and Andrew Mills have been engaged as consultants to assist with the review. The Board has also appointed an Expert Panel comprising Ken Spence, Tony Stolarek, Wayne Plummer, Peter Murray and Paul Lyon to provide further specialist assistance to the Board in understanding the complex operation of the relevant taxation law and its practical application.

1.12 The Working Group is being assisted by officials from the Treasury and the Australian Taxation Office (ATO) and members of the Board's Secretariat.

REVIEW PROCESSES

Submissions

1.13 The Board is inviting written submissions to assist with its review. Submissions should address the issues and questions outlined in this discussion paper (a full list of questions is at Appendix 1). It is not expected that each submission will necessarily address all of the questions raised in the discussion paper. The closing date for submissions is 12 October 2012. Submissions can be sent by:

Mail to: The Board of Taxation
 c/The Treasury
 Langton Crescent
 PARKES ACT 2600

Fax to: (02) 6263 4471

Email to: taxboard@treasury.gov.au

1.14 Stakeholders making submissions should note that Board members, the review team, and those assisting it, will have access to all submissions. All information (including name and contact details) contained in submissions may be made available to the public on the Board's website unless it is indicated that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like only part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request for a submission to be made available under the *Freedom of Information Act 1982* (Commonwealth) that is marked 'confidential' will be determined in accordance with that Act.

Consultation Meetings

1.15 The Board is planning to hold consultation meetings in Sydney and Melbourne in September and October as a further mechanism for obtaining views and to assist stakeholders in preparing written submissions.

1.16 Information regarding the consultation meetings can be found on the Board of Taxation website, www.taxboard.gov.au, or by calling the Board of Taxation Secretariat on (02) 6263 4366.

The Board's report

1.17 The Board will consider the issues raised by stakeholders in their submissions and in consultation meetings. However, the Board's report and its recommendations will reflect the Board's independent judgement.

1.18 Depending on the issues raised during consultation, the Board expects to provide its report to Government by the end of 2012.

CHAPTER 2: LIABILITIES HELD BY AN ENTITY THAT JOINS A CONSOLIDATED GROUP

2.1 The consolidation regime was introduced in 2002 following a recommendation of the Review of Business Taxation. Under the consolidation regime, a group of Australian resident entities wholly-owned by an Australian resident company can choose to form a tax consolidated group (consolidated group). Specific rules also allow certain resident wholly-owned subsidiaries of a foreign holding company to form a multiple entry tax consolidated group (MEC group).

2.2 The objects of the consolidation regime are outlined in section 700-10 of the *Income Tax Assessment Act 1997* (ITAA 1997). The benefits of the consolidation regime are the removal of double taxation of gains, reducing compliance costs and improving business efficiency. Consolidation also seeks to improve the integrity of the taxation of corporate groups, including through the removal of loss duplication and by ignoring intra-group transactions.

2.3 Following a choice to consolidate, the consolidated group is treated as a single entity for income tax purposes. Subsidiary entities lose their individual income tax identity on entry into a consolidated group and are treated as parts of the head company.

2.4 When an entity becomes a subsidiary member of a consolidated group, the single entity rule operates so that the entity's assets are treated as the assets of the head company. The tax costs of those assets are reset at an amount that reflects the group's cost of acquiring the joining entity. The reset tax cost of assets is determined, broadly, by a process of allocating the cost of acquiring a joining entity (otherwise known as allocable cost amount) to the joining entity's assets based on their relative market values. The tax cost of some types of assets, such as cash, is retained.

2.5 The key impact of the tax cost setting process is that the tax cost setting amount for an asset (rather than its original cost), is used for the purposes of working out the taxation consequences that arise when a subsequent taxing event arises for the asset.

2.6 Similarly, when a subsidiary member leaves a consolidated group, the head company recognises, just before leaving time, the membership interests in the leaving entity. The process at joining time is reversed and the consolidated group must set the tax costs of the membership interests in the leaving entity. The tax costs of the membership interests are derived from the net assets of the leaving entity just before leaving time.

THE TAX COST SETTING PROCESS

2.7 When an entity becomes a member of a tax consolidated group, the tax cost setting process broadly aligns the tax costs of underlying assets of the entity with the cost of acquiring the entity that holds those assets.⁶ This process is designed to prevent a duplicate gain or loss being realised on the sale of those assets.⁷

2.8 When an entity leaves the tax consolidated group, the tax cost setting process broadly seeks to align the tax costs of the membership interests (shares) in the leaving entity with the tax cost of underlying assets.⁸

2.9 Under the tax cost setting rules that apply when an entity joins a consolidated group, the group must work out the allocable cost amount for the joining entity. There are eight steps in the allocable cost amount calculation process. Broadly, the allocable cost amount calculation starts with the cost of the membership interests in the joining entity (step 1), increased by the joining entity's liabilities (step 2) and adjusted to take account of the joining entity's retained profits (step 3), CGT roll-overs before the joining time (step 3A), distributions of certain profits (step 4), losses accrued to or transferred to the group (steps 5 and 6) and certain inherited deductions (step 7).⁹ If the remaining amount is positive, it is the group's allocable cost amount for the joining entity (step 8).

2.10 Step 2 of the allocable cost amount calculation deals with the liabilities of the joining entity. Step 2 adds the value of the joining entity's liabilities to the cost of the membership interests in the joining entity. This step ensures that the joining entity's liabilities are reflected in the tax costs of the joining entity's assets. This is because the value of the joining entity's assets reflects the combined value of its liabilities and the equity held in the entity.

2.11 The relevant liabilities included at step 2 are the accounting liabilities that are recognised in the joining entity's statement of financial position as a liability of the joining entity, at the joining time, in accordance with accounting standards or authoritative pronouncements of the Australian Accounting Standards Board (AASB).¹⁰

2.12 The step 2 amount is adjusted if some or all of a liability will become a future tax deduction to the head company of the consolidated group when it is paid. In this situation, the amount of the liability included in the allocable cost amount is reduced by the tax benefit for the deduction (currently 30 per cent of the value of the liability).

⁶ Subsection 705-10(2) ITAA 1997.

⁷ Subsection 705-10(3) ITAA 1997.

⁸ Subsection 711-5(2) ITAA 1997.

⁹ Section 705-60 ITAA 1997.

¹⁰ Section 705-70 ITAA 1997.

This ensures that only the net cost of the liability to the group is included in the tax cost setting calculation.¹¹

2.13 Once the allocable cost amount has been calculated, it is reduced by the amount allocated to an entity's retained cost base assets. The remaining amount is then allocated across all of the remaining assets that the joining entity brings into the tax consolidated group, in proportion to their market value.¹²

2.14 The tax cost setting process effectively resets the tax costs of the assets of the joining entity. However, except in limited circumstances¹³, the consolidation regime does not reset the value of the joining entity's liabilities. Instead, the entry history rule¹⁴ applies so that the head company is taken to assume the joining entity's liabilities at their historical value and date.

2.15 When an entity leaves a consolidated group, the tax cost setting process resets the tax cost of the membership interests (shares) in the leaving entity. This is, broadly, the difference between the tax cost of assets held by the entity (step 1) and accounting liabilities of the entity (step 4) just before the leaving time. Where a liability will result in a future deduction for the leaving entity, the amount is reduced by the tax benefit arising from the future deduction (currently 30 per cent of the value of the deductible liability).¹⁵ The liability may then be further adjusted to take into account any unrealised gains or losses.¹⁶ These two adjustments often have the effect of reducing the value of the liability to nil.¹⁷ Essentially, the adjustments treat the liability as though it had been deducted for tax purposes just before the leaving time.

2.16 At the time the consolidation regime was introduced, it was considered that the single entity rule and the entry history rule would apply to give the appropriate treatment to liabilities held by joining entity, including liabilities that are subsequently deductible.¹⁸ Essentially, the entry history rule allowed the consolidated group to adopt the joining entity's value for liabilities.

¹¹ Paragraph 5.70 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002.

¹² Section 705-35 ITAA 1997.

¹³ For example, section 715-375 ITAA 1997 deems an assumption of the liability at its accounting value under the taxation of financial arrangements (TOFA) regime.

¹⁴ Section 701-5 ITAA 1997.

¹⁵ Subsection 711-45(3) ITAA 1997.

¹⁶ Subsection 711-45(5) ITAA 1997.

¹⁷ In some cases (such as liabilities denominated in a foreign currency and taxed under Division 775) the adjustments do not reduce the value to nil.

¹⁸ When the consolidation regime was introduced, a capital gain or capital loss arose where a liability that was taken into account under the tax cost setting rules was subsequently discharged for a different amount (CGT event L7 in former section 104-530 ITAA 1997). CGT event L7 was subsequently removed, with retrospective effect, because it had limited scope and gave rise to unreasonable compliance and administrative burdens.

ISSUES IDENTIFIED

2.17 During the course of the Board's review of the consolidation rights to future income and residual cost setting rules, the Board became aware of various issues that arise in respect of certain types of liabilities included in the tax cost setting process for a joining entity. In particular, these issues arise for liabilities that are ultimately deductible, including derivatives, provisions and foreign currency loans which are liabilities at the joining time. The then Assistant Treasurer asked the Board to further consider these issues.¹⁹

2.18 The tax costs of assets held by a joining entity are reset at the time the entity joins a consolidated group under the tax cost setting rules. This systematically prevents the double taxation of unrealised gains or losses in respect of those assets.

2.19 In contrast, the values of liabilities held by the joining entity that are brought into a consolidated group are not reset. As a result, where the head company is subsequently entitled to a deduction for a liability, this can result in:

- double recognition of liabilities – that is, in some cases the same liability is effectively recognised at both the vendor shareholder level (through lower proceeds on the sale of shares) and the entity level on payment of the liability; and
- a mismatch of commercial and tax outcomes – that is, in some cases the amount brought to tax does not reflect the commercial outcomes.

Double recognition of deductible liabilities

2.20 A primary object of the consolidation regime is to prevent the double taxation of the same economic gain and to prevent a double benefit from arising in respect of the same economic loss.²⁰

2.21 In the case of gains and losses on assets that are brought into a consolidated group by a joining entity that is acquired by the group, the tax cost setting rules effectively achieve this objective. That is, when a consolidated group acquires all the membership interests in a joining entity, the price paid to the former shareholders will reflect any unrealised gains or losses on assets held by the joining entity at the joining time. Those former shareholders are taxed on those unrealised gains or are able to use those losses against other income to the extent possible under the tax law. By resetting the tax costs of the joining entity's assets, the tax cost setting rules effectively ensure that the head company of the consolidated group is not taxed again on the unrealised gains or able to use those losses against other income in respect of those assets.

¹⁹ Media Release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation.

²⁰ Section 700-10 ITAA 1997.

2.22 With some limited exceptions, the income tax law does not have specific provisions that deal systematically with changes in the value of liabilities.²¹ Unrealised gains and losses on liabilities held by a joining entity that is acquired by a consolidated group are effectively taken into account at the shareholder level. As the consolidation regime does not consistently reset the values of a joining entity's liabilities, if the head company of the consolidated group can deduct an amount in respect of a liability when it is discharged or otherwise changes in value, the unrealised gain or loss is recognised again. As a result, generally, there is a systemic duplication of gains and losses on deductible liabilities.

2.23 A key objective of the consolidation regime is to eliminate the duplication of gains and losses. This is achieved for unrealised gains and losses on assets. Allowing gains and losses on liabilities to be duplicated is inconsistent with this objective.

2.24 Example 2.1 illustrates how a double tax benefit arises due to the double recognition of liabilities when an entity is sold from one consolidated group to another consolidated group. For the same reasons, deductible liabilities can also result in 'gain duplication'. For example, if a foreign exchange loan that is not taxed under the Taxation of Financial Arrangements (TOFA) regime moves in a way that results in an unrealised gain arising on the loan, the gain is duplicated as it would be reflected at both the shareholder level and as a foreign exchange gain when the loan is settled.

Example 2.1: Double recognition of deductible liabilities

Company A is a subsidiary of Vendor Co and a member of the Vendor Co consolidated group. Company A was incorporated within the Vendor Co consolidated group and has issued share capital of \$200. Company A acquired land at an historical cost of \$100. Company A's only other asset is cash. Since incorporation, Company A has derived net profits after tax of \$140. Accordingly, the cash at bank has increased from \$100 to \$240.

Vendor Co sells its shares in Company A to Purchaser Co. Prior to the sale, Company A makes an accounting provision for \$200. As the provision will be a future tax deduction, a deferred tax asset of \$60 is recorded in recognition of the temporary timing difference. In addition, the market value of the land has increased from \$100 to \$500, and the amount of the increase (\$400) is recorded in an asset revaluation reserve.

²¹ The income tax law applies a systematic treatment for liabilities in the case of liabilities that are covered by the TOFA regime and in the case of insurance liabilities.

The balance sheet of Company A prior to its sale is as follows:

Assets		Liabilities and Equity	
Cash at bank	\$240	Provisions	\$200
Land	\$500	Share capital	\$200
Deferred tax asset	\$60	Retained earnings	-
		Asset revaluation reserve	\$400
Total	\$800	Total	\$800

Vendor Co subsequently sells all the shares it holds in Company A to Purchaser Co (the head company of the Purchaser Co consolidated group) for \$600 (the market value of Company A). Therefore, Company A becomes a member of the Purchaser Co consolidated group. Purchaser Co subsequently disposes of the land for \$700 and settles the provision for \$200.

The tax consolidation provisions should operate to ensure that the net commercial profit of \$400 is recognised only once in the tax system (that is the total taxable profit on the sale of land of \$600, less a deduction for the settlement of the provision of \$200).

Vendor Co's disposal of Company A

When the Vendor Co consolidated group sells its shares in Company A, it reconstructs the tax cost of the shares by working out the exit allocable cost amount under Division 711, as follows:

Step 1	Terminating value of assets	\$340
Step 4	Accounting liabilities	nil
Step 5	Exit allocable cost amount	\$340

The step 4 value is originally equal to the accounting value of the liability provision (\$200). However, as that liability will be deductible for tax purposes at a later point in time, the step 4 amount is reduced to nil.²² Essentially, this adjustment operates as though Vendor Co is provided with a tax deduction for the settlement of the accounting liabilities.

Accordingly, Vendor Co's cost base for its Company A shares is \$340. Vendor Co received \$600 on the sale of those shares. Therefore Vendor Co has realised a taxable profit of \$260. This taxable profit comprises a tax profit on the sale of land (\$400), less

²² Subsection 711-45(5) ITAA 1997.

the effective deduction for the settlement of the provision (\$200), plus a tax profit on the sale of the deferred tax asset (\$60).

Purchaser Co's subsequent disposal of land

On acquiring Company A, Purchaser Co resets the tax cost setting amount of the assets by working out the entry allocable cost amount for Company A under Division 705, as follows:

Step 1	Cost of membership interests	\$600
Step 2	Accounting liabilities	\$140 ²³
Step 8	Entry allocable cost amount	\$740

The entry allocable cost amount of \$740 is then allocated to cash (\$240) and land (\$500).

When Purchaser Co subsequently sells the land for \$700 it makes a taxable gain of \$200 (that is \$700 less \$500). The settlement of the provision for \$200 results in a deduction of \$200. Accordingly, the taxable income of Purchaser Co is nil.

2.25 In Example 2.1, both the vendor and acquirer recognise an amount equal to the liability for tax purposes. In the case of the vendor, the deduction occurs because of the exit tax cost setting rules. That is, the vendor group effectively obtains a tax deduction or loss because the liability that is taken into account in the exit calculation is reduced to nil.²⁴

2.26 The acquirer group can also deduct the liability when it is paid. Essentially, this results in a duplication of the loss related to the single commercial realisation of the same liability.

Mismatch between commercial and tax outcomes

2.27 In some cases, the double recognition of liabilities can result in a mismatch between commercial and tax outcomes.

2.28 That is, where a liability that is brought into a consolidated group by a joining entity is allowed as a tax deduction at the time the liability is discharged or otherwise comes to an end, the head company may obtain a commercial benefit that is not taxed.

²³ The accounting liability of \$200 is reduced by the tax effected future deduction of \$60 under section 705-75 ITAA 1997.

²⁴ Subsections 711-45(3) and (5) ITAA 1997.

2.29 Example 2.2 illustrates this issue.

Example 2.2: Mismatch between commercial and tax outcomes

In Example 2.1, a duplication of deductions resulted in an additional tax benefit of \$140. In that example, Purchaser Co obtained a benefit as a result of the duplication, as demonstrated in the following table.

	Vendor Co	Purchaser Co
Payments	\$340 ²⁵	\$600 ²⁶
Net receipts	\$600	\$740 ²⁷
Commercial profit	\$260	\$140
Tax profit	\$260	-
Difference	-	\$140

That is, Purchaser Co derived a commercial profit of \$140, but has no tax profit.

There are two reasons for this difference. First, both Vendor Co and Purchaser Co have recognised an amount of \$200 relating to the same liability. This essentially reflects a double recognition of liabilities in the tax system by virtue of the tax consolidation regime. Second, Vendor Co has been assessed on the value placed on the deferred tax asset of \$60.

POSSIBLE SOLUTIONS

2.30 The Board considered a number of ways to address these issues and is mindful that any resolution should aim to balance the elimination of loss and gain duplication on liabilities to achieve commercial taxation and the need to minimise compliance costs.

2.31 The options considered by the Board are:

- Option 1: Deem deductible liabilities to be assumed by the head company, at their accounting value, at the time the entity joins a consolidated group.
 - As a result, the amount included at step 2 would not be altered, which means that an appropriate amount will continue to be allocated to assets. Subsequently,

²⁵ Cost of acquiring land (\$100) and cash at bank (\$240).

²⁶ Cost of acquiring shares (\$600) (that is, market value of assets (\$740) less future liability (\$140)).

²⁷ Proceeds from the sale of land (\$700) plus cash at bank (\$240) less payment of provision (\$200).

amounts deducted, or included in assessable income, in respect of the liability will have regard to the deemed receipt.

- Option 2: Deny the deduction for deductible liabilities (equal to the step 2 amount) after the entity has joined the consolidated group.
 - As a result, the head company would not have to track the deductible liabilities after the joining time. However, anomalies will arise where the liability is settled for less than the step 2 amount and where periodic cash flows are involved.
- Option 3: Disregard deductible liabilities at step 2 of the entry tax cost amount.
 - As a result, the tax cost setting amounts allocated to assets would be reduced. However, anomalies will arise because there could be significant distortions to the tax cost setting amounts allocated to assets.
- Option 4: Deem the acquiring consolidated group to have realised a capital gain at the joining time equal to the final step 2 amount for deductible liabilities.
 - As a result, the head company would not have to track deductible liabilities. However, this would cause a tax liability to arise at the joining time, resulting in potential cash flow issues and capital/revenue mismatches. In addition, anomalies would arise if a deductible liability is ultimately settled for less than its step 2 amount or if the joining entity leaves the group without the deductible liability having been settled.

THE BOARD'S PRELIMINARY VIEW

2.32 Within consolidation, duplication of gains and losses on assets is symmetrically prevented, but duplication of gains and losses on liabilities continues to exist. This is difficult to justify as it would appear to give consolidated groups an unintended advantage over other taxpayers who are unable to or choose not to form a consolidated group.

2.33 The Board considers that, within the consolidation regime, the treatment of assets and liabilities should be broadly symmetrical. In this regard, an objective of the consolidation regime is to remove the double taxation of gains and double use of losses that can arise outside of consolidation. In the case of gains and losses on assets, the tax cost setting rules achieve this objective.

2.34 In these circumstances, the Board considers that the best option is to deem deductible liabilities to be assumed by the head company, at their accounting value, at the joining time (Option 1). Any tax consequences relating to the movement in liabilities that arise for the head company after the joining time will then be determined having regard to the assumed value of the liabilities.

2.35 There having been a deemed assumption of a liability for its accounting value at the joining time, amounts subsequently deducted, or included in assessable income, in respect of the liability, will have regard to the deemed receipt. One approach could be that all amounts that would otherwise have been recognised as deductions or income in respect of a liability would have regard to the deemed receipt, with a balancing adjustment on final discharge. Alternatively, where the value of the liability changes over time, changes in the value of the liability could be tax recognised: the change in value of the liability could be worked out using a first in first out (FIFO) basis or another suitable shortcut method.

2.36 Modifications to the assumption of liability rule may be required in some cases, such as liabilities that are subject to the foreign currency gains and loss rules.²⁸

2.37 An advantage of this option is that it will have the effect of removing the double taxation of gains and losses on liabilities and produces the correct allocable cost amount outcomes.

2.38 In addition, the ‘assumption of liability’ rule is the method that has been used for TOFA liabilities.²⁹

2.39 Example 2.3 outlines how the liability assumption rule would apply utilising the facts contained in Example 2.1.

Example 2.3: Liability assumption rule

Assume that the facts in Example 2.1 remain the same. In addition, Purchaser Co is taken to assume Vendor Co’s liabilities for their accounting value (\$200). As Purchaser Co will not be entitled to a deduction on the settlement of the liability for \$200, the purchase price will be reduced to \$540, as the deferred tax asset (previously \$60) has no value.

Vendor Co’s disposal of Company A

On the disposal of the shares in Company A, Vendor Co consolidated group reconstructs the tax cost of those shares. The ‘liability assumption’ rule will not change the outcome that occurs under Example 2.1 – that is, the cost base of the shares will be \$340 under the exit tax cost setting rules in Division 711.

However, the disposal price will be \$540. Accordingly, Vendor Co will make a taxable gain of \$200, which is equal to the unrealised gain on land at that time.

²⁸ Division 775 ITAA 1997.

²⁹ Section 715-375 ITAA 1997.

Purchaser Co's subsequent disposal of land

On acquiring Company A, Purchaser Co will reset the tax cost setting amount of the assets under Division 705. The entry allocable cost amount for the Purchaser Co consolidated group's holding in Company A, will be calculated as follows:

Step 1	Cost of membership interests	\$540
Step 2	Accounting liabilities	\$200
Step 8	Entry allocable cost amount	\$740

The step 2 amount will be increased to \$200 (from \$140 previously) as the liability will no longer be deductible in the future.

The entry allocable cost amount of \$740 will be allocated to cash (\$240) and land (\$500).

On the subsequent disposal of the land for \$700, Purchaser Co will make a taxable gain of \$200 (that is \$700 less \$500). The subsequent settlement of the provision for \$200 will not result in an overall deduction to Company A (that is as the liability is effectively assumed for \$200 and settled for \$200). Accordingly, the taxable income of Purchaser Co will be \$200.

Overall result

The total taxable income of both Vendor Co and Purchaser Co is \$400, being the tax profit derived by Vendor Co of \$200 and the tax profit derived by Purchaser Co of \$200. This equates to the total commercial profit in this example of \$400.

In relation to mismatch issues, the following table demonstrates how the commercial result equates with the tax result of each entity.

	Vendor Co	Purchaser Co
Payments	\$340 ³⁰	\$540 ³¹
Net receipts	\$540	\$740 ³²
Commercial profit	\$200	\$200
Tax profit	\$200	\$200
Difference	-	-

³⁰ Acquisition of land (\$100) and cash at bank (\$240).

³¹ Acquisition of shares (\$600).

³² Proceeds from the sale of land (\$700) plus cash at bank (\$240) less payment of provision (\$200).

2.40 The loss duplication and commercial/tax outcomes mismatch issues do not arise where the tax system specifically deals with the movement in the value of the liability. For example, liabilities that are subject to the TOFA regime or that are dealt with by the specialist insurance provisions would not need to change. Accordingly, the treatment of these liabilities should remain unaffected by any proposed changes, at least to the extent that the tax and accounting recognition of the liabilities align at the joining time.

2.41 The Board is seeking stakeholder comments on any transitional issues that may arise if changes are made to the treatment of liabilities under the consolidation regime.

Question 2.1

The Board seeks stakeholder comment on

- a) Do stakeholders agree with the Board's analysis in this chapter? Why, or why not?
- b) Do stakeholders agree with the Board's preferred solution to the issues? Why, or why not?
- c) Are there additional types of liabilities (other than those covered by the TOFA and insurance regimes) that should be excluded from the operation of the Board's preferred solution? If so, what are these liabilities? Should these particular types of liabilities have a particular solution?
- d) The Board considered that the implementation of the preferred solution should have manageable ongoing compliance costs. Do stakeholders agree? If not please provide specific details of the compliance costs involved.
- e) If the Board's preferred solution is adopted, do any inappropriate consequences arise when the acquirer or the purchaser is not a member of a consolidated group? If so, what are those consequences and how can they be resolved?
- f) If the Board's preferred solution is adopted, do any transitional issues arise? If so, what are those transitional issues? How should they be resolved?

CHAPTER 3: DEFERRED TAX LIABILITIES

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

3.2 Deferred taxes are, usually, measured in respect of temporary differences. Temporary differences are differences that arise between the carrying value of an asset or liability in the balance sheet of an entity and the tax base (the amount attributed for tax purposes) of the liability or asset.

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

3.4 Deferred tax assets represent the amount of income tax recoverable in future periods on deductible temporary differences. Deferred tax assets can also result from carry forward unused tax losses.

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

ISSUES IDENTIFIED

3.6 The Board first raised the issue of deferred taxes within the consolidation regime in its October 2010 Position Paper³³, seeking stakeholder comments on how best to simplify the current treatment of deferred tax assets and deferred tax liabilities.

3.7 In relation to deferred tax liabilities, the primary issues identified by the Board are that the current treatment results in:

- a mismatch of commercial and tax outcomes – that is, in some cases a commercial benefit that arises as a result of a change in value of a liability is not taxed; and
- integrity risks and uncertainty.

³³ Board of Taxation, Post-Implementation Review Into Certain Aspects of the Consolidation Regime (October 2010).

Mismatch between commercial and tax outcomes

3.8 The mismatch between the commercial and tax outcomes caused by deductible liabilities which are discussed in Chapter 2 is magnified when there is a deferred tax liability. Deferred tax liabilities give rise to over taxation for the vendor consolidated group when an entity is sold. Where the deductible liability ceases within the purchaser consolidated group, deferred tax liabilities give rise to under taxation.

3.9 However, the mismatch caused by deferred tax liabilities is not limited to deductible liabilities. Investigations show that deferred tax liabilities are effectively double counted under both the entry allocable cost amount and the exit allocable cost amount. In the entry case, this results in too much allocable cost being pushed onto the underlying assets of a joining entity. In the exit case, the double counting results in a reduced allocable cost amount being pushed into the tax costs of the membership interests.

3.10 Example 3.1 below demonstrates the commercial/tax outcomes mismatch caused by deferred tax liabilities.

Example 3.1: Deferred tax liabilities

Company D is a subsidiary of Vendor Co and a member of the Vendor Co consolidated group. Company D was incorporated within the Vendor Co consolidated group and has issued share capital of \$200. Company D has assets of cash (\$100) and land (with an original cost of \$100 and a current market value of \$200). Company D revalues the land in its accounts to market value and records a \$30 deferred tax liability on the revaluation. The balance sheet of Company D is as follows:

Assets		Liabilities and Equity	
Cash at bank	\$100	Deferred tax liability	\$30
Land	\$200	Share capital	\$200
		Asset revaluation reserve	\$70
Total	\$300	Total	\$300

Company D is sold to Purchaser Co, the head company of the Purchaser Co consolidated group, for its net asset value of \$270.

Vendor Co consolidated group's gain/loss on disposal of Company D

The exit allocable cost amount for Company D is:

Step 1	Terminating value of assets	\$200 ³⁴
Step 4	Accounting liabilities	\$30 ³⁵
Step 5	Exit allocable cost amount	\$170

As a result, the cost base of shares that Vendor Co holds in Company D is \$170. This results in the tax outcome for Vendor Co being different to the commercial outcome, as illustrated by the following table:

	Tax outcome	Commercial outcome
Net receipts	\$270	\$270
Cost base	\$170 ³⁶	\$200 ³⁷
Profit	\$100	\$70

From a tax perspective, Vendor Co has made a gain of \$100. However, from a commercial perspective, it has made a gain of \$70. The difference of \$30 is directly attributable to the deferred tax liability. This suggests that Vendor Co has been overtaxed on the disposal of the shares in Company D.

Purchaser Co consolidated group's tax cost in Company D

The entry allocable cost amount for Company D on joining the Purchaser Co consolidated group is:

Step 1	Cost of membership interests	\$270
Step 2	Accounting liabilities ³⁸	\$30
Step 8	Entry allocable cost amount	\$300

³⁴ Cost base of land (\$100) plus cash at bank (\$100).

³⁵ Represented by the deferred tax liability.

³⁶ The exit allocable cost amount for the shares held in Company D.

³⁷ The cost of incorporating Company D.

³⁸ The deferred tax liability.

The re-iteration process required by subsection 705-70(1A) results in the deferred tax liability at step 2 being changed to \$6.92. This results in the following reiterated entry allocable cost amount:

Step 1	Cost of membership interests	\$270
Step 2	Accounting liabilities	\$6.92
Step 8	Entry allocable cost amount	\$276.92

The entry allocable cost amount of \$276.92 is then allocated to cash (\$100) and land (\$176.92).

As a result, the tax outcome for Purchaser Co on the sale of the land is different to the commercial outcome, as illustrated by the following table:

	Tax outcome	Commercial outcome
Net receipts	\$200	\$200
Cost base	\$176.92 ³⁹	\$170 ⁴⁰
Profit	\$23.08	\$30

From a tax perspective Purchaser Co has made a gain of \$23.08. However, from a commercial perspective, it has made a gain of \$30. The difference of \$6.92 is directly attributable to the deferred tax liability. This suggests that Purchaser Co has been undertaxed on the disposal of the land.

3.11 Example 3.1 demonstrates that the effect of including deferred tax liabilities in the allocable cost amount calculations causes a mismatch between the tax outcomes and the commercial outcomes for both the vendor and the purchaser. However, if the deferred tax liability was ignored, the tax outcomes and the commercial outcomes would align.

Integrity risks and uncertainty

3.12 In addition to the mismatch between commercial and tax outcomes, the Board is concerned about the integrity risks and uncertainty that arises as a result of including deferred tax liabilities in the allocable cost amount calculations.

3.13 There is currently a considerable degree of scope afforded to companies in recognising deferred tax liabilities under accounting standard AASB 112. The Board is

³⁹ The entry allocable cost amount allocated to the land.

⁴⁰ The amount paid to acquire the shares in Company D less the entry allocable cost amount allocated to the cash.

concerned about the interaction of this standard with other accounting standards in the context of tax consolidation, which could allow a divergence between the measurement of deferred tax liabilities as used in the tax cost calculation and measurement of those used in the accounting standards. In some cases it could have the effect of moving the tax cost calculation further away from a realistic expectation of the liability that the purchaser will have to assume.

3.14 The Board is concerned about the uncertainty that arises due to the need to recognise deferred tax liabilities under the consolidation tax cost setting rules. Issues that arise include the appropriate carrying values and tax bases for deferred tax liabilities being taken into account in the tax cost calculation; differing deferred tax liability balances in different accounts (that is stand alone accounts or consolidated accounts); and deferred tax liabilities arising on assets that are not recognised by the consolidation regime.

VIEWS IN SUBMISSIONS

3.15 The submissions received in respect of the Position Paper acknowledged that the inclusion of deferred taxes, particularly deferred tax liabilities, added complexity to the tax cost setting process. Many of the submissions suggested that the resolution of these issues may need to be a trade-off between the 'correct' result and reducing complexity.

3.16 This complexity arises from the varied scenarios in which deferred tax assets and deferred tax liabilities arise; the application of choices within AASB 112; the interaction of AASB 112 with other accounting standards; and interpretational issues within the legislative provisions.

3.17 A number of submissions⁴¹ raised particular problems that arise from the inclusion of deferred tax liabilities which would support their removal in certain circumstances, such as on exit. However, the submissions did not advocate a full removal, on the basis that deferred taxes, particularly deferred tax liabilities, would need to be included in some scenarios to get the 'correct' answer. In this regard, the submissions did not provide details of situations where the retention of deferred tax liabilities are required or the possible problems that could be created by the removal.

THE BOARD'S PRELIMINARY VIEW

3.18 The Board's investigations suggest that the recognition of deferred tax liabilities as part of the tax cost setting rules results in anomalous outcomes.

⁴¹ Deloitte Submission, CTA Submission.

3.19 Furthermore, if deductible liabilities held by a joining entity are taken to be assumed by the head company at the joining time for their accounting value, then it would appear that there is no need to recognise deferred tax liabilities.

3.20 Therefore, the Board's preliminary view is that deferred tax liabilities should cease to be recognised for tax cost setting purposes. This will reduce the circumstances in which the tax outcomes differ from the commercial outcomes. It will also reduce the complexity of the consolidation regime and overcome integrity concerns that arise with the recognition of deferred tax liabilities.

3.21 In this regard, the Board is concerned that the recognition and inclusion of only some types of deferred tax liabilities in the allocable cost amount calculation may not result in tax and commercial results aligning at a consolidated group level and adds complexity to the consolidation regime.

3.22 The Board acknowledges that concerns were raised in submissions about the need to identify deferred tax liabilities in some circumstances in order to get the 'correct' outcome. However, if deferred tax liabilities are not recognised for tax cost setting purposes, then the price paid for joining entities would most likely reflect this change. This is examined in Example 3.2.

Example 3.2: Observations on the interaction between the purchase price and deferred tax liabilities

Assume that the facts are the same as in Example 3.1.

Vendor Co consolidated group's gain/loss on disposal of Company D

In Example 3.1, Purchaser Co pays \$170 to purchase Company D, taking the deferred tax liability into account. This results in Vendor Co making a tax gain of \$100 and a commercial gain of \$70.

If the deferred tax liability did not reduce the purchase price (that is the purchase price is \$200), there would still be a mismatch between the commercial outcome (which would be a gain of \$100) and the tax outcome (which would be a gain of \$130).

However, the removal of the deferred tax liability from the exit allocable cost amount would reduce the tax gain by \$30 (to \$100), thereby equalling the commercial gain.

Purchaser Co consolidated group's tax cost in Company D

In Example 3.1, the deferred tax liability is included in the entry allocable cost amount when Company D joins Purchaser Co's consolidated group. Therefore, from a tax perspective Purchaser Co has made a gain of \$23.08. However, from a commercial perspective, it has made a gain of \$30. This difference of \$6.92 is directly attributable to the deferred tax liability.

If the deferred tax liability is not included in the tax cost calculation, so that the purchase price is not discounted for it, the entry allocable cost amount is:

Step 1	Cost of membership interests	\$300
Step 2	Accounting liabilities	nil
Step 8	Entry allocable cost amount	\$300

The entry allocable cost amount of \$300 is then allocated to cash (\$100) and land (\$200). However, when the land is sold for its market value (\$200), there is no gain or loss either from a tax perspective or a commercial perspective. This is an appropriate outcome as there has been no movement in the underlying asset in this period.

3.23 Before reaching a final view, the Board seeks further stakeholder input on the proposal to no longer recognise deferred tax liabilities for tax cost setting purposes. In particular, the Board is seeking further input about whether there should be any exceptions to this proposal. In reviewing the proposal, stakeholders should consider:

- the complexity involved in recognising deferred tax liabilities;
- the impact, if any, of the recent changes to the law to restrict the consolidation tax cost setting rules to tax assets; and
- the impact of the Board's proposal to deem an assumption of liabilities, as outlined in Chapter 2.

Question 3.1

The Board seeks stakeholder comment on:

- Do you agree with the Board's proposal to remove deferred tax liabilities from the entry and exit allocable cost amount calculations? If not please provide examples outlining when and why these liabilities need to be retained in the calculations.
- Are there are other situations where deferred tax liabilities should continue to be recognised? Are there alternative solutions that could achieve the same result?
- If deferred tax liabilities were to be removed from the exit and entry tax cost setting calculations do you think that any additional modifications would be needed to the tax cost setting process on exit or on entry? If so please provide detailed examples showing the need for such modifications.
- What alternatives, if any, are there for reducing the complexity introduced by deferred tax liabilities?

CHAPTER 4: ADJUSTMENTS TO THE VALUE OF LIABILITIES UNDER THE TAX COST SETTING RULES

4.1 Under the tax cost setting rules, the amount that is allocated to a joining entity's assets is based on, broadly, the amount paid to acquire the joining entity's shares plus the accounting value of the joining entity's liabilities. The amount included in step 2 of the entry allocable cost amount is generally the joining entity's accounting value for a liability. However, the joining entity's accounting value for a liability is adjusted in some circumstances, including where:

- the accounting value of the liability for the head company is different; or
- the liability subsequently gives rise to a tax gain or loss for the head company.

DIFFERENT VALUE OF LIABILITIES FOR THE HEAD COMPANY

4.2 The value of a liability that is included in step 2 of the entry allocable cost amount is adjusted if the head company's accounting value of a liability is different to the joining entity's accounting value. In these circumstances, the step 2 amount is the head company's accounting value for the liability.⁴²

4.3 It appears that this adjustment was originally introduced to address a joining entity having deferred tax liabilities. Therefore, this raises the question whether, if deferred tax liabilities are no longer recognised in the allocable cost amount calculation, the adjustment should be removed. The Board also notes that inputs to the entry allocable cost amount calculation are generally from the joining entity's perspective.

4.4 In these circumstances, the Board thinks the question should be asked whether the adjustment that applies if the head company's accounting value of a liability is different to the joining entity's accounting value should be removed. The Board is seeking stakeholder views about the circumstances in which the adjustment applies and whether it should be retained. In addition, if the adjustment should be retained, the Board is seeking views on how it could be clarified.

⁴² Subsection 705-70(1A) ITAA 1997.

Question 4.1

The Board seeks stakeholder comment on:

- a) Do you think that the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value is relevant only to deferred tax liabilities? If so, do you think that the adjustment should be removed?
- b) If you do not think that the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value is relevant only to deferred tax liabilities, in what other circumstances is the adjustment relevant? How can the adjustment be modified to clarify its operation?

LIABILITIES THAT GIVE RISE TO A FUTURE TAX GAIN OR LOSS

4.5 The value of a liability that is included in step 2 of the entry allocable cost amount is adjusted if the liability is taken into account at a later time for tax purposes than it is for accounting purposes, and, if the accounting and tax treatments had been the same, the group's allocable cost amount would have been different. In these circumstances, the step 2 amount is the joining entity's accounting value for the liability increased or decreased by the amount of the difference.⁴³

4.6 Examples of such liabilities include accrued annual leave entitlements or foreign exchange gains and losses.

4.7 The amount of the adjustment reflects the unrealised gain or loss on the liability at the joining time. To work out the amount of the adjustment, the original allocable cost amount is compared with a notional allocable cost amount calculated as if the liability was deductible for tax purposes at the same time as it had been taken into account for accounting purposes.

4.8 The calculation of a notional allocable cost amount requires a notional reconstruction of the joining entity's accounting and tax positions. The reconstruction may result in notional adjustments to the amounts at various steps in the working out the allocable cost amount – that is, adjustments may be required at step 2 (liabilities), step 3 (undistributed profits that have accrued to the group), step 5 (unused losses that have accrued to the group) and step 6 (losses transferred to the head company).

4.9 The original allocable cost amount is then adjusted by any difference in the two calculations to eliminate unrealised gains and losses from the tax cost process.

⁴³ Section 705-80 ITAA 1997.

4.10 The adjustment for unrealised gains and losses on liabilities is needed where the allocable cost amount for a joining entity is adjusted because the joining entity has undistributed profits that have accrued to the group (step 3 of the allocable cost amount) or unused losses that have accrued to the group (step 5 of the allocable cost amount).

4.11 In a full acquisition case (involving the acquisition of all of the membership interests in a joining entity), where the joining entity is not a member of another consolidated group, the adjustment for unrealised gains and losses is generally nil.⁴⁴ Therefore, the adjustment process results in unnecessary compliance. Where an entity is acquired from another consolidated group, the adjustment process can also cause unintended outcomes to arise.⁴⁵ Therefore, the Board considers that an adjustment for unrealised gains and losses should not be required in a full acquisition case.

4.12 The Board notes that the adjustment for unrealised gains and losses on liabilities should apply continue to apply in formation cases and in progressive acquisition cases.

Question 4.2

The Board seeks stakeholder comment on:

- a) Do you agree with the Board's proposal to remove the adjustment for unrealised gains and losses on liabilities in full acquisition cases? If not, why not?

⁴⁴ This is because steps 2, 6 and 7 all adjust the acquired losses and deductions by the same amount.

⁴⁵ This is because the step 2 adjustment is not replaced by a step 6 adjustment (as tax losses are not transferred from the old group to the new group).

CHAPTER 5: ASSETS AND LIABILITIES RECOGNISED ON DIFFERENT BASES

5.1 The tax cost setting rules in the consolidation regime apply separately to each asset and liability.⁴⁶ However, the basis used for recognising assets under the consolidation regime is different to the basis used for recognising liabilities.

5.2 In this regard, as recommended in the Board's report on consolidation rights to future income⁴⁷, only tax assets are recognised for consolidation purposes.⁴⁸ In contrast, a liability is recognised for consolidation purposes if it is an accounting liability.⁴⁹

5.3 The general approach for recognising assets and liabilities is modified for assets and liabilities that are linked.⁵⁰ An asset is linked to a liability if, under accounting principles, the asset is to be set off against the liability in preparing the joining entity's financial statements and the net amount after the set-off is recognised in those statements. Broadly, the linked assets and liabilities are set off against each other, so that the net asset or liability is taken into account in the allocable cost amount calculation and in the tax cost setting process.

5.4 The operation of the tax cost setting rules is also modified in relation to assets that are subject to a finance lease.⁵¹ These modifications ensure that the entry tax cost setting rules apply appropriately to an entity that is either the lessor or lessee by specifying:

- which assets in relation to the lessor or lessee will have their tax cost set when an entity joins a consolidated group; and
- which liabilities arising from a finance lease will be taken into account in step 2 of the entry allocable cost amount.

5.5 The finance lease rules also modify the exit allocable cost amount rules where an entity leaves a consolidated group taking with it:

⁴⁶ Section 705-58 ITAA 1997.

⁴⁷ Board of Taxation, Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules (May 2011).

⁴⁸ Section 701-67 ITAA 1997.

⁴⁹ Section 705-70 ITAA 1997.

⁵⁰ Section 701-59 ITAA 1997.

⁵¹ Section 701-56 ITAA 1997.

- an asset that was treated as a retained cost base asset under the entry modifications for finance leases⁵²; or
- a liability that was disregarded under the entry modifications for finance leases.⁵³

5.6 The Board is concerned that there may be circumstances in which an asset may be recognised for consolidation purposes but a related liability may be disregarded, or vice versa. This can cause distortions to arise under the tax cost setting rules.

RECOGNISING AN ACCOUNTING LIABILITY BUT NO CONSOLIDATION ASSET

5.7 Where the tax cost setting rules recognise an accounting liability that has a corresponding asset that is not recognised, or which is recognised at a different value, then the amount of the liability inappropriately inflates the tax costs of other assets. This can lead to a commercial/tax mismatch. This may arise, for example, in respect of the securitisation of residential mortgages.⁵⁴

Example 5.1: Securitisation of residential mortgages

Company B originates mortgage loans to borrowers. The value of those mortgage loans is equal to \$100. Trust A is then set up with independent investors and Company B holding a residual unit. The balance sheet of Trust A is as follows:

Assets		Liabilities and Equity	
Cash at bank	\$100	Loans for investors	\$98
		Share capital	\$2
Total	\$100	Total	\$100

Company B equitably assigns the loans to Trust A for a payment of \$100. Under the assignment, Company B is required to pay all interest and principal amounts to Trust A over the life of the mortgages.

Under the accounting standards, Company B holds the 'risks and rewards' associated with the mortgages. Consequently, Company B recognises the mortgages as an asset on its balance sheet of \$100. This is in addition to the \$100 of cash that has been received by Company B from Trust A. An imputed accounting liability of \$100 (to pay monies received under the mortgages to the trust) is recognised in Company B.

⁵² Subsection 711-30(3).

⁵³ Subsection 711-45(2).

⁵⁴ Assuming that they are not taxed under the TOFA regime.

The balance sheet of Company B is as follows:

Assets		Liabilities and Equity	
Cash at bank	\$100	Imputed loan to Trust A	\$100
Mortgage loans	\$100	Share capital	\$100
Total	\$200	Total	\$200

The membership interests in Company B are purchased by the head company of a consolidated group (Head Co) for \$100. Company B (but not Trust A) joins the Head Co consolidated group. The entry allocable cost amount for Company B is:

Step 1	Cost of membership interests	\$100
Step 2	Accounting liabilities	\$100
Step 8	Entry allocable cost amount	\$200

As cash is a retained cost base asset, \$100 of the entry allocable cost amount is allocated to cash.

There is a question as to whether the mortgages are an 'asset' of Company B for tax cost setting purposes, given that they have been equitably assigned to Trust A. Even if the mortgages are an asset, the market value of these mortgages to Company B may also be questionable (which may result in little allocable cost amount being allocated to the asset). Accordingly, the remaining allocable cost amount of \$100 may instead be allocated to the remaining assets of Company B. If Company B has no other assets, a capital loss of \$100 may arise under CGT event L4 or L8. In either case, as the liability recognised in step 2 of the allocable cost amount process may not correspond with an asset for tax cost setting purposes, Company B may be provided with an additional benefit of \$100.

5.8 Example 5.1 demonstrates issues that may occur on entry into a consolidated group as a result of the asymmetry of assets and liabilities. However, the circumstances in Example 5.1 (that is, where assets not recognised for consolidation have a corresponding accounting liability) may also give rise to a mismatch on exit from a consolidated group.

5.9 In an exit scenario, if Company B were part of a tax consolidated group and were to exit the group with the balance sheet contained in Example 5.1, the value of the exit step 1 amount (the terminating value of the assets of the leaving entity) may only be equal to \$100 (that is referable to the tax cost base of cash at bank). That is, the mortgages may not be a tax asset of Company B and may not have a tax cost base.

5.10 However, the exit step 4 (value of liabilities at the leaving time) would take into account the accounting liability from the imputed loan of \$100. Accordingly, in this example, the cost base of the shares in Company B may be equal to nil under Division 711. If Company B were sold for its market value of \$100, this has the potential to leave the vendor group with a capital gain under CGT event A1.⁵⁵ It is noted that, in this case, there is no commercial gain to the Vendor and that the capital gain may solely arise due to the recognition of an accounting liability of \$100, without the recognition of a corresponding asset.

RECOGNISING A CONSOLIDATION ASSET BUT NO ACCOUNTING LIABILITY

5.11 Mismatches can also occur where a liability is not recognised for accounting purposes, but an asset exists for consolidation purposes. In this scenario, because the liability is not recognised under the accounting standards it is not recognised by the consolidated group when working out the allocable cost amount for the joining entity (that is, it would not be included in the entry step 2 amount).

5.12 As these liabilities are not included in the entry allocable cost amount, the assets of the joining entity receive a lower tax cost setting amount relative to their market value. All other things being equal, when those assets are disposed of, there is the possibility of a larger gain. Furthermore, this can also give rise to capital gains under CGT event L3.⁵⁶

5.13 An example where this situation can arise is where an entity gains legal ownership of trading stock without recording an accounting liability.

Example 5.2: Legal ownership of trading stock without accounting liability

Company C has share capital of \$2 and cash at bank of \$2. Company C purchases products on extended credit from a manufacturer. The value of the goods delivered to Company C is \$100. Legal title to the goods passes on delivery to Company C. The goods are stored at Company C's premises until they are on sold to a third party. Company C is not required to pay the manufacturer for the goods until it on sells such products. If the goods are not sold within example six months, Company C can either return the goods for no cost or acquire them for the contract price. Therefore, commercially, Company C owns an asset of \$100 and has a (contingent) legal liability to the manufacturer.

Under the accounting standards, Company C may not be able to recognise the trading stock as an asset of \$100 until it is known how the goods will be dealt with (that is

⁵⁵ A capital gain may also arise under CGT event L5 if the exit allocable cost amount is negative.

⁵⁶ This can occur if the entry allocable cost amount is not sufficient to cover the retained cost base assets of the joining entity.

until there is a sale to a third party or the six months have passed). Effectively, this is akin to treating the trading stock as an in-substance consignment of inventory. Where the asset of \$100 is not recognised by Company C, the liability of \$100 would also not be recognised by Company C for accounting purposes.

The membership interests in Company C are then purchased by Head Co, the head company of a consolidated group, for \$2 (being the market value of the entity). Company C joins the Head Co consolidated group.

In Company C's tax cost calculation there is no liability to include at step 2 of the entry allocable cost amount as this liability is not recognised for accounting purposes. Therefore, the tax cost setting amount of \$2 is allocated to the cash at bank. No amount is allocated to the goods (trading stock). Accordingly, there is a reduction in the tax cost of the goods from \$100 (pre-consolidation) to nil (post-consolidation).

Accordingly, a subsequent disposal of the goods for their cost price by Company C (that is for \$100) may inappropriately result in the taxation of the goods when they are sold by Company C.

5.14 Example 5.2 demonstrates issues that can occur on entry into a consolidated group when an asset is recognised for tax consolidation purposes (that is the legal ownership of trading stock), while an accounting liability is not recognised for tax cost setting purposes.

5.15 The circumstances in Example 5.2 can also give rise to a mismatch on exit from a consolidated group. Using the facts in Example 5.2, if Company C were to exit a tax consolidated group, it would have held assets with terminating values equal to \$102 prior to the exit time.⁵⁷ This amount would be taken into account on exit at step 1. However, there would be no reduction through the inclusion of liabilities on exit at step 4, as there are no accounting liabilities to take into account. As the market value of the entity is only \$2, this would inflate the tax cost base of the membership interests by \$100 and would result in a capital loss on disposal of Company C of \$100.

5.16 Accordingly, this asymmetry in the treatment of assets and liabilities on exit could potentially shelter any gains made on the sale of an entity or produce inappropriate tax losses.

POSSIBLE SOLUTIONS

5.17 The Board considers that modifications should be made to the entry and exit tax cost setting rules where there is asymmetry in the recognition of assets and related

⁵⁷ Cash at bank (\$2) and trading stock (\$100).

liabilities. The Board is seeking stakeholder comments on whether there are circumstances other than those identified in which this problem arises.

5.18 The primary objective of the tax cost setting rules is to reset the tax costs of assets held by an entity that joins a consolidated group. Therefore, the Board's preliminary view is that:

- where an asset is recognised under the consolidation tax cost setting rules and a related liability is not an accounting liability, the related liability should be recognised for tax cost setting purposes; and
- where an asset is not recognised under the consolidation tax cost setting rules and a related liability is an accounting liability, the related liability should not be recognised for tax cost setting purposes.

5.19 The Board is seeking stakeholder comments on this preliminary view.

Question 5.1

The Board seeks stakeholder comment on:

- a) Are there other instances giving rise to the asymmetry of assets and liabilities in a consolidation context? If so please outline the circumstances where this occurs.
- b) Do you agree with the Board's preliminary view for resolving this issue? If not, are there other approaches that should be considered?
- c) What are the appropriate circumstances in which assets and liabilities can be said to be related?

CHAPTER 6: CAPPING THE TAX COST SETTING AMOUNT OF ASSETS

6.1 When a consolidated group acquires an entity, the membership interests in the acquired entity cease to be recognised for taxation purposes and the entity's assets effectively become assets of the head company.

6.2 The tax costs of those assets are reset at an amount that reflects their respective share of the group's cost of acquiring the joining entity (based on the relative market values of those assets). However, some specified assets (such as cash) retain their original tax cost.

6.3 For some assets that have their tax costs reset (reset cost base assets), the amount of the reset cost is capped at the greater of market value and terminating value (which is generally the CGT cost base for the asset).⁵⁸ This capping mechanism applies to assets that are trading stock, depreciating assets, registered emissions units and revenue assets.

6.4 Under this mechanism, where the tax cost setting amount allocated to an asset is capped, any excess allocable cost amount is allocated to the reset cost base assets that are not capped.

6.5 The objective of the capping mechanism is to prevent unrealised capital losses from being converted to revenue losses when an entity joins a consolidated group.⁵⁹

6.6 During the course of conducting its *review of the consolidation rights to future income and residual tax cost setting rules*⁶⁰, the Board considered an option to cap the tax cost setting amount for all assets in the consolidation regime at the greater of their market value or terminating value. This would extend the current treatment for revenue type assets in the tax cost setting process to all tax assets.

6.7 In its report on that review, the Board suggested that any excess allocable cost amount remaining after the tax costs of assets are capped could be deemed to be allocated to goodwill (if goodwill exists) or alternatively would result in a capital loss under CGT event L4 or L8.

⁵⁸ Section 705-40 ITAA 1997.

⁵⁹ Paragraph 5.37 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No 1) 2002.

⁶⁰ Board of Taxation, *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules* (May 2011).

6.8 The Board's preliminary view is that the adoption of this proposal may result in greater neutrality, in most circumstances, between consolidated groups that acquire a business (by acquiring the entity that carries on the business) and entities that acquire a business directly. However, it may not be the case in all circumstances – for example, where a purchaser, for commercial reasons, is willing or required to pay more than what would otherwise be the market value.

6.9 The Board is also aware that, in a progressive acquisition case, the market value of the asset of the business at the joining time may not reflect the price paid by the acquirer over the course of the acquisition.

Question 6.1

The Board seeks stakeholder comment on:

- a) Do you consider that rules should be introduced to cap the tax cost of all assets?
- b) Would capping the tax cost setting amount for all assets result in greater neutrality between consolidated groups that acquire a business (by acquiring the entity that carries on the business) and entities that acquire a business directly?
- c) What difficulties, if any, could arise if the tax cost setting amount for all assets was capped?
- d) Do you agree with the Board's suggestion to allocate any excess allocable cost amount to goodwill? If so, what should happen to the excess if a company does not have goodwill?
- e) If you do not agree with the Board's suggestion to allocate any excess allocable cost amount to goodwill, what should happen to the excess allocable cost amount?
- f) Are there circumstances in which capping at the greater of market value or terminating value of an asset would produce undesirable outcomes?

CHAPTER 7: CGT ISSUES

7.1 The Board identified some CGT issues during the course of its post-implementation review of certain aspects of the consolidation regime relating to:

- the interaction between the CGT roll-over rules and the consolidation regime; and
- the operation of CGT event J1.

INTERACTION BETWEEN THE CGT ROLL-OVER RULES AND THE CONSOLIDATION REGIME

7.2 One or more entities in a group of entities with common ownership are able to restructure and qualify for a CGT rollover ('rollover') in respect of the membership interests of the entity prior to joining a tax consolidated group. The following table outlines the various rollover provisions under the ITAA 1997 that are available for these purposes.

Rollover	Generally applies to the following consolidation cases
Subdivision 122-A	Individual or trustee interposes a 100 per cent holding company over another company.
Subdivision 122-B	Partnership interposes a 100 per cent holding company over another company.
Subdivision 124-G	Joint owners interpose a 100 per cent holding company over another company.
Subdivision 124-H	Joint owners interpose a 100 per cent holding company over a unit trust.
Subdivision 124-M	Acquisition of an 80 per cent or more interest in a company through the issue of scrip
Subdivision 126-B	Acquisition of a wholly owned group company from a non-resident entity.

7.3 The Board is aware of a number of anomalous outcomes that can occur when entities join a tax consolidated group following a rollover. Most of these outcomes occur as the tax consolidation provisions do not provide an appropriate tax cost setting amount in many cases. These outcomes generally occur when the rollover involves a restructuring of the group, rather than the acquisition of an entity outside of the group.

7.4 Most of these issues identified are more prevalent where small to medium sized groups (SME groups) are restructured. The Board has broadly identified the following four anomalous outcomes that can occur:

- Issue 1: owned profits of the joining entity may not be picked up when an entity is rolled into a tax consolidated group following a restructure.
- Issue 2: the tax consolidation provisions rely on the CGT cost base rules contained in each of the rollover provisions, which may not provide an appropriate cost base for step 1 purposes of the tax cost setting process.
- Issue 3: where the joining entity has a goodwill asset (or other asset) with value, this can inappropriately skew the tax cost setting process under a restructure.
- Issue 4: the interposition of a new holding company under a restructure using certain CGT rollovers can result in the old group ceasing to exist and may require a new group to be formed. This can result in exit calculations, CGT event L3 capital gains and inappropriate entry calculations.

WHAT IS A RESTRUCTURE?

7.5 For the purpose of this chapter, a ‘restructure’ is an event which effectively does not involve a change to the underlying ownership of the relevant entity and its assets. An example is the interposition of a shelf company over an existing tax consolidated group, which does not change the underlying ownership of the tax consolidated group.

7.6 Currently, Subdivision 124-M contains provisions that aim to differentiate between a restructure and an acquisition.⁶¹ Where these provisions operate, special cost base rules apply.⁶² Furthermore, specific tax consolidation interaction rules apply where the restructured entity joins a tax consolidated group.⁶³

7.7 These provisions in Subdivision 124-M were introduced in 2009 and were aimed at providing appropriate outcomes when an entity was restructured rather than acquired. The amendments were developed through significant consultation with industry and professional bodies. Accordingly, the changes specifically attempt to deal with the four issues identified above.

7.8 However, the provisions have limited application to restructures involving widely held entities. Accordingly, where a restructure under Subdivision 124-M involves a closely held group, the modifications do not apply.

⁶¹ Section 124-784A ITAA 1997.

⁶² Section 124-784B ITAA 1997.

⁶³ Subdivision 715-W ITAA 1997.

7.9 Furthermore, outside of Subdivision 124-M, the CGT rollover rules generally apply only when there is a group restructure rather than an acquisition of an entity. That is, rollovers under Subdivision 122-A, 122-B, 124-G, 124-H or 126-B all (essentially) involve restructures of an existing group. However, the restructure provisions contained in Subdivision 124-M do not apply more broadly to other types of CGT rollovers.

INTERACTION ISSUES

Issue 1: Owned profits of joining entity

7.10 When an entity is rolled over into a consolidated group, the rollover may inappropriately result in the 'owned profits' of the group being considered 'acquired profits' of the consolidated group. This results in a lower tax cost setting amount being allocated to assets (or even capital gains under CGT event L3).

7.11 Example 7.1 illustrates the how the CGT rollover provisions may interact with the consolidation rules to treat the 'owned profits' of a group as 'acquired profits' of the consolidated group.

Example 7.1: Subdivision 122-A rollover

Trust A incorporates a new company, Company A for \$1,000 and holds all of the shares in Company A. At 30 June 20X1, Company A has the following balance sheet.

Assets		Liabilities and Equity	
Cash at bank	\$5,000	Loans	\$2,000
Depreciable assets	\$10,000	Share capital	\$1,000
		Retained profits	\$12,000
Total	\$15,000	Total	\$15,000

All of the retained profits (\$12,000) are taxed profits of Company A. Trust A also owns all of the shares in Hold Co, being the head company of an existing tax consolidated group.

Trust A disposes of the shares in Company A to Hold Co under Subdivision 122-A rollover. Under the rollover, Hold Co inherits a cost base of the shares in Company A, being \$1,000.⁶⁴ Company A automatically joins Hold Co's tax consolidated group.

⁶⁴ Section 122-70 ITAA 1997.

As Hold Co has acquired Company A, all the profits are taken to be acquired profits for step 3 purposes. Accordingly, the allocable cost amount for Company A is:

Step 1	Cost of membership interests	\$1,000
Step 2	Accounting liabilities	\$2,000
Step 8	Entry allocable cost amount	\$3,000

Cash is a retained cost base asset and therefore is allocated a tax cost setting amount of \$5,000. As this exceeds the entry allocable cost amount of \$3,000, Hold Co makes a capital gain of \$2,000 under CGT event L3. The cost base of the depreciable assets is also reduced to nil.

7.12 In Example 7.1, while Trust A has jointly owned both Hold Co and Company A, the consolidation provisions treat the owned profits of Company A as acquired profits.

7.13 Example 7.2 is another example of the how, in some cases, the CGT rollover provisions may interact with the consolidation rules to inappropriately treat the ‘owned profits’ of a group as ‘acquired profits’ of the consolidated group.

Example 7.2: Subdivision 124-H rollover

Trust A is a unit trust. The units in Trust A are owned 50 per cent by individual X and 50 per cent by individual Y. The unit capital of Trust A is equal to \$1,000. Trust A holds only one asset, being shares in Company A, being a company incorporated by Trust A for \$1,000. At 30 June 20X1, Company A has the following balance sheet.

Assets		Liabilities and Equity	
Cash at bank	\$5,000	Loans	\$2,000
Depreciable assets	\$10,000	Share capital	\$1,000
		Retained profits	\$12,000
Total	\$15,000	Total	\$15,000

All of the retained earnings (\$12,000) are taxed profits of Company A and Trust A. Trust A wishes to form a tax consolidated group. Accordingly, a new holding company (Hold Co) is interposed between individual X and individual Y using Subdivision 124-H rollover.

Under the rollover, the cost base of the units in Trust A that are held by Hold Co are determined by the underlying tax cost base of assets of Trust A – being \$1,000.⁶⁵ Hold Co, Trust A and Company A form a new tax consolidated group.

As Hold Co is taken to have acquired Trust A and Company A, all the profits of Company A are taken to be acquired profits for step 3 purposes (resulting in a step 3 amount of nil). Accordingly, the allocable cost amount for Company A is:

Step 1	Cost of membership interests	\$1,000
Step 2	Accounting liabilities	\$2,000
Step 3	Undistributed taxed profits	nil
Step 8	Entry allocable cost amount	\$3,000

Cash is a retained cost base asset and therefore is allocated a tax cost setting amount of \$5,000. As this exceeds the entry allocable cost amount of \$3,000, Hold Co makes a capital gain of \$2,000 under CGT event L3. The cost base of the depreciable assets is also reduced to nil.

Issue 2: Cost base of membership interests

7.14 Rollovers that occur under Subdivision 124-G, 124-H and 124-M utilise an underlying tax asset approach when determining the cost base of the shares held by the new interposed entity. However, rollovers under Subdivision 122-A and 122-B utilise the old cost base of the shares in the rolled entity.

7.15 Furthermore, where the shares in the entity are pre-CGT, it is not entirely clear how the cost base rules interact with the rollover provisions.

7.16 Example 7.3 illustrates, in a simple case, how the underlying tax asset approach can give rise to an appropriate tax cost setting outcome. That is, the underlying tax asset approach avoids the step 3 'owned profits' issue.

⁶⁵ Subsection 124-470(3) ITAA 1997.

Example 7.3: Subdivision 124-G rollover

Individual X and individual Y each own 50 per cent of the shares in Company A. At 30 June 20X1, Company A has the following balance sheet.

Assets		Liabilities and Equity	
Cash at bank	\$5,000	Loans	\$2,000
Depreciable assets	\$10,000	Share capital	\$1,000
		Retained profits	\$12,000
Total	\$15,000	Total	\$15,000

Hold Co is interposed above Company A using Subdivision 124-G rollover. The cost base of the shares in Company A (that are held by Hold Co) are determined by looking at the net (tax) assets⁶⁶ of Company A as at the rollover. In this case, the cost base of the shares in Company A would be equal to \$13,000.

Hold Co and Company A form a new tax consolidated group. The tax cost setting process results in an allocable cost amount for Company A of:

Step 1	Cost of membership interests	\$13,000 ⁶⁷
Step 2	Accounting liabilities	\$2,000
Step 8	Entry allocable cost amount	\$15,000

Cash is a retained cost base asset and therefore is allocated a tax cost setting amount of \$5,000. The remaining entry allocable cost amount of \$10,000 is allocated to the depreciable assets.

7.17 However, a number of anomalies have also been identified with the way in which the rollovers under Subdivision 124-G and 124-H apply. For example, the rollovers do not interact well when there are trading stock assets and CGT assets that have no cost base (example service receivables).

7.18 A number of these issues have been addressed in the underlying tax asset approach taken by Subdivision 124-M.⁶⁸ That is, Subdivision 124-M provides a more sophisticated approach to determining the cost base of the shares held by the interposed entity, which was developed through extensive consultation.

⁶⁶ Section 124-385 ITAA 1997.

⁶⁷ Cost base of shares in Company A after the rollover.

⁶⁸ Section 124-784B ITAA 1997.

Issue 3: Goodwill (or market value) skewing

7.19 While the underlying tax asset approach provides appropriate outcomes in a basic case (Example 7.3), it is noted that the existence of assets with a market value in excess of their tax cost base value will give rise to a skewing of tax cost amounts under tax consolidation.

7.20 For example, assume the same facts as Example 7.3 above, whereby the tax cost setting process results in \$15,000 to be allocated to various assets. However, assume that Company A has internally generated goodwill with a market value of \$1 million just before the formation time.

7.21 In this revised example, allocable cost amount that is allocated to the depreciable assets would be equal to \$99,⁶⁹ while allocable cost amount allocated to goodwill would be equal to \$9,901.⁷⁰ Accordingly, while nothing has really changed with respect of Company A, the tax consolidated group is required to reduce (significantly) the tax cost of its revenue assets.

7.22 Accordingly, the underlying tax asset approach may not provide an appropriate outcome in many restructure cases due to market value skewing.

Issue 4: Interposing a new holding company

7.23 A new holding company may be interposed above a tax consolidated group using CGT rollover. When there has not been a change in the underlying ownership of the tax consolidated group, it would generally be expected that the tax consolidation provisions should not result in fundamental changes to the tax attributes of the existing tax consolidated group. However, this outcome depends on the rollover provision that is applicable.

7.24 Consider the scenario below in Example 7.4.

⁶⁹ $\$10,000 / \$1,010,000$ (0.99 per cent) x \$10,000.

⁷⁰ $\$1,010,000 / \$1,010,000$ (99.01 per cent) x \$10,000.

Example 7.4: Interposing a new holding company

Hold Co owns all of the shares in Company A, being the operational entity. A new company (Company X) is interposed above Hold Co using rollover relief. Company X is a \$2 shelf company.

As Company X is simply a shelf company, the tax consolidation provisions should not have a material effect on the existing group. However, this will depend on the rollover provision that applies.

If the old consolidated group makes a choice to continue to be in existence, Subdivision 124-G will apply to the interposition of Company X. If this choice is made, the old group is taken not to have ceased and the new holding company (Company X) is taken to have become the head company of the consolidated group.

7.25 As demonstrated by Example 7.4, the effect of a Subdivision 124-G rollover is least intrusive from a tax consolidation perspective. However, Subdivision 124-G requires at least two shareholders in order for the provisions to apply.⁷¹

7.26 A similar outcome can occur under Subdivision 124-M, where the tax consolidated group is widely held. That is, a choice can be made so that the tax cost of assets held Hold Co and Company A are not reset.⁷² However, in this case, the old group is taken to cease and a new group is required to be formed. As compared to the Subdivision 124-G rollover, this means that exit calculations may be required. This may give rise to capital gains under CGT event L5 on cessation of the old group. Furthermore, if the group is closely held, this option is not available.

7.27 Finally, if the interposition occurs under Subdivision 122-A, the old group is taken to cease to exist and a new group must be formed. This can give rise to capital gains on exit under CGT event L5 and all profits of the group being taken to be acquired profits (giving rise to possible capital gains under CGT event L3 – see Example 7.2).

7.28 The Board notes that the interposition under each of the three rollover provisions outlined above provide for the same commercial outcome. However, the tax consolidation outcomes are substantially different in each case. This would appear to be an anomalous way in which the tax consolidation provisions operate and interact with the rollover provisions.

⁷¹ A single shareholder company requires the application of Subdivision 122-A ITAA 1997.

⁷² Subsection 715-920(3) ITAA 1997.

POSSIBLE SOLUTIONS

7.29 In its review of the rollover provisions, the Board has observed that each CGT rollover has different interaction issues with the tax consolidation provisions. For example, Subdivision 122-A gives rise to an 'owned profits' issue and entry/exit issues. While Subdivision 124-G overcomes the entry/exit issues, it can also give rise to the 'owned profits' issue if there is a chain of two or more subsidiary entities in the acquired group.

7.30 The Board acknowledges that it is possible to address each of the specific issues with each of the rollover provisions on a case by case basis. For example, the owned profits issue could be dealt with by amending step 3. However, such an approach would require a significant amount of work to ensure that it appropriately applied and interacted with each rollover provision.

7.31 Alternatively, the Board is also aware of solutions that have been implemented for various rollover provisions to deal with these issues, including specific provisions for Subdivision 124-G and 124-M rollovers. The Board is of the view that these solutions could be applied more broadly to all rollovers in order to provide a systemic solution. Accordingly, this latter approach is favoured by the Board as a means of dealing with these issues.

INTEGRATING A SYSTEMIC SOLUTION

7.32 In order to ensure that rollovers interact more appropriately with the tax consolidation provisions, the Board considers that a number of systemic solutions should be implemented. These solutions would seek to provide a consistent result, irrespective of the rollover used.

7.33 It is noted that the solutions outlined below draw upon existing measures contained within the Income Tax Assessment Act. Accordingly, the Board believes that a simpler approach would be to draw on those measures when drafting solutions to these issues.

Rule 1: Differentiate between an acquisition and a restructure

7.34 As outlined earlier, the issues identified in this chapter seem to occur when there is a restructure of an entity rather than an acquisition. While Subdivision 124-M provides rules for determining whether the rollover of an entity involves a restructure or an acquisition, these provisions have limited application.

7.35 The Board considers that where a closely held entity satisfies the restructure test in Subdivision 124-M⁷³, the closely held entity should also apply the restructure provisions. Furthermore, where there is a rollover under Subdivision 122-A, 122-B, 124-G, 124-H or 126-B, such rollovers should be deemed to be restructures for the purpose of apply the following suggested rules.

7.36 For the purpose of the following suggested rules, the previous paragraph is referred to as the expanded meaning of a 'restructure'.

Rule 2: Determining the cost base of membership interests

7.37 Where an entity is rolled over, the cost base of the shares in the entity is currently determined by reference to the applicable rollover. For example, rollovers under Subdivision 122-A utilise the original cost base of shares of the entity, while rollovers under Subdivision 124-G utilise the cost base of underlying tax assets. There is currently no consistent basis for determining the cost base of the shares for the purpose of utilising that cost base in the consolidation provisions at step 1 of the allocable cost amount.

7.38 The Board notes that the Subdivision 122-A approach gives rise to step 3 'owned profits' issue (as outlined by Example 7.1). This issue can be addressed by utilising an underlying tax asset approach (as outlined in Example 7.3). Accordingly, the Board considers that where an entity joins a tax consolidated group and the membership interests were acquired using a CGT rollover under a restructure (using the expanded definition in Rule 1), the cost base of the shares should be determined using an underlying tax asset approach, rather than the approach contained in the specific rollover provisions.⁷⁴

Rule 3: Interposition of a new holding company

7.39 Where a new holding company is interposed over an existing tax consolidated group under a restructure (using the expanded definition in Rule 1), the old tax consolidated group should be taken to continue to exist with the new holding company being taken to be the new head company of the old group. This would mean that there would be no requirement to perform exit calculations or entry calculations.

7.40 This is essentially the outcome that occurs where Subdivision 124-G rollover is currently used.

⁷³ Section 124-784A ITAA 1997.

⁷⁴ Section 124-784A ITAA 1997 could be used as a starting point for determining the underlying tax asset approach.

Rule 4: Retaining existing tax costs

7.41 When a rollover involves a restructure and the entity joins the tax consolidated group, the Board is of the view that there is little change with respect to the ultimate ownership of the assets of the joining entity.

7.42 Accordingly, the Board suggests that it would be appropriate to require entities that are rolled into a tax consolidated group to retain the existing tax costs, rather than require a resetting of amounts. This approach is recognised under the restructure provisions contained in Subdivision 124-M, which allow joining entities to utilise a stick method.

7.43 While under Subdivision 124-M, it may be appropriate to provide this as an option (that is as not all of the membership interests may have been acquired via the rollover), the Board does not consider that restructures under other rollover provisions (as outlined in Rule 1) should provide for such optionality. This is because it is unlikely that anything less than 100 per cent of the membership interests could be acquired other than by way of rollover under those other rollover provisions.

7.44 Accordingly, where an entity is rolled over into an existing tax consolidated group under a restructure (using the expanded definition in Rule 1), the Board suggests that it would be appropriate for the consolidated group to retain the existing tax cost of assets, without the option or choice.

Rule 5: Other interaction rules

7.45 A number of other tax consolidation interaction issues were identified on implementing the Subdivision 124-M restructure rules in 2009. These special interaction rules were introduced into Subdivision 715-W.

7.46 These provisions help to ensure that the underlying tax asset approach works appropriately when an entity joins a tax consolidated group. The rules include:

- determining the time at which the underlying tax asset approach is applied (that is the completion time)⁷⁵; and
- switching off the single entity rule so that the underlying tax assets of the joining entity can be seen for the purpose of the underlying tax asset approach.⁷⁶

7.47 The Board suggests that these additional interaction rules should also be considered with respect to the proposed changes.

⁷⁵ Paragraph 715-910(2)(a) ITAA 1997.

⁷⁶ Paragraph 715-910(2)(b) ITAA 1997.

Question 7.1

The Board seeks stakeholder comment on:

- a) Do you agree with the CGT rollover interaction issues that are outlined in this chapter?
- b) Do you agree with the Board's proposal to introduce systemic rules dealing with CGT rollovers of entities into consolidated groups? If not, please outline why you do not believe that it is appropriate.
- c) Do you agree with the Board's suggested rules for dealing with CGT rollovers into consolidated groups? If you do not agree with one or more of the rules, why do you disagree?
- d) Are there any consequential issues which arise if the Board's suggested rules for dealing with CGT rollovers into consolidated groups are adopted?

CGT EVENT J1

7.48 The Board's 2010 *post implementation review into certain aspects of the consolidation regime*⁷⁷ position paper identified concerns about the appropriateness of the outcomes that arise under CGT event J1 in certain circumstances where CGT assets which have been rolled over between members of a wholly-owned group are subsequently transferred out of the wholly-owned group

7.49 Prior to the introduction of the consolidation regime, a CGT roll-over was available when assets were transferred between companies that were members of the same wholly-owned group.⁷⁸

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

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

7.51 CGT event J1⁷⁹ broadly operates to end the deferral that happened under the roll-over. Generally, CGT event J1 happens where a CGT asset is rolled over between

⁷⁷ Board of Taxation, *Post-Implementation Review into Certain Aspects of the Consolidation Regime* (October 2010).

⁷⁸ Subdivision 126-B ITAA 1997.

two companies that are members of the same wholly-owned group, and the company that owns the CGT asset after the roll-over stops being a wholly-owned member of that group.

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

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

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

Eligible tier-1 company leaves a MEC group

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

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

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

Subsidiary member leaves a MEC group

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

⁷⁹ Section 104-175 ITAA 1997.

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

Head company of a consolidated group leaves the group

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

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

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

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

7.63 The Board's 2010 Position Paper raised a number of questions and proposed tax treatments to address the problems that arise in these cases (Positions 4.9 to 4.12).⁸⁰

7.64 The Board received a number of submissions from stakeholders responding to the Board's questions and proposals regarding changes to the operation of CGT event J1. The Board will consider these submissions and report on its findings as part of this review.

7.65 In order to resolve these issues raised in relation to CGT event J1, the Board is proposing to hold a workshop to discuss the issues. You should contact the Board's Secretariat if you would like to attend the workshop. Alternatively, you can provide your views as part of a submission to the Board in response to this discussion paper.

⁸⁰ Board of Taxation, Post Implementation Review into Certain Aspects of the Consolidation Regime (October 2010).

Question 7.2

The Board seeks stakeholder comment on:

- a) Do you have any suggestions as to how the difficulties that arise with CGT event J1 can be addressed? If so, what do you suggest?

APPENDIX 1: DISCUSSION PAPER QUESTIONS

CHAPTER 2: LIABILITIES HELD BY AN ENTITY THAT JOINS A CONSOLIDATED GROUP

Question 2.1

The Board seeks stakeholder comment on:

- (a) Do stakeholders agree with the Board's analysis in this chapter? Why, or why not?
- (b) Do stakeholders agree with the Board's preferred solution to the issues? Why, or why not?
- (c) Are there additional types of liabilities (other than those covered by the TOFA and insurance regimes) that should be excluded from the operation of the Board's preferred solution? If so, what are these liabilities? Should these particular types of liabilities have a particular solution?
- (d) The Board considered that the implementation of the preferred solution should have manageable ongoing compliance costs. Do stakeholders agree? If not please provide specific details of the compliance costs involved.
- (e) If the Board's preferred solution is adopted, do any inappropriate consequences arise when the acquirer or the purchaser is not a member of a consolidated group? If so, what are those consequences and how can they be resolved?
- (f) If the Board's preferred solution is adopted, do any transitional issues arise? If so, what are those transitional issues? How should they be resolved?

CHAPTER 3: DEFERRED TAX LIABILITIES

Question 3.1

The Board seeks stakeholder comment on:

- a) Do you agree with the Board's proposal to remove deferred tax liabilities from the entry and exit allocable cost amount calculations? If not please provide examples outlining when and why these liabilities need to be retained in the calculations.

- b) Are there are other situations where deferred tax liabilities should continue to be recognised? Are there alternative solutions that could achieve the same result?
- c) If deferred tax liabilities were to be removed from the exit and entry tax cost setting calculations do you think that any additional modifications would be needed to the tax cost setting process on exit or on entry? If so please provide detailed examples showing the need for such modifications.
- d) What alternatives, if any, are there for reducing the complexity introduced by deferred tax liabilities?

CHAPTER 4: ADJUSTMENTS TO THE VALUE OF LIABILITIES UNDER THE TAX COST SETTING RULES

Question 4.1

The Board seeks stakeholder comment on:

- a) Do you agree with the Board's view that the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value is relevant only to deferred tax liabilities? If so, do you agree that the adjustment should be removed?
- b) If you do not agree with the Board's preliminary view that the adjustment which applies if the head company's accounting value of a liability is different to the joining entity's accounting value is relevant only to deferred tax liabilities, in what other circumstances is the adjustment relevant? How can the adjustment be modified to clarify its operation?

Question 4.2

The Board seeks stakeholder comment on:

- a) Do you agree with the Board's proposal to remove the adjustment for unrealised gains and losses on liabilities in full acquisition cases? If not, why not?

CHAPTER 5: ASSETS AND LIABILITIES RECOGNISED ON DIFFERENT BASIS

Question 5.1

The Board seeks stakeholder comment on:

- a) Are there other instances giving rise to the asymmetry of assets and liabilities in a consolidation context? If so please outline the circumstances where this occurs.
- b) Do you agree with Board's preliminary view for resolving this issue? If not, are there other approaches that should be considered?
- c) What are the appropriate circumstances in which assets and liabilities can be said to be related?

CHAPTER 6: CAPPING THE TAX COST SETTING AMOUNT OF ASSETS

Question 6.1

The Board seeks stakeholder comment on:

- a) Do you consider that rules should be introduced to cap the tax cost of all assets?
- b) Would capping the tax cost setting amount for all assets result in greater neutrality between consolidated groups that acquire a business (by acquiring the entity that carries on the business) and entities that acquire a business directly?
- c) What difficulties, if any, could arise if the tax cost setting amount for all assets was capped?
- d) Do you agree with the Board's suggestion to allocate any excess allocable cost amount to goodwill? If so, what should happen to the excess if a company does not have goodwill?
- e) If you do not agree with the Board's suggestion to allocate any excess allocable cost amount to goodwill, what should happen to the excess allocable cost amount?
- f) Are there circumstances in which capping at the greater of market value or terminating value of an asset would produce undesirable outcomes?

CHAPTER 7: CGT ISSUES

Question 7.1

The Board seeks stakeholder comment on:

- a) Do you agree with the CGT rollover interaction issues that are outlined in this chapter?
- b) Do you agree with the Board's proposal to introduce systemic rules dealing with CGT rollovers of entities into consolidated groups? If not, please outline why you do not believe that it is appropriate.
- c) Do you agree with the Board's suggested rules for dealing with CGT rollovers into consolidated groups? If you do not agree with one or more of the rules, why do you disagree?
- d) Are there any consequential issues which arise if the Board's suggested rules for dealing with CGT rollovers into consolidated groups are adopted?

Question 7.2

The Board seeks stakeholder comment on:

- a) Do you have any suggestions as to how the difficulties that arise with CGT event J1 can be addressed? If so, what do you suggest?