

# TAX NEWS



## GUIDANCE ON CONSOLIDATION EXIT TAX COST SETTING

On 30 October 2009, the ATO released two Interpretative Decisions (ATO IDs) addressing the tax cost setting process where an entity ceases to be a subsidiary member of a tax consolidated group: ATO ID 2009/120 and ATO ID 2009/121.

ATO ID 2009/120 and ATO ID 2009/121 consider the tax cost setting treatment of membership interests in an entity that ceases to be a member of a tax consolidated group, where the membership interests are also accounting liabilities of the leaving entity and the cost of the relevant membership interests was included in the step 1 amount of the entry ACA calculation and not added as a liability at step 2 (in accordance with Taxation Determination TD 2004/74).

### ATO ID 2009/121

ATO ID 2009/121 addresses the question of whether membership interests the head company holds in a leaving entity that are also accounting liabilities of the subsidiary should be subtracted at Step 4 of the exit ACA calculation under section 711-20 of the *ITAA 1997*.

Division 711 of the *ITAA 1997* provides that when an entity ceases to be a member of a tax consolidated group, the tax cost of the head company's membership interests in the leaving entity should reflect the group's cost of the leaving entity's net assets. This is achieved via the "exit ACA" calculation under section 711-20 of the *ITAA 1997*. Broadly, this sets the tax cost of the head company's membership interests in the leaving entity based on the tax cost of the leaving entity's assets, less the accounting liabilities (under accounting standards) that the leaving entity takes with it.

ATO ID 2009/121 states that membership

interests that are also liabilities of the leaving entity should not be subtracted at Step 4 of the exit ACA calculation. Notwithstanding that section 711-45 of the *ITAA 1997* provides that each thing that, in accordance with accounting standards, is an accounting liability of the exiting subsidiary at the leaving time is subtracted at Step 4, the ATO considers that the better view is that section 711-45 of the *ITAA 1997* does not contemplate liabilities which also constitute membership interests in the leaving entity.

### ATO 2009/120

ATO ID 2009/120 addresses the question of whether the tax cost of a membership interest in a leaving entity that is also a liability is set via item 2 of the table in section 701-60 of the *ITAA 1997* (which applies for membership interests) or item 3 (which applies for liabilities owed to the head company by the leaving entity).

In an approach similar to that taken in ATO ID 2009/121, the ATO acknowledges that although both item 2 and item 3 appear to be applicable, the ATO considers that the reference to an "asset of the head company" in section 701-20 of the *ITAA 1997* does not contemplate assets which are membership interests that are dealt with in section 701-15. Accordingly, ATO ID 2009/120 suggests that such membership interests will have their tax cost set under item 2 of the table in section 701-60 of the *ITAA 1997*, and not under item 3.

## BDO COMMENT

The decisions taken in ATO ID 2009/120 and ATO ID 2009/121 are a common sense outcome. Nevertheless, these ATO IDs do reveal shortcomings in the drafting of the relevant provisions.

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# COMMERCIAL DEBT FORGIVENESS

## COMMISSIONER'S APPEAL UPHELD



In a case addressing the commercial debt forgiveness provisions in Schedule 2C to the *ITAA 1936*, the Full Federal Court has upheld the Commissioner's appeal from the earlier Federal Court decision, holding that the solvency assumption in sections 245-55(2) and (3) applied for the purposes of valuing the debts forgiven by the taxpayer's non-resident parent company. The Full Federal Court also dismissed the taxpayer's cross-appeal, holding that the relevant loans were both "debts" and "commercial debts", and that the relevant amounts had been forgiven for the purposes of section 245-35(1): *FCT v Tasman Group Services Pty Ltd* [2009] FCAFC 148 (22 October 2009).

### Background

The taxpayer, Tasman Group Services Pty Ltd, was formerly known as SBA Foods Pty Ltd (SBAF). SBAF was a wholly-owned subsidiary of Sumikin Bussan Corporation Limited (SBC), a Japanese resident company. In November 1996, SBC used SBAF as a vehicle to acquire a meat processing and export business based in Altona, Victoria. The business was unsuccessful and incurred substantial losses. SBC advanced a series of loans to SBAF, and as at 1 March 2002, the total amount outstanding on the loans was approximately \$118.7 million.

The loans were advanced under formal agreements, with each agreement specifying a rate of interest payable and stipulated repayment dates.

On 29 June 2000, SBC agreed to exempt SBAF from interest payable on the loans and extended the time for repayment to 31 March 2002. SBC also gave SBAF's bankers an undertaking that the loans would not be withdrawn without the bank's consent, and SBC issued SBAF's auditors a Letter of Comfort in which SBC covenanted not to call for repayment of the loans outstanding at 31 October 2001 prior to 30 September 2003.

Under a Share Sale Agreement executed on 27 February 2002, SBC sold the shares in SBAF to a third party. Under the Share Sale Agreement, SBC agreed to ensure that on the Completion Date (1 March 2002), SBAF would have no amount of financial indebtedness to SBC and its related entities. After the sale of the shares had been completed, SBAF's balance sheet disclosed no indebtedness to SBC.

The Commissioner applied the commercial debt forgiveness provisions in Division 245 of Schedule 2C of the *ITAA 1936*, which broadly require the "net forgiven amount" of all commercial debts forgiven in the year of income to be applied to reduce certain revenue and capital losses, deductible amounts and the cost bases of certain assets of the taxpayer whose debt has been forgiven.

At first instance, the Federal Court held that the relevant loans constituted commercial debts and that those loans had been forgiven by SBC by virtue of the Share Sale Agreement. Accordingly, the commercial debt forgiveness provisions applied. However, in valuing the amount of the commercial debts forgiven, the Federal Court held that the "solvency assumption" in sections 245-55(2) and (3) did not apply, on the basis that the loans were CGT assets having the "necessary connection with Australia", in that the loans were used by SBC in carrying on its business through a permanent establishment in Australia.

### The solvency assumption

Broadly, sections 245-55(2) and (3) provide that the notional value of the debt forgiven is based on the assumption that the debtor is able to pay all its debts as and when they fall due (the "solvency assumption"). However, the solvency assumption does not apply where the exception provided in section 245-55(4) applies. Section 245-55(4) provides:

**(4) Paragraph (2)(a) and subparagraph (3)(a)(i) do not apply in relation to a debt if:**

- (a) either:
  - (i) at the time when the debt was forgiven the creditor was a resident; or
  - (ii) the forgiveness of the debt was a CGT event involving a CGT asset having the necessary connection with Australia; and
- (b) the debtor and the creditor were not dealing with each other at arm's length in respect of the incurring of the debt; and
- (c) the debt was not a moneylending debt.

At first instance, the Federal Court held that the solvency assumption did not apply, on the basis that the loan in question was a CGT asset of SBC having "the necessary connection with Australia". At the relevant time, section 136-25 of the *ITAA 1997* included "a CGT asset that you have used at any time in carrying on a business through a permanent establishment in Australia" as a category of CGT asset having "the necessary connection with Australia". Curiously, the primary judge held that SBC carried on the meat processing and export business in Australia through the premises at Altona, Victoria and accordingly the loans were used by SBC in carrying on a business through the permanent establishment constituted by the Altona premises.

### Decision of the Full Federal Court

#### i) Forgiveness of commercial debts

On appeal, the taxpayer raised a series of arguments contending that the relevant loans did not constitute "debts" or "commercial debts" that had been "forgiven".

Broadly, the taxpayer's arguments were that:

- the loans were not "debts" because, as a consequence of SBC's undertakings to the bank and to the auditors, SBAF had no immediately enforceable legal obligation to repay the loans;
- the loans were not "commercial debts" because, as SBC had no realistic prospect of being repaid, the loans were akin to equity investments and thus should not be seen as commercial debts within the meaning of section 245-25; and
- the loans had not been "forgiven" for the purposes of section 245-35, on the basis that section 245-35 requires an "express" forgiveness of a debt, which SBC did not provide.

The Full Federal Court dismissed these arguments, holding that the amounts concerned were both debts and commercial debts. The Full Federal Court considered that the undertakings to the bank and to the auditors merely deferred the repayment date, but did not mean that SBAF ceased to be under an enforceable legal obligation to repay the loans. Furthermore, the Full Federal Court held that the loans were used by SBAF for the purpose of deriving assessable income, and

# DRAFT TAXATION RULING

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thus were commercial debts for the purposes of section 245-25.

Finally, the Full Federal Court held that there was no basis for reading down section 245-35 such that the provision applies only to express forgiveness, acknowledging that under Australian law (as well as Japanese law), there can be an effective waiver by conduct.

### The solvency assumption – SBC did not have a permanent establishment in Australia

In addressing whether the solvency assumption applied, the Full Federal Court held that the loan did not have the necessary connection with Australia, as it was not used in carrying on the business of SBC through a permanent establishment in Australia.

Whilst the meat processing and export business of SBAF (which was based in Altona) was financed by SBC, the Full Federal Court held that this should not lead to the conclusion that SBC was carrying on that business. Instead, the loans were advanced by SBC in conducting its own business (that of a holding company) which it carried on from Japan, not through a permanent establishment in Australia.

As the relevant loans were not used by SBC in carrying on a business through a permanent establishment in Australia, the loans did not have the “necessary connection with Australia” and accordingly, the solvency assumption applied for the purposes of determining the notional value of the debts forgiven.

### BDO COMMENT

In many respects, the decision in *Tasman Group Services* represents a straightforward application of the commercial debt forgiveness rules.

However, a welcome aspect of the Full Federal Court judgement is the clear decision that the business of a subsidiary should not necessarily be taken to be the business of the parent company. The decision of the Federal Court at first instance appeared to indicate that a non-resident parent company will carry on the business operated by its subsidiary and therefore may have a permanent establishment in the country in which its subsidiary operates. However, the Full Federal Court determined that this should not necessarily be the case, holding that “[i]rrespective of how closely [the parent company] may monitor the business activities of the subsidiary, the parent does not itself carry on those activities but is engaged in the separate business of a parent or holding company which is, normally, the receipt of income in the form of dividends from the subsidiary.”

On 14 October 2009, the ATO released Draft Taxation Ruling TR 2009/D5 which discusses the ATO's views on when a dividend will be included in the capital proceeds from a disposal of shares under a contract of sale or a scheme of arrangement.

Importantly, TR 2009/D5 addresses dividends declared or paid by an Australian resident company to an Australian resident shareholder who has disposed of shares in a company under a contract of sale or a scheme of arrangement. It does not consider the CGT consequences for resident shareholders who dispose of shares in non-resident companies, or non-resident shareholders who dispose of shares in resident companies.

TR 2009/D5 states that, in the ATO's view, a dividend declared or paid by a company to the vendor will be capital proceeds in respect of CGT event A1 happening if the vendor has bargained for the receipt of the dividend (whether or not in addition to other consideration) in return for giving up the shares.

Amongst other cases, TR 2009/D5 states that a dividend will be capital proceeds from CGT event A1 happening in respect of a disposal of shares under a contract in the following circumstances:

- the vendor shareholder is entitled under the contract to refuse to complete the transfer of the shares if the dividend is not declared or paid by the company; or
- the vendor is entitled to refuse to complete the transfer of the shares if a purchaser or third party does not finance or facilitate payment of the dividend; or
- the vendor has bargained for any other obligation on the part of the purchaser to bring about the result that the dividend will be received by the vendor.

Similarly, where shares are transferred under a scheme of arrangement, a dividend declared or paid by the company to the vendor will be capital proceeds for the disposal of the shares if the dividend is paid as a term of the scheme of arrangement.

However, a dividend paid independently of a contract for the sale of shares, or independently of a scheme of arrangement, will not be capital proceeds in respect of CGT event A1 happening merely because payment of the dividend is contingent on the sale or scheme of arrangement proceeding, nor merely because payment of the dividend is contemporaneous with the disposal of the shares.

TR 2009/D5 also notes that, notwithstanding that a dividend may be included in the capital proceeds for the vendor, a dividend will not be included in the first element of the cost base of the shares for the purchaser, as the dividend is not money paid, or property given, by the

purchaser in respect of acquiring the shares  
Application of the anti-overlap provisions

TR 2009/D5 notes that where a dividend forms part of the capital proceeds from the sale of shares and is also assessable income, exempt income, or non-assessable non-exempt income of the vendor, a capital gain from the disposal of the shares is reduced by the amount of the dividend (but not to an amount that is below zero), pursuant to the anti-overlap rule in section 118-20 of the ITAA 1997 (unless one of the exceptions in section 118-20 of the ITAA 1997 applies). Thus, a dividend that forms part of the vendor's capital proceeds from the sale of shares in a resident company will not ordinarily increase a capital gain the vendor might make from the disposal.

However, where the vendor makes a capital loss, the inclusion of a dividend in the vendor's capital proceeds will reduce the capital loss arising from the disposal.

### BDO COMMENT

The question of whether a dividend connected with the sale of shares can form part of capital proceeds for CGT purposes has been an uncertain issue of late, especially since the decision (in a stamp duty context) of the High Court in *Commr of State Revenue (NSW) v Dick Smith Electronics Holdings Pty Ltd* (2005) 221 CLR 496. Four years later, the ATO has issued a Draft Taxation Ruling addressing the matter.

It is interesting to note that TR 2009/D5 only applies to dividends paid by Australian resident companies to Australian resident shareholders. It is unclear as to why TR 2009/D5 does not also apply to dividends paid by non-resident companies – there is no explanation in TR 2009/D5 as to whether the ATO considers there to be any conceptual difference between dividends paid by non-resident companies under a contract for the sale of shares compared to those paid by resident companies.

Furthermore, when structuring share sale agreements that include the payment of a dividend to the vendor, taxpayers should be mindful that although the anti-overlap rule in section 118-20 of the ITAA 1997 may assist in reducing the incidence of double taxation where the disposal of the shares results in a capital gain, the anti-overlap rule will not assist in reinstating the full amount of a capital loss incurred by the vendor if the dividend is included in capital proceeds.

# EMPLOYEE SHARE SCHEMES LEGISLATION INTRODUCED

On 21 October 2009 the Government introduced a Bill to Parliament to implement the changes to the taxation of employee share schemes, as foreshadowed in the 2009/10 Federal Budget (*Tax Laws Amendment (2009) Budget Measures No. 2 Bill*) 2009.

The Bill follows no less than three rounds of Exposure Drafts, the publication of a Policy Statement and extensive consultation processes.

Broadly, the new legislation will reform the taxation of employee share schemes by:

- replacing the existing employee share scheme provisions contained in Division 13A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) with a new Division 83A of the *Income Tax Assessment Act 1997* (ITAA 1997); and
- inserting a new Subdivision 14-C and Division 392 in Schedule 1 to the Taxation Administration Act 1953 to extend the TFN withholding regime to employee share schemes and to impose new reporting requirements on employers.

The new employee share scheme rules will apply to interests in shares, rights and stapled securities acquired on or after 1 July 2009. Certain transitional rules will also apply to shares and rights acquired before 1 July 2009.

## What are the new rules?

- The default position for employees is that tax on the discount given in respect of shares and rights to acquire shares ("ESS interests") under an employee share scheme will generally be upfront (ie: in the income year that an employee acquires a beneficial interest in a share or a right to acquire a share).
- However, the taxing point will be deferred where the ESS interests are subject to a "real risk of forfeiture" and certain other conditions are satisfied (which broadly mirror the existing conditions under Division 13A of the *ITAA 1936* for a qualifying employee share scheme).
- Where an ESS interest is subject to the deferral of the taxing point, the taxing point (the "ESS deferred taxing point") is the earliest of when:
  - there is no real risk that the employee will forfeit the ESS interest and there are no genuine restrictions preventing disposal;
  - the employee ceases the employment in respect of which they acquired the ESS interest; or
  - seven years after the employee acquired the ESS interest.
- Where rights to acquire shares that are subject to the deferral of the taxing point (as outlined above) are exercised and the resulting shares are subject to forfeiture or

restrictions preventing their disposal, the taxing point will be deferred based on the point at which there is both no longer a real risk of forfeiture and there are no genuine restrictions preventing the taxpayer from disposing of the shares.

- Where an employee is subject to upfront taxation in relation to an ESS interest, and the ESS interest is subsequently forfeited, a refund for the tax paid upfront will generally be available. However, a refund will not be available where the forfeiture is a result of:
  - a choice exercised by the employee, other than a choice to leave employment (eg: a refund will not be available where an employee allows a right to acquire a share lapse unexercised); or
  - a condition of the scheme that protects the employee against a fall in market value.
- A deferral of tax will also be available for ESS interests acquired by employees under certain salary sacrifice arrangements for up to \$5,000 worth of shares in an income year.
- Employees with an adjusted taxable income of less than \$180,000 may be eligible for a tax exemption on the first \$1,000 of discounts received, if the scheme meets certain conditions.

## More guidance on "real risk of forfeiture"

Compared to the previous Exposure Drafts, the Explanatory Memorandum provides further guidance and examples to illustrate the concept of a "real risk of forfeiture". This is a critical concept as the existence of a "real risk of forfeiture" is a gateway to the deferral of the taxing point.

"Real risk of forfeiture" includes situations in which a share or right is subject to meaningful performance hurdles or will be forfeited if a minimum term of employment is not completed. However, the Explanatory Memorandum suggests that a condition that merely restricts an employee from disposing of a share or right for a specified time carries with it no real risk of forfeiture.

## Other compliance and reporting obligations of employers

Entities that provide ESS interests under an employee share scheme must report to the employee, and the ATO, the number and estimated value of ESS interests provided to the employee at both grant and, where applicable, the deferred taxing point.

Furthermore, TFN withholding tax is imposed on entities that provide an ESS interest under an employee share scheme at the rate of 46.5% of the discount included in an employee's assessable income for an income year where the employee does not provide their Tax File Number (TFN) or Australian Business Number (ABN) to the provider. Where a provider is

liable to TFN withholding, the provider will be entitled to recover the relevant amount from the employee.

## Further developments to come

The Government has previously asked the Board of Taxation to consider two further issues:

- how best to determine the market value of employee share scheme benefits; and
- whether shares and rights provided under employee share schemes operated by start-up, R&D or speculative focused companies should have separate tax deferral arrangements, despite the shares or rights not being subject to a real risk of forfeiture.

The Board of Taxation is currently considering these issues and will report their findings to the Government by February 2010.

## BDO COMMENT

Companies that conduct employee share schemes should review their arrangements and consider how the new rules will impact upon their obligations and those of their employees.

Companies who have usually offered "qualifying" shares or rights (ie: shares or rights where the taxing point was subject to deferral under Division 13A of the *ITAA 1936*) should review their share scheme documentation and consider whether the terms of their share schemes should be updated to ensure that access to the deferral of the taxing point is maintained going forward. To maintain access to the deferral of the taxing point, ESS interests must to be subject to a real risk of forfeiture – share schemes that only impose restrictions on the disposal of shares (without a real risk of forfeiture) will no longer be subject to the deferral of the taxing point.

Also, companies and employees should note that the maximum deferral period is reduced to seven years, compared to 10 years under the existing laws. Therefore, companies that impose a 10 year restriction period in respect of shares or rights provided under employee share schemes should consider updating the terms of their share plans to reduce the restriction period to seven years in order to align the taxing point with the time that the employee is free to deal with the shares or rights.

Companies will also need to ensure that their systems are updated to track the number and value of ESS interests provided to employees (at both the time of grant and, where applicable, the taxing point) to ensure that the new reporting obligations are satisfied.

# TREASURY RELEASES DRAFT LEGISLATION TO SIMPLIFY GST

**O**n 6 October 2009, Treasury released Exposure Draft legislation and explanatory materials setting out proposed measures intended to streamline various administrative aspects of the GST law.

The Exposure Draft addresses 7 of the 42 recommendations made to the Government by the Board of Taxation and represents the first tranche of changes to implement the Government's reform of the GST. Further Exposure Drafts will be released for consultation in coming months.

The key amendments to the GST law proposed by the Exposure Draft are set out below.

## Four-year limit on claiming input tax and fuel tax credits

The Government is concerned that as the GST and fuel tax credit laws currently stand, there is no effective limitation period that applies to taxpayers' claims for input tax credits or fuel tax credits. To address these concerns, the Exposure Draft proposes to amend the GST Act, the Fuel Tax Act and the Taxation Administration Act so that a taxpayer will cease to be entitled to an input tax credit or fuel tax credit if the credit has not been claimed within four years from the tax period to which the credit would be attributable under the basic attribution rules.

Thus, for GST purposes the four year period will commence:

- for taxpayers who account for GST on a non-cash basis - the period in which the taxpayer holds a tax invoice or provides any part of the consideration for the relevant acquisition; or
- for taxpayers who account for GST on a cash basis - the period in which the taxpayer provides the relevant portion of the consideration.

However, the Exposure Draft provides that entitlements to credits will not cease where:

- the taxpayer, or the Commissioner, provides the appropriate notice allowing more time in relation to the credit; or
- the credits directly relate to an amount of tax not paid or a claim for a refund that resulted from fraud or evasion.

The Exposure Draft also provides for a decreasing adjustment for taxpayers who are required to make additional payments to a supplier under a GST gross-up clause in a contract because the supplier is liable for GST and the four-year period has expired.

For GST purposes, the proposed measures would apply to GST returns or assessments lodged or issued after 12 May 2009. For fuel tax purposes, the measures would apply from 1 July 2010.

## Broadening the operation of the GST agency provisions

The Exposure Draft proposes to amend the GST Act to allow entities acting for a principal, but

are not agents in the common law sense, to access the simplified accounting procedures in subdivision 153-B of the GST Act.

The proposed amendments will allow entities who facilitate supplies or acquisitions for another entity to utilise the simplified accounting procedures in subdivision 153-B of the GST Act, subject broadly to the principal and intermediary agreeing that the intermediary will take responsibility for using those accounting procedures in relation to certain transactions.

The proposed measures will apply to supplies and acquisitions attributable to tax periods commencing on or after 1 July 2010.

## Introducing a bulky goods refund system for residents of Australia's external territories

The Exposure Draft proposes to amend the GST Act and the Wine Equalisation Tax Act to allow residents of Australia's External Territories (such as the Norfolk, Cocos and Keeling and Christmas Islands) to claim refunds of GST and wine equalisation tax under the tourist refund scheme. Under the proposed new laws, claims may be made if Australian External Territory residents can show proof that the goods have been exported to their External Territory within 60 days after the day on which the goods were acquired.

The proposed measures will commence on 1 July 2010 and will apply to goods purchased on or after that date.

## Clarifying the Commissioner's power to recover overpaid refunds

The Exposure Draft proposes to amend the GST Act, the Luxury Car Tax Act and the Fuel Tax Act so that an overpaid refund of tax is treated as an amount due and payable by the taxpayer to the ATO from the date of the overpayment.

The proposed measures will apply to overpayments made by the Commissioner from the start of the first quarterly tax period after Royal Assent.

## Clarifying the GST law concerning gambling supplies to persons outside Australia

The Exposure Draft proposes to amend the GST Act to clarify how a gambling operator's margin is calculated where the supplies made by the operator are GST-free. Specifically, the Exposure Draft proposes to exclude from "total monetary prizes" amounts that the gambling operator is liable to pay out on supplies (bets) that are GST-free. This will mean that the prize money that the gambling operator is liable to pay to entities outside Australia will be excluded from total monetary prizes.

The change will apply to monetary prizes that



arise in the first or subsequent tax periods of the gambling operator on or after the first quarterly tax period after Royal Assent.

## Clarifying the interaction of the associate rules with other GST provisions

The Exposure Draft proposes to amend the GST Act to ensure the GST treatment of a supply to an associate without consideration is as an input taxed supply or a GST-free supply where appropriate. The proposed amendments will also ensure that a supply to an associate that would be a sale (or some other particular kind of supply) if made for consideration will be taken to be a supply of such a kind, despite there being no consideration. Similarly, an acquisition from an associate that would be by way of sale (or some other particular means) if consideration was provided will be taken to be an acquisition by that means despite there being no consideration.

## Increasing the adjustment note threshold

Treasury has also released draft regulations to increase the threshold below which an adjustment note need not be issued or held in relation to a decreasing adjustment from \$50 to \$75. This will align the threshold at which an adjustment note must be held in relation to a decreasing adjustment with the corresponding tax invoice threshold.

The proposed amendments will commence on the date of Royal Assent.

## BDO COMMENT

The proposed amendments to the GST law outlined in the Exposure Draft represent the first tranche of reforms aimed at simplifying the administrative aspects of the GST law. Of particular note are the proposed amendments to the agency provisions and the four-year limit for claiming input tax credits and fuel tax credits.

The amendments to the agency provisions in subdivision 153-B of the GST Act are a welcome development. However, it is interesting to note that the Government considers 1 July 2010 to be the appropriate commencement date for these particular amendments. Given that the proposed changes to the agency provisions are administrative in nature, there seems to be no reason why these amendments should not have effect from the date of Royal Assent.

# CONSOLIDATION EXIT CASE – APPEAL DISMISSED

**O**n 9 October 2009, the Full Bench of the Federal Court dismissed the taxpayer's appeal in *Handbury Holdings Pty Ltd v FCT* [2009] FCAFC 141 in relation to the tax cost setting process when an entity ceases to be a subsidiary member of a tax consolidated group.

The Full Bench held that for the purposes of Division 711 of the *Income Tax Assessment Act 1997* (ITAA 1997), the liabilities to be taken into account at Step 4 of the exit ACA calculation are the liabilities that exist just before the leaving time.

## Background

The taxpayer was the head company of a tax consolidated group. On 30 July 2004, one of its wholly-owned subsidiaries, Murdoch Magazines Pty Ltd (Magazines) ceased to be a wholly-owned subsidiary of the taxpayer when it satisfied certain debts owed to an external creditor by issuing shares in satisfaction of the debts (ie: it undertook a debt for equity swap). As a result of the debt for equity swap, the subsidiary ceased to be a member of the tax consolidated group.

Where an entity ceases to be a subsidiary member of a consolidated group, the tax cost of the head company's shares in the leaving entity is calculated under Division 711 of the *ITAA 1997*. This is achieved via the "exit ACA" calculation under section 711-20 of the *ITAA 1997*, which broadly sets the tax cost of the head company's membership interests in the leaving entity based on the tax cost of the leaving entity's assets, less its liabilities.

Section 711-45(1) of the *ITAA 1997* provides that for the purposes of Step 4 of the exit ACA calculation, the head company must recognise each liability of the leaving entity "at the leaving time". The issue in this case was whether the liabilities owed to the external creditor that were extinguished by the debt for equity swap should have been taken into account in the exit ACA calculation on the basis that they constituted liabilities of the leaving entity "at the leaving time". In other words, if a liability is extinguished at the same time that the subsidiary leaves the consolidated group (as occurred under the debt for equity swap in this particular case), should the liabilities be taken to exist "at the leaving time" and thus be subtracted at Step 4 of the exit ACA calculation?

The Commissioner argued that the liabilities owed to the external creditor should have been taken into account at Step 4 of the exit ACA calculation, arguing that, in the context of Division 711 of the *ITAA 1997*, the phrase "at the leaving time" should be interpreted to mean "just before the leaving time".

The taxpayer argued that step 4 of the exit ACA calculation should only take into account liabilities the entity takes with it upon exit from the consolidated group, especially given that item 4 of the table under section 711-20(1) describes Step 4 of the exit ACA as being about "the liabilities that the leaving entity takes with it when it ceases to be a subsidiary member".

## Decision

The Full Federal Court upheld the decision of the Federal Court at first instance, finding that in the context of Division 711 of the *ITAA 1997*, the phrase "at the leaving time" should be interpreted to mean "just before the leaving time". Accordingly, the liabilities that were extinguished by the debt for equity swap should have been recognised at step 4 of the exit ACA calculation.

Although section 711-45 of the *ITAA 1997* provides that the head company must recognise each liability of the leaving entity "at the leaving time", and notwithstanding that item 4 of the table under section 711-20(1) describes step 4 of the exit ACA as being about "the liabilities that the leaving entity takes with it when it ceases to be a subsidiary member", the Full Federal Court held that the phrase "at the leaving time" should be interpreted to mean "just before the leaving time". The Court favoured that construction because, in its view, "the scheme of Division 711 is about... putting a value on the interests held by a company in a subsidiary at deconsolidation. This is only a meaningful endeavour just before the leaving time."

## BDO COMMENT

The consolidation exit rules are becoming increasingly important as consolidated groups dispose of subsidiary members and arguably these rules have to date not received as much attention as the consolidation entry rules.

Readers should note that the issue raised in *Handbury Holdings* is likely to be of limited relevance going forward, as the Government proposes to introduce legislation to clarify that the liabilities recognised at step 4 of the exit ACA calculation will be those that exist just before the leaving time (as opposed to the current legislative drafting, which refers to liabilities "that the leaving entity takes with it" or "each thing...that is a liability of the leaving entity at the leaving time"). This legislation is proposed to take effect from 1 July 2002.

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