



## TECHNICAL UPDATE

### TAX CONSOLIDATION POSITION PAPER RELEASED

► **IN THE LATEST CHAPTER IN THE BOARD OF TAXATION'S POST-IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE CONSOLIDATION REGIME, THE BOARD HAS RELEASED A POSITION PAPER SETTING OUT A NUMBER OF PROPOSED POLICY POSITIONS IN RELATION TO THE TAX CONSOLIDATION REGIME.**

#### Background to the post-implementation review

The post-implementation review into the consolidation regime was announced on 3 June 2009, when the Government instructed the Board to review whether the consolidation regime was meeting the primary objectives behind its introduction, namely:

- To promote business efficiency
- To improve the integrity of the Australian taxation system
- To reduce ongoing income tax compliance costs for wholly owned corporate groups that choose to consolidate.

In conducting the review, the Board was asked to focus on the following aspects of the consolidation regime:

1. The operation of the single entity rule
2. The interaction between the consolidation provisions and other parts of the income tax law
3. The operation of the inherited history rules
4. The effectiveness of the consolidation regime for small business groups.

After the announcement of the post-implementation review, the Board issued a Discussion Paper on 9 December 2009. This canvassed a range of issues and posed a number of questions to be addressed as part of the consultation process.

The recently released Position Paper sets out the Board's considered views on the issues raised in the Discussion Paper and seeks feedback from stakeholders. Subject to stakeholder feedback, the Policy Positions outlined in the Position Paper are likely to form the basis of the Board's recommendations to Government for legislative amendment to the consolidation regime.

Our review of the key proposals in the Position Paper is presented below.

All of the Board's Policy Positions are listed as an Appendix to this Technical Update.

#### SECTOR

Corporate & International Tax

#### CONTACT

GREG THOMPSON

National Tax Technical Director

Tel: +61 3 8320 2102

Email: [greg.thompson@bdo.com.au](mailto:greg.thompson@bdo.com.au)



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### Proposed policy framework: the “asset acquisition” model

An interesting aspect of the Position Paper is the Board's proposal that the consolidation regime be amended to adopt an “asset acquisition” model.

Under the asset acquisition model, the “inherited history” rules would not apply to assets. Instead, the consolidation provisions would be updated such that the assets of a joining entity would be taken to be acquired by the consolidated group at the joining time. Similarly, assets that a leaving entity takes with it would be taken to be acquired by the leaving entity at the leaving time.

The objective of the asset acquisition model would be to more closely align the tax treatment of assets when an entity joins (or leaves) a consolidated group with those that would apply if the group acquired (or disposed of) the assets directly.

The most important implications of the asset acquisition model as proposed by the Board include:

- Pre CGT assets held by the joining entity at the joining time would become post CGT assets on joining the consolidated group
- Capital allowance deductions (eg: depreciation) would be determined on the basis that the consolidated group acquired the relevant asset at the joining time — as a consequence the effective life of an asset for capital allowance purposes would be determined at the joining time
- The capital/revenue character of assets brought into the consolidated group would be determined on the basis of the consolidated group's (rather than the joining entity's) treatment of the asset
- Assets held by the joining entity that become intra group assets of the consolidated group would be treated as coming to an end at the joining time for a payment equal to the allocable cost amounts allocated to the assets
- To the extent that a private ruling relates to an asset of the joining entity, the private ruling would cease to apply after joining the consolidated group

- The consolidated group could deduct trade debts held by a joining entity that are written off as bad only if the group is a money lender.

The Position Paper notes that modifications could be made to alter these outcomes where necessary – such as for pre-CGT assets and depreciating assets (including pre-July 2001 mining rights) in formation cases, or cases where there is a change in ownership of a joining entity.

### Concessions for small business groups

The Position Paper acknowledges that the consolidation provisions associated with forming a consolidated group are highly complex and that the costs associated with navigating the consolidation provisions, especially the allocable cost amount calculations, have proven to be a significant barrier to small business groups electing to form a consolidated group. Submissions to the post-implementation review also noted that the tax cost setting process on formation often leads to adverse outcomes for small business groups.

To overcome these issues, the Board proposes that ongoing formation concessions be made available to eligible wholly-owned groups. Under this proposal, if an eligible group chooses to apply the formation concessions:

- The existing tax cost bases of assets for all subsidiary members would be retained
- Losses of subsidiary members that are transferred to the consolidated group would be able to be utilised over three years.

The formation concessions would be available to wholly owned corporate groups with an aggregated turnover of less than \$100 million and assets of less than \$300 million in an income year. The concessions would not be available to foreign-owned corporate groups that elect to form MEC groups.

The Board also proposes that the same formation concessions be extended to all consolidatable groups for a specified period (perhaps 12 months) which have to date chosen not to consolidate.



“Many of the proposals outlined in the Position Paper will prove to be welcome developments, providing improved clarity in areas of the consolidation regime that have long been a source of uncertainty.”

Importantly, the Position Paper proposes that the concessions apply only for the initial formation of a consolidated group - the tax cost setting rules would apply when entities join or leave the consolidated group after the initial formation.

### Operation of the single entity rule

The single entity rule operates to treat a consolidated group as a single taxpayer. This is achieved by section 701-1 of the *Income Tax Assessment Act 1997 (ITAA 1997)* which provides that the subsidiary members of the group are treated as parts of the head company for the purpose of calculating the taxable income (or tax loss) of the head company and subsidiary members of the consolidated group.

Although the Board considers that the single entity rule generally operates appropriately, there are uncertainties in the way the single entity rule operates in relation to intra-group assets and liabilities, certain intra-group transactions and dealings by third parties with a consolidated group.

### Intra-group assets

The single entity rule presents uncertainties in relation to expenditure on assets that become intra-group assets. This is especially the case for assets that are not intra-group membership interests or debt interests – such as rights under a lease, licence or option agreement which do not have a corresponding accounting liability.

The Position Paper states that as a general principle, it is appropriate for expenditure to third parties in relation to intra-group assets to be recognised in the consolidation regime. The Position Paper therefore proposes that:

- The consolidation regime be amended to recognise the tax cost of intra-group assets that do not have an accounting liability recognised elsewhere in the consolidated group
- This recognition should occur when the consolidated group disposes of the asset or when the asset lapses.

### Intra-group liabilities

When an entity leaves a consolidated group, the allocable cost amount (ACA) for the leaving entity is adjusted (at Step 3 of the

exit ACA calculation) to reflect intra group liabilities owed by members of the old group to the leaving entity. The Position Paper notes that the Government has proposed to amend this rule such that the Step 3 amount would only reflect accounting liabilities.

However, submissions to the post-implementation review noted that there may be situations involving intra group assets where there is no corresponding liability owed by members of the old group to the leaving entity. Accordingly, there may be no recognition of expenditure on the asset when the entity leaves the group. This issue would be compounded if the Step 3 adjustment were to be restricted to accounting liabilities.

To address this issue, the Position Paper suggests that the Government consider amending the Step 3 adjustment such that:

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

### Third party dealings

Whilst the single entity rule operates to treat the consolidated group as one entity for the purposes of calculating the tax liability of the head company and its subsidiary members, the single entity rule does not apply for the purposes of working out the tax liabilities of a third party who deals or transacts with a member of the consolidated group.

This limitation of the single entity rule causes difficulties where the tax position of the person dealing with the consolidated group depends on the tax attributes of the consolidated group – especially for shareholders of the head company in relation to capital gains tax, applying the private company loan rules in Division 7A of the *ITAA 1997* and liquidations.

In May 2008, the Government announced that it would amend the consolidation rules to provide that the single entity rule would apply to shareholders who dispose of shares in the head company of a consolidated group for the purposes of the CGT discount rules and CGT event K6.

However, the Board sought views on whether the single entity rule should be extended to third parties in a broader range of circumstances.

The Board noted that a theme emerging from the submissions is that shareholders and liquidators of the head company “clearly see the group as a single entity”. Accordingly, the Board proposes that the single entity rule should be extended to third parties who are:

- Shareholders of the head company of a consolidated group
- Liquidators appointed to the head company of a consolidated group.

The Position Paper also canvasses whether it would be appropriate to extend the single entity rule so that it applies to the dealings of a related third party with a consolidated group.

### **Other consolidation interactions**

In addition to the above proposals, the Position Paper outlines a number of proposals to deal with technical issues associated with the interaction of the consolidation regime and other parts of the income tax law, including the taxation of trusts where trusts become members of a consolidated group and a range of international tax issues.

### **BDO comment**

Many of the proposals outlined in the Position Paper will prove to be welcome developments, providing improved clarity in areas of the consolidation regime that have long been a source of uncertainty.

The proposal to move to an asset acquisition model should reduce the extent to which tax outcomes differ when undertaking an acquisition of an entity, rather than a purchase of assets. However, whilst such a shift to an asset acquisition model appears relatively sound for acquisition scenarios, in our view the rules will need to be carefully designed to ensure that anomalous outcomes do not occur for formation cases, or in cases where an entity joins a consolidated group because of the head company acquiring the remaining (minority) interests in the joining entity. In such cases, a complete freshening up of assets (especially pre-CGT assets) may not always be appropriate.

Extending the application of the single entity rule to shareholders and liquidators is long overdue – its non-application to shareholders and liquidators of the head company has to date caused outcomes that do not appear to be consistent with the policy intent of law. In our view, it may also be appropriate to extend the single entity rule to associates of shareholders of the head company, given that both shareholders and associates of the head company often view themselves as being part of the same “group” (especially in privately held structures).

BDO also welcomes the proposed formation concessions for small business groups, which will be similar to the transitional “stick” and “three year drip” elections that were available until 31 December 2005. Access to these concessions should assist in addressing the compliance costs and sometimes anomalous outcomes that often apply to small business groups that choose to consolidate.

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# SUMMARY OF BOARD OF TAXATION POSITIONS

## APPENDIX

### Chapter 2: Policy framework for the consolidation regime

#### Position 2.1

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

### Chapter 3: Operation of the single entity rule

#### Position 3.1

The Board considers that:

- (a) the tax costs of an intra-group asset that does not have a corresponding accounting liability which is recognised elsewhere in the consolidated group should be recognised for income tax purposes;
- (b) this tax cost should be recognised when the consolidated group subsequently disposes of the asset or when the asset lapses intra-group; and
- (c) the income tax history the intra-group asset had prior to coming into the consolidated group is irrelevant when the consolidated group subsequently disposes of the intra-group asset or the asset lapses.

#### Position 3.2

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

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

#### Position 3.3

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

#### Position 3.4

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

- (a) shareholders of the head company of a consolidated group; or
- (b) liquidators appointed to the head company of a consolidated group.

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

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

##### **Position 4.1**

The Board considers that:

- (a) a trust's net income for the non membership period be calculated by reference to the income and expenses that are reasonably attributable to the period and a reasonable proportion of such amounts that are not attributable to any particular period within the income year; and
- (b) to the extent income and expenses are apportioned in calculating the trust's net income for the non membership period, similar adjustments are appropriate when calculating the trust law income.

##### **Position 4.2**

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

##### **Position 4.3**

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

##### **Position 4.4**

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

##### **Position 4.5**

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

##### **Position 4.6**

The Board considers that:

- (a) foreign hybrids should be eligible to become members of a consolidated group; and
- (b) this should be reviewed if evidence suggests that integrity risks arise as a result of this outcome.

##### **Position 4.7**

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

##### **Position 4.8**

The Board considers that, where Division 855 applies to an asset, the consolidation tax cost setting rules should not apply unless

there is a change in the underlying beneficial ownership of assets.

##### **Position 4.9**

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

##### **Position 4.10**

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

##### **Position 4.11**

The Board considers that:

- (a) CGT event J1 should apply to rolled over membership interests when the non resident owner disposes of its interests in the head company; and
- (b) further work is needed to determine how the cost base of these membership interests in the subsidiary member should be calculated.

##### **Position 4.12**

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

#### **Chapter 5: Operation of the consolidation regime and small business corporate groups**

##### **Position 5.1**

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

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

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

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

##### **Position 5.2**

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