



Australian Government

The Board of Taxation

POST IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE CONSOLIDATION REGIME

A report to the Assistant Treasurer

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

June 2012

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ASPECTS OF THE
CONSOLIDATION REGIME**

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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its post-implementation review into certain aspects of the consolidation regime.

The Board has made a number of recommendations that seek to improve the operation of certain aspects of the consolidation regime with regard to the key objectives of the regime. These objectives are to promote business efficiency, improve the integrity of the Australian tax system and reduce ongoing income tax compliance costs for wholly-owned corporate groups that choose to consolidate.

The Board has also set out some reflections on the operation of the consolidation regime as a whole, as well as observations on issues which could be taken into account for the design and implementation of future tax regimes.

The Board will continue its investigation of the treatment of liabilities and other aspects of the consolidation regime, and expects to report to the Government on these issues by the end of 2012.

The Board established a Working Group chaired by Keith James to oversee the review. In the course of the review, the Board conducted consultations with stakeholders, issued a Discussion Paper and Position Paper and received 19 submissions. The Board would like to thank all those who so readily contributed information and time to assist the Board in conducting the review.

The Board would also like to express its appreciation for the assistance provided by Alexis Kokkinos, Andrew Mills and Geoffrey Lehmann, engaged as consultants to the Working Group, and to Matthew Hayes, Ken Spence and Tony Stolarek as members of the Expert Panel, in addition to the assistance received from officials from the Treasury and the Australian Taxation Office.

The *ex officio* members of the Board – the Secretary to the Treasury, Martin Parkinson PSM, the Commissioner of Taxation, Michael D’Ascenzo AO, and the First Parliamentary Counsel, Peter Quiggin PSM – have reserved their final views on the recommendations in this report for advice to Government.

Chris Jordan AO
Chairman, Board of Taxation

Keith James
Chairman of the Board’s Working Group
Deputy Chairman, Board of Taxation

EXECUTIVE SUMMARY

1. The consolidation regime was introduced in 2002 as a system of tax rules for wholly-owned corporate groups. It was recommended by the Review of Business Taxation in 1999 to overcome efficiency and integrity concerns that arose regarding the taxation of wholly-owned groups under the previous corporate tax system.
2. The consolidation regime is now a fundamental component of the business tax system in Australia. Approximately 83 per cent of wholly-owned groups in the medium to large business sector (groups with turnover of more than \$50 million) have elected to enter the consolidation regime, and 93 per cent of wholly-owned groups in the large business sector (groups with turnover of more than \$250 million) are within the consolidation regime.¹
3. On 3 June 2009 the Government announced that it had asked the Board of Taxation to undertake a post-implementation review of certain aspects of the consolidation regime.
4. As part of this post-implementation review, the Board released a Discussion Paper in December 2009, a Position Paper in October 2010, conducted targeted consultations and received 19 written submissions addressing the issues covered by the scope of the review.
5. In addition to making a number of recommendations to address specific issues arising in relation to the aspects of the consolidation regime within the scope of this post-implementation review, the Board considered it important to make a number of high-level reflections on the consolidation regime as a whole (Chapter 2). These reflections also draw upon the Board's experience in undertaking a related review on the consolidation rights to future income and residual tax cost setting rules which it completed in May 2011.
6. In summary, the Board considers that the consolidation regime has delivered substantial efficiency and integrity improvements to the Australian tax system when compared with the income tax grouping rules which wholly-owned groups previously had to apply. However, the Board also acknowledges there is substantial complexity in the operation of the consolidation regime and its implementation has been attended by some difficulties. The Board therefore considers that sufficient resources need to be allocated to the care and maintenance of the regime. It also considers that a further review could be undertaken of the consolidation regime within five years of the

1 Refer to Table A on page 70.

implementation of the recommendations contained in this report to determine whether structural changes are needed.

7. The Board also outlines its reflections on lessons which can be learnt for the design and implementation of future tax regimes.

8. A summary of the Board's key recommendations regarding those aspects of the consolidation regime within the scope of this review is set out as follows:

- Formal recognition should be given to the business acquisition approach in the consolidation core rules, along with the entry history rule, in relation to the treatment of assets transferred to a consolidated group from a joining entity. This should provide greater clarity in respect of the policy principles of the consolidation regime within the core rules of the regime (Chapter 3).
- An 'ending/creation model' should apply to ensure that the tax costs of intra-group assets (apart from membership interests) acquired, or disposed of, by consolidated groups, whether directly or indirectly, are appropriately recognised. However, some exceptions to the ending/creation model may be needed and should be considered on a case by case basis. This should provide a more consistent treatment of intra-group assets in the consolidation regime (Chapter 4).
- A number of recommendations are made to address issues concerning the interaction of the consolidation provisions with other provisions in the general income tax law (Chapter 5).
- Simplified rules should be introduced to assist small to medium sized business groups in overcoming the complexity and high compliance costs they face in entering the consolidation regime. These rules should also be made available to all wholly-owned corporate groups for a limited period of time (Chapter 6).

9. On 25 November 2011, the Government also requested that the Board investigate the treatment of liabilities under the consolidation regime and whether the consolidation tax cost setting amount for assets should be capped.

10. Given the time available and the substantial overlap between the treatment of liabilities and certain other issues being considered, the Board has decided to defer its advice on the following consolidation issues for inclusion in a separate report to the Government:

- the treatment of liabilities;²
- the treatment of deferred tax assets and deferred tax liabilities;
- investigating whether the tax cost of assets of entities joining a consolidated group should be capped;³
- issues arising in relation to the operation of CGT event J1; and
- issues arising in relation to the interaction between the CGT roll-over rules and the consolidation provisions.

11. The Board expects to report to the Government on these issues by the end of 2012.

2 Recommended by the Board at paragraphs 6.27 to 6.31 of its report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

3 Recommended by the Board at paragraphs 6.32 to 6.35 of its report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

CHAPTER 1: INTRODUCTION

BACKGROUND TO THE REVIEW

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

SCOPE OF THE REVIEW

Original scope

1.2 As it was not feasible to review the whole of the consolidation regime, the Board of Taxation was asked to focus on the following three key elements of the consolidation regime:

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

1.3 In light of empirical evidence which indicated a relatively poor take-up of the consolidation regime by eligible small business groups, the Board also considered the effectiveness of the consolidation regime for small business groups.

Announced measures subsumed into the Board's review

1.4 The Board notes that the implementation of a number of measures to amend the consolidation regime announced by the Government prior to June 2009 was deferred for consideration as part of the scope of the Board's post-implementation review.

1.5 A list of these announced (but unenacted measures) is in Appendix B.

Review of the consolidation rights to future income and residual tax cost setting rules

1.6 In the course of undertaking this post-implementation review, the Government requested that the Board review the consolidation rights to future income and residual tax cost setting rules.⁴

1.7 The Board completed its review of the consolidation rights to future income and residual tax cost setting rules and provided its report to the Assistant Treasurer on 31 May 2011.⁵

Review of consolidation liabilities and capping the tax cost setting amount

1.8 On 25 November 2011, the Government also requested that the Board investigate the treatment of liabilities under the consolidation regime⁶ and whether the consolidation tax cost setting amount for assets should be capped⁷, and asked that the Board include advice on these issues when it reports back on its consolidation post-implementation review.⁸

1.9 Given the time available and the substantial overlap between the treatment of liabilities and other issues being considered, the Board decided to defer its advice on the following consolidation issues for inclusion in a separate report to the Government:

- the treatment of liabilities;
- the treatment of deferred tax assets and deferred tax liabilities;
- investigating whether the tax cost of assets of entities joining a consolidated group should be capped;
- issues arising in the operation of CGT event J1; and
- issues arising in the interaction between the CGT roll-over rules and the consolidation provisions.

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

5 Board of Taxation, *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules* (May 2011) – http://www.taxboard.gov.au/content/reviews_and_consultations/consolidation_rights_to_future_income/report/BOT_Consolidation_rights_report.pdf.

6 Recommended by the Board at paragraphs 6.27 to 6.31 of its report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

7 Recommended by the Board at paragraphs 6.32 to 6.35 of its report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*.

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

1.10 The Board expects to report to the Government on these issues by the end of 2012.

Additional consolidation issues outside of the Board's review

1.11 A number of aspects of the consolidation regime are outside the scope of the Board's review, notwithstanding that some of these may be longstanding areas of concern. Appendix C lists a number of these additional consolidation issues. As noted in Appendix C, the Board considers that it would be desirable for these issues to be resolved as soon as practicable.

REVIEW TEAM

1.12 The Board of Taxation is an independent, non-statutory body established to advise government on various aspects of the Australian taxation system.

1.13 The Board appointed a Working Group of its members to oversee the review. The members of the Working Group were Keith James (Chairman of the Working Group, and Deputy Chairman of the Board), Chris Jordan AO (Chairman of the Board) and Curt Rendall. Richard Warburton AO (former Chairman of the Board) was the Chairman of the Working Group until his retirement in February 2011.

1.14 Alexis Kokkinos, Andrew Mills and Geoffrey Lehmann were engaged as consultants to assist with the review. The Board also appointed an Expert Panel comprising Matthew Hayes, Ken Spence and Tony Stolarek to provide further specialist assistance to the Board in understanding the complex operation of the relevant taxation law and its practical application.

1.15 The Working Group was also assisted by officials from the Treasury and the ATO and members of the Board's Secretariat.

REVIEW PROCESS

1.16 Following the announcement of the review, the Board conducted targeted consultations with key stakeholders. Drawing on these consultations and other information, the Board developed a Discussion Paper which was released on 9 December 2009.

1.17 The Board received 11 submissions (two of which were confidential), in respect of the issues raised in the Discussion Paper. A list of submissions, other than confidential submissions, is provided in Appendix D.

1.18 In response to the submissions received and consultations undertaken, the Board prepared a Position Paper to provide a framework for further consideration of the key issues. The Position Paper set out the Board's proposed views on the following issues raised in the Discussion Paper:

- Chapter 2 considered the policy framework for the consolidation regime (including the operation of the inherited history rules);
- Chapter 3 considered issues relating to the operation of the single entity rule;
- Chapter 4 considered issues relating to interactions between the consolidation regime and other parts of the income tax law; and
- Chapter 5 considered the operation of the consolidation regime for small business corporate groups.

1.19 The Board received eight submissions (one of which was a confidential) in response to the proposals raised in the Position Paper.

1.20 The Board acknowledges the assistance provided by those who made submissions to the review. These submissions made a vital contribution to the review and, together with views expressed during consultations, were integral in helping to shape the recommendations contained in this report. Apart from those made in confidence, submissions have been published on the Board's website and a list of individuals and organisations that provided public submissions to the review is at Appendix D.

BOARD'S REPORT

1.21 In developing this report, the Board considered the views raised by stakeholders in their submissions and at the consultation meetings, and the views of the Board's consultants and members of the Expert Panel. However, the recommendations made by the Board in this report reflect the Board's independent judgment.

CHAPTER 2: OVERVIEW AND REFLECTIONS OF THE BOARD ON THE CONSOLIDATION REGIME

BACKGROUND

2.1 Prior to the introduction of the consolidation regime on 1 July 2002, members of Australian corporate groups were treated as separate entities for income tax purposes. Specific grouping rules for wholly-owned corporate groups allowed:

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

2.2 A number of specific rules were also introduced over time to address certain integrity issues which arose in the taxation of corporate groups.

2.3 The Review of Business Taxation in 1999 identified a large number of efficiency and integrity concerns that arose under this system. These were summarised in the Explanatory Memorandum which accompanied the introduction of the consolidation regime as follows:⁹

- tax impediments to business reorganisations – for example, possible tax costs of liquidating a redundant company in a wholly-owned group or buying back shares from a group entity;
- high compliance costs and complex tax laws to deal with groups – for example, the costs of dealing with the tax implications of group reorganisations, intra-group dividends and disposals of ordinary assets and revenue assets (including trading stock) within groups;
- double taxation – where gains realised in ordinary commercial transactions are taxed again on the disposal of equity;
- loss duplication – where losses realised in carrying on a business or on disposal of assets are realised again on the disposal of equity;

⁹ Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraph 2.3.

- loss cascading – where group companies (as well as companies that are less than 100 per cent owned) use a chain of companies to create multiple tax losses based on one initial economic loss;
- value shifting – where artificial losses are created (where there is no economic loss) through shifting value between group companies; and
- tax avoidance through intra-group dealings – for example, manipulating dealings between group companies to reduce or defer tax.

2.4 The consolidation regime was introduced as a structural solution to address these problems by:

- ceasing to recognise multiple layers of ownership within an Australian wholly-owned group; and
- treating Australian wholly-owned groups as a single entity for income tax purposes – that is, members of a consolidated group lose their separate tax identity when they join a consolidated group and acquire a tax identity when they leave the group.¹⁰

2.5 The objectives of the consolidation regime were to assist in the simplification of the tax system, reduce taxpayer compliance costs and ATO administration costs, improve the efficiency of business restructuring and strengthen the integrity of the tax system.¹¹

OVERVIEW OF THE CONSOLIDATION RULES

2.6 The consolidation regime applies primarily to wholly-owned groups of Australian resident entities that choose to form a consolidated group for income tax purposes.

2.7 A consolidated group generally consists of an Australian resident ‘head company’ and all of its wholly-owned Australian resident subsidiaries. Specific rules also allow certain resident wholly-owned subsidiaries of a foreign holding company to consolidate (a multiple entry consolidated group (MEC group)).

2.8 The ‘single entity rule’, ‘inherited history rules’ and ‘tax cost setting rules’ are core rules in the consolidation regime.¹²

10 *ibid*, paragraph 1.10.

11 *ibid*, paragraph 1.11.

12 Division 701 of the *Income Tax Assessment Act 1997* (ITAA 1997).

The single entity rule

2.9 Following a choice to consolidate, under the 'single entity rule' the members of a consolidated group are treated as parts of the head company of the group for income tax purposes (that is, the group is treated as a single entity). This means that:

- a single income tax return is lodged by the group and the group meets a single tax liability as well as pays a single set of pay as you go instalments;¹³
- losses, franking credits and foreign income tax offsets are pooled in the head company;
- the assets and liabilities (other than intra-group assets and liabilities) of the subsidiary members are treated as if they were assets and liabilities of the head company;
- the actions of the subsidiary members (for example, acquisition or disposal of assets) are treated as if they had been undertaken by the head company; and
- intra-group transactions (for example, the transfers of assets between group members) are treated as arrangements between divisions of a single company.¹⁴

2.10 The operation of the 'single entity rule' also means that where an entity joins a consolidated group, the entity will cease to be recognised as a separate entity, and its assets, liabilities and other tax attributes will be treated as though they are those of the head company of the group. Where an entity leaves a consolidated group, it will be recognised as a separate entity distinct from the consolidated group, and it will take its assets and liabilities out of the group.

2.11 Particular issues which arise in relation to the operation of the 'single entity rule' are discussed in Chapter 4 of this report.

The inherited history rules

2.12 The 'inherited history rules' support the 'single entity rule' by determining the tax history that the head company of a consolidated group inherits from an entity which joins the group (the 'entry history rule'), and determining the tax history that an entity inherits when it leaves the group (the 'exit history rule').

2.13 The history that is inherited has an impact on the tax implications which apply to the consolidated group after an entity joins the group and the tax implications which apply to an entity after it leaves. For example, under the 'entry history rule', a consolidated group may become entitled to certain deductions for expenditure

13 Generally in the quarter commencing after the consolidated tax return has been lodged.

14 Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002, paragraphs 2.5 and 2.6.

incurred by a joining entity prior to it joining the group (such as being entitled to expenditure incurred by the joining entity which was allocated to a project pool). Similarly, the pre-CGT treatment of an asset in the hands of a joining entity is inherited by a consolidated group.

2.14 The operation of the ‘inherited history rules’ and a consideration of its relevance as part of the ongoing policy framework for the consolidation regime are set out in Chapter 3 of this report.

The tax cost setting rules

2.15 The ‘single entity rule’ is also supported by ‘tax cost setting rules’ which apply to the assets of an entity which joins a consolidated group that become assets of the group.

2.16 Where a subsidiary member joins a consolidated group and its assets are treated as belonging to the head company of the group, a question arises as to what tax cost should be given to these assets. If the consolidated group adopts the joining entity’s tax cost for these assets, this may not reflect the cost which the group paid to acquire the joining entity which could result in the duplication of gains and losses.

2.17 To eliminate the duplication of gains and losses, the ‘tax cost setting rules’ often reset the tax cost of a joining entity’s assets to reflect the consolidated group’s cost of acquiring the joining entity. The group’s cost also takes into account liabilities of the joining entity which become liabilities of the group.¹⁵ The group’s cost – which is allocated to the joining entity’s assets – is also adjusted for certain retained earnings, distributions, losses and entitlements to future deductions which the group receives from the joining entity.¹⁶

2.18 The ‘tax cost setting rules’ also apply when an entity leaves a consolidated group.

2.19 When an entity leaves a consolidated group, a question arises as to what cost the group should recognise for selling its membership interests in the leaving entity. The ‘tax cost setting rules’ reconstruct the group’s cost for these membership interests based on the group’s tax cost of the net assets the leaving entity takes with it¹⁷. This ensures there is no duplication of gains and losses for the group, as the tax outcome for selling an entity out of the group aligns with the tax outcome that would arise from selling the net assets.

15 *ibid*, paragraph 5.6.

16 *ibid*, paragraph 5.10.

17 *ibid*, paragraph 5.13.

REFLECTIONS OF THE BOARD

2.20 The Board notes that the scope of its post-implementation review is limited to the operation of certain elements of the consolidation regime. Although the Board received some brief comments on the assessment of the consolidation regime as a whole, for the most part stakeholders' comments concentrated on particular problems in relation to the operation of the consolidation rules.

2.21 This report largely focuses on specific problems which have arisen with respect to certain elements of the consolidation regime, and sets out the Board's recommendations as to how these specific problems can be addressed.

2.22 The Board also considered other specific elements of the consolidation regime in its review of the consolidation rights to future income and residual tax cost setting rules, which was completed in May 2011. That report also focused mainly on specific problems which had arisen with respect to the operation of particular rules in the consolidation regime.

2.23 Although the Board's two consolidation reviews have highlighted specific areas for the improvement of the consolidation regime, broader questions have been raised as to whether the benefits of the consolidation regime outweigh its problems. The Board therefore considered it appropriate to convey some high-level reflections on the consolidation regime as a whole.

2.24 In summary, the Board considers that the consolidation regime as a whole has delivered substantial efficiency and integrity improvements to the Australian tax system when compared with the income tax grouping rules which wholly-owned groups previously had to apply. In particular, existing consolidated groups now face significantly less complexity in relation to intra-group dealings and group reorganisations. In many respects, the consolidation provisions operate in a workable manner.

2.25 However, despite significant improvements relative to the previous tax grouping rules, the Board also acknowledges there is substantial complexity in the current operation of the consolidation regime, particularly when entities enter a consolidated group. In some cases, this can create difficulty for groups and their advisors when applying the consolidation provisions, and in some areas places significant resource requirements on the Government to maintain and administer the regime. The complexity of the rules and their interaction with the general tax law can also result in anomalous outcomes and make it difficult to predict the revenue consequences of changes to the consolidation rules.

2.26 The Board is of the view that the Government should allocate sufficient resources for the care and maintenance of the consolidation regime to ensure that issues can be addressed in a timely manner. The Government should also consider whether structural changes could be made to the consolidation regime to simplify its operation

whilst maintaining the efficiency and integrity benefits it has delivered to the Australian tax system. As discussed below, this may include undertaking a review to assess whether an 'entity based model' of consolidation would be more effective than the current 'asset based model' for the consolidation regime.

2.27 The Board provides more detailed comments below which address these matters.

2.28 In preparing these comments, the Board considered views raised by its consultants, members of its Expert Panel and officers of the Treasury and the ATO. The Board also met with members of the Corporate Tax Association to obtain their views. However, the Board's conclusions reflect its own independent judgment.

IMPROVEMENTS DELIVERED BY THE CONSOLIDATION REGIME

2.29 The Board is of the view that the consolidation regime has delivered substantial improvements to the Australian tax system in providing a set of rules for the taxation of wholly-owned corporate groups. Prior to the introduction of the regime in 2002, wholly-owned corporate groups were required to apply multiple provisions in the general income tax law which did not appropriately cater for the characteristics of corporate groups or the types of transactions they undertook.

2.30 The key improvements from the introduction of the consolidation regime are summarised below.

Better alignment with reporting for business and accounting purposes

2.31 The consolidation rules provide greater simplicity and transparency for wholly-owned corporate groups by more closely aligning the income tax position of the group with its position from a business and accounting perspective. Prior to consolidation, each member of the group was required to lodge an income tax return, and the tax position for the overall group was difficult to decipher from these multiple tax returns. Treating a group as a single entity for tax purposes facilitates better decision making by business managers, and also increases transparency and efficiencies for administration by the ATO.

Efficiency for business reorganisations

2.32 There has been a significant reduction in the tax analysis required where groups undertake corporate restructures and intra-group asset transfers under the consolidation regime. This has resulted in increased operational efficiency for wholly-owned corporate groups and has substantially reduced compliance costs. In the pre-consolidation environment, even the simplest corporate reorganisation required specific tax choices and elections to be made. Market valuations were often required to avoid the risk of triggering the value shifting provisions, and a range of difficult issues commonly had to be confronted relating to the transfer of revenue assets such as trading stock, consumables and trade debts which were not capable of relief under the

CGT roll-over rules. Tax issues were therefore often regarded as impediments to businesses wanting to restructure their operations for commercial reasons.

Pooling of tax attributes

2.33 The consolidation pooling of tax attributes such as tax losses, franking credits and foreign income tax offsets has been instrumental in generating sensible, simple and appropriate tax outcomes. In the pre-consolidation environment, many corporate groups faced significant complexity in ensuring that (via chains of dividend payments) sufficient franking credits were available to the holding company of the groups prior to their boards' declaration of a dividend.

2.34 Similarly, the intricacies and risks associated with the transfer of losses between group companies were substantial, particularly where there were pending tax disputes that could subsequently alter taxable income for specific group members. These complexities in relation to intra-group dividends and loss transfers were significant for both taxpayers to apply and for the ATO to administer. Consolidation allows corporate groups to manage their affairs as a single economic entity.

Internal gain and loss duplication

2.35 Prior to the consolidation regime, corporate groups transferred tax profits to prevent the duplication of taxable gains to the holding company prior to the sale of a subsidiary. The introduction of rules to counter intra-group loss duplication also led to increasingly complex legislative provisions and compliance costs for corporate groups. The consolidation regime provided a systemic framework which eliminates the occurrence of intra-group gain and loss duplication issues.

CONCERNS WITH THE CONSOLIDATION REGIME

2.36 Despite the above benefits, some stakeholders have raised concerns about the compliance costs associated with the consolidation regime. They have also raised concerns about the complexity and uncertainty of certain aspects of the regime. In addition, the ATO identified a number of ongoing structural concerns with the regime.

Compliance costs

2.37 The consolidation regime reduces compliance costs for intra-group transactions for consolidated groups once they have formed.

2.38 However, compliance costs can and do arise when an entity joins a consolidated group, or when a new consolidated group is formed. These costs include the costs for the accounting or tax function of a business familiarising themselves with the consolidation tax rules, the costs of paying advisers to provide advice on the law, costs of undertaking consolidation tax cost setting calculations and the costs of working out the treatment of losses held by an entity that joins the group. Corporate groups may also incur additional compliance costs to update reporting software and intra-group accounting systems.

Complexity

2.39 Some stakeholders and the ATO have raised concerns about the complexity of the rules which govern the tax outcomes that arise when an entity joins a consolidated group, or when a consolidated group forms. Most of these concerns relate to the complexity of the operation of the tax cost setting rules in certain cases.

2.40 The Board understands that, when looked at in isolation, the complexity of the tax cost setting rules is generally manageable. However, dealing with the rules is sometimes difficult when the complexity is compounded by the uncertainty associated with their detailed application, particularly when regard is had to interactions with other areas of the tax law.

Uncertainty

2.41 The primary concern with the operation of the consolidation regime is that it continues to give rise to uncertain outcomes. While this has been highlighted in a limited number of circumstances, they cover some important issues with potentially significant consequences.

2.42 Since the introduction of the consolidation regime, a number of anomalous and unintended outcomes have been identified when an entity joins a consolidated group, such as the inappropriate triggering of capital gains, incorrect amounts being recognised in the allocable cost amount, or the inability to recognise the tax cost amount allocated to an asset. Anomalous outcomes often arise as a result of specific facts interacting with very prescriptive tax rules. Many of these issues have been corrected via legislative amendments over the last decade; however, some remain outstanding. In some cases, amendments introduced have themselves resulted in anomalous and unintended outcomes requiring further amendment.

2.43 The interaction of the consolidation regime with the rest of the general tax law has also given rise to significant uncertainty. In this regard, that uncertainty often arises due to uncertainty about the operation of, and interaction with, other areas of the tax law, rather than the operation of the consolidation regime.

2.44 A number of interactions and uncertainties have been clarified via legislative amendment or via the provision of guidance material by the ATO. However, stakeholders have commented that many issues remain outstanding for a long period of time and that, of those which have been resolved, many took a significant amount of time for certainty to be provided.

2.45 The ATO also commented that many of the interaction uncertainties arise because different assumptions need to be made by consolidated groups, including the single entity rule and the inherited history rules. These assumptions require certain facts to be taken to exist and for other facts to be disregarded. This results in the general tax law applying to a consolidated group on the basis of a reconstituted set of facts, which often gives rise to uncertainty.

2.46 The Board addresses a number of specific consolidation interaction issues, including issues relating to the treatment of intra-group assets, in Chapters 4 and 5.

Unpredictability of revenue outcomes

2.47 The ATO commented that the complexity of the consolidation rules and their interaction with the rest of the general tax law makes it very difficult for the Government to predict the revenue consequences of introducing changes to the consolidation regime. This makes the consolidation regime difficult for the Government to change.

Concerns regarding valuations

2.48 The Board notes that the consolidation rules which apply when an entity joins a consolidated group rely heavily on the valuation of assets. Expert valuers can have vast differences in opinion on the value of an asset depending on the assumptions and methodologies they use. Also, it is difficult to dispute valuations due to the flexibility of valuation methodologies, the limited pool of expertise in Australia, and the expense involved.

2.49 The critical role valuation plays as part of the tax cost setting amount for assets, and the flexibility of different valuation methodologies that may be sought to be used, potentially pose a high risk to the revenue.

REFLECTIONS ON THE FUTURE OPERATION OF THE CONSOLIDATION REGIME

Policy principles

2.50 As an overarching principle, the Board considers that the operation of the income tax law for consolidated groups should be consistent with its operation for other taxpayers that do not, or cannot, form a consolidated group. For example, consolidated groups should not be entitled to deductions that are not available to other taxpayers.¹⁸

2.51 The Board considers that this overarching principle would have particular relevance in the context of the tax rules which apply when entities are acquired by a consolidated group. The Board elaborates further on this issue in Chapter 3 of this report.

2.52 However, the Board recognises that there are intended exceptions to this overarching principle. In particular, as a result of the core design principles of the

18 At the same time, the core design principles (as reflected by the tax cost setting rules) may change the amount of a deduction and the timing of the deduction in some circumstances. Timing differences are expected to be reduced by the adoption of the business acquisition approach for the purposes of applying the residual tax cost setting rule (see Recommendation 2 of the Board's report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*, which has been agreed to by the Government).

consolidation regime, the tax outcomes for consolidated groups are different to those for other taxpayers that do not, or cannot, form a consolidated group in some circumstances. For example, under those core design principles the tax costs of assets brought into a consolidated group by a joining entity are reset, intra-group transactions are ignored, and tax attributes (such as tax losses, franking credits and foreign income tax offsets) are pooled.

2.53 The different outcomes that arise for consolidated groups because of the core design principles are intended to encourage wholly-owned corporate groups to enter the consolidation regime. However, if the Government decides to make future changes that cause the tax outcomes for consolidated groups to be different to those for other taxpayers that do not, or cannot, form a consolidated group, the changes should be properly evaluated before any announcement to ensure that the implications (including the budgetary implications) are fully understood. Also, the intention that there be different policy outcomes should be explicitly stated.

Care and maintenance and addressing unresolved issues

2.54 Although the Board considers the consolidation regime has been largely successful in providing a set of rules for the taxation of wholly-owned corporate groups in the Australian tax system, the Board is concerned about the complexity of the regime and the number of consolidation issues which remain unresolved.

2.55 The Board's current report seeks to address a number of these consolidation issues. However, a significant number of issues are outside the scope of the Board's review. A list of such issues is set out in Appendix C. The Board understands that some of these issues were originally raised with the ATO National Tax Liaison Group as priority issues as far back as May 2005.

2.56 For the consolidation regime to be adequately maintained over future years, the Board considers it critical for problems and issues with the operation of the consolidation regime to be identified, prioritised and resolved within a reasonable time frame.

2.57 The consolidation regime is a significant element of the business tax system, and it is likely that new issues will continue to arise as changes are made to the regime and to other provisions in the general tax law. Therefore, adequate resources should be given to the Treasury, the ATO and the Office of Parliamentary Counsel to ensure that appropriate care and maintenance can continue to be carried out, and to ensure that legislative amendments can be made where necessary on a timely basis.

2.58 If a proposal to change the law that is consistent with policy directions cannot be implemented in the short term due to budgetary considerations or because there are other parts of the system that warrant more urgent attention or are of greater priority, the Government could announce its broad support for the proposal, with an indication that it will be further considered once the budgetary conditions and priorities change.

2.59 The Board recommends that the Government implement a more systematic approach for addressing and resolving issues arising with the operation of the consolidation regime. This would include ensuring that an appropriate forum is available for these issues to be identified, prioritised and addressed, and that relevant people from the private sector, the Treasury and the ATO participate in the forum.

2.60 The Government could also review the existing consolidation provisions to assess whether the drafting of the provisions could be improved to reduce complexity and make the operation of the consolidation regime more certain. The Board appreciates this would be a significant exercise for the Government and for key stakeholders. An appropriate assessment should be done of the advantages of any re-drafting process against the resources and time required, and the likelihood of other uncertainties or unintended outcomes arising from the re-drafted rules.

Consideration of an alternative model for consolidation

2.61 The Board also notes that the Review of Business Taxation's discussion paper, *A Platform for Consultation*, considered two models for the implementation of Australia's consolidation regime.

2.62 The 'entity based model' for consolidation would retain the dual recognition of the cost base of the membership interests in an entity distinct from the cost base of that entity's assets. As such, the cost base of an entity's assets would not be reset upon entry into consolidation. Instead, where intra-group transactions or intra-group asset transfers are undertaken, these will result in changes to the cost base of the membership interests in the entities involved in those intra-group dealings. The 'entity based model' therefore involved very little cost for taxpayers to enter, but would require significant ongoing costs to adjust for intra-group transactions.¹⁹

2.63 The 'asset based model' for consolidation, which was adopted for the Australian consolidation regime on the recommendation of the Review of Business Taxation, requires the cost bases of an entity's assets (except for cash and other retained cost base assets) to be reset upon entry into consolidation. However, once reset, there is no need for recognition to be given for the cost bases of that entity's membership interests until the entity leaves the group. Under this model, a consolidated group is not required to make any adjustments where transactions occur intra-group. Thus, the 'asset based model' involves upfront costs for groups to reset the cost base of assets upon entry into consolidation, but thereafter has minimal costs for groups on an ongoing basis.

2.64 The Review of Business Taxation favoured the 'asset based model' because it did not require consolidated groups to track intra-group transfers of assets, which was seen as having less compliance and administrative costs than the 'entity based model'. It was also seen to have a broad degree of consistency with accounting consolidation.

19 Review of Business Taxation, *A Platform for Consultation* (February, 1999), Chapter 27: Determining the cost base for disposal of equity.

The Review of Business Taxation also commented that any substantial complexity with resetting the tax cost of assets could be avoided via its recommendation for a transitional ‘stick’ option, under which a group could keep the existing tax costs of the assets of a subsidiary.²⁰

2.65 The Board notes that most other countries with tax consolidation regimes have taken an approach based on accounting principles that is more consistent with an ‘entity based model’. Therefore, by adopting an ‘asset based model’, Australia’s consolidation regime appears to be unique.

2.66 An ongoing criticism of the ‘asset based model’ is that it can result in significant uncertainty, particularly due to the operation of the tax cost setting rules in certain situations. Reducing this uncertainty could, however, require a more prescriptive approach that may entail an increase in compliance costs and potentially lead to more arbitrary outcomes. However, if uncertainty continues to be a major concern following the implementation of the recommendations contained in this report, consideration could be given to making more substantive changes to the consolidation regime.

2.67 In this regard, there are a range of approaches that could be considered. One approach would be to retain the ‘asset based model’ but consider fundamental changes to the way that it has been implemented.

2.68 An alternative approach would be to explore whether an ‘entity based model’ would be a better model for Australia’s consolidation regime moving forward. However, shifting from the current ‘asset based model’ to an ‘entity based model’ would itself be inherently complex and raise significant transitional issues.

2.69 It would be a significant exercise to convert Australia’s consolidation regime from an ‘asset based model’ to an ‘entity based model’. Therefore, a thorough assessment would need to be undertaken to ensure that the adoption of a different model would result in net benefits for the Australian tax system, and that these net benefits outweigh the costs of re-designing, re-drafting and implementing an alternative consolidation model. The assessment would need to include an analysis of the experiences of other tax jurisdictions which have adopted an ‘entity based model’.

Conclusion

2.70 The Board considers that the consolidation regime has delivered significant efficiency and integrity improvements to the Australian tax system as compared with the previous income tax rules which wholly-owned groups needed to comply with. The Board agrees with the sentiments raised by its Expert Panel and members of the Corporate Tax Association that reverting to the old tax rules for corporate groups would be ‘a return to the stone age’.

20 Review of Business Taxation, *A Tax System Redesigned* (July, 1999), Section 15: Consolidated groups, pages 527-529.

2.71 In this regard, some aspects of the consolidation regime reduce the complexity of the business tax system. For example, the consolidation regime improves the efficiency of business reorganisations by ignoring intra-group transactions. It also reduces complexity by allowing tax attributes (such as tax losses, franking credits and foreign income tax offsets) to be pooled.

2.72 However, other aspects of the consolidation regime, such as the tax cost setting rules and the way that the consolidation regime interacts with other parts of the income tax law, in certain circumstances add to the complexity and uncertainty of the business tax system and require significant care and maintenance. As noted in paragraph 2.40, this complexity is generally manageable. At the same time, the complexity and uncertainty often makes it difficult to fully evaluate the consolidation impacts that arise when broader reforms are made to the income tax law.

2.73 The Board has recently conducted a review of tax design processes in its post-implementation review of the Tax Design Review Panel recommendations, and considers that its recommendations therein for improved tax design should be applied to the ongoing maintenance of the consolidation regime. Without a systematic maintenance program, the likelihood of the need for fundamental repair of, or change to, the system in the future will increase.

2.74 The Board expects that the adoption of the recommendations made in this report will improve the operation of the consolidation regime by clarifying the policy settings, reducing complexity and removing uncertainty. However, if significant issues continue to arise with the operation of the consolidation regime, it may be appropriate to explore whether more substantive changes should be made to the regime either by making fundamental changes to the 'asset based model' or by exploring an alternative approach to consolidation consistent with the 'entity based model'. Therefore, the Board recommends that the Government evaluate the state of the consolidation regime within five years of the implementation of the recommendations contained in this report, to assess the extent to which problems and issues continue to arise that may point to on-going structural problems with the regime.

Recommendation 2.1

The Board recommends that the Government:

- implement a more systematic approach for addressing and resolving issues arising in the operation of the consolidation regime; and
- evaluate the state of the consolidation regime within five years of the implementation of the recommendations in this report to assess the extent to which problems and issues continue to arise that may point to the need to address on-going structural problems with the regime.

GENERAL OBSERVATIONS ON THE DESIGN AND IMPLEMENTATION OF FUTURE TAX REGIMES

2.75 Despite the overall benefits delivered by the consolidation regime, the Board recognises that many specific problems have been raised in the course of the Board's two consolidation reviews.

2.76 After reflecting on these specific problems, the Board has made some observations about the design and implementation of future tax regimes into the Australian tax system.

Shared understanding of policy principles

2.77 There should be a shared understanding of the policy principles supporting the new regime during its design and implementation phases (including any particular mischief or concerns that are to be addressed by such a new regime). These policy principles should be clearly articulated in the design phase, be tested through consultation with the private sector, and be clearly incorporated into the drafting of the regime in the tax law.

2.78 This will ensure that collaboration with stakeholders will result in a coherent design of the tax law based on a common understanding of what the regime seeks to accomplish. It should also assist in the later interpretation of the enacted law by practitioners and the ATO.

Principle-based rules

2.79 Legislation to implement new regimes should be developed using coherent principles. The use of coherent principles generally results in law that is more sustainable and robust. Coherent principles can be supported by lower level details in the law and by interpretative products. However, a clear advantage is that law based on coherent principles generally requires less care and maintenance than 'black-letter' law.

2.80 In developing law to implement new regimes, the complexity of the rules should be assessed taking into account the intended users of the rules. In this regard, the Board is of the view that, whilst intended to provide certainty for consolidated groups, the complexity of the consolidation operative provisions makes the regime difficult for many business groups and their advisors to comply with. In particular, the provisions are overly complex for small to medium sized business groups even though they were intended users of the regime. The Board discusses this issue in more detail in Chapter 6.

Fully developed prior to introduction

2.81 The new regime should be fully developed before it is introduced, taking into account appropriate 'road-testing' via consultations. This may require the date of

introduction of the regime to be delayed. ATO guidance material should also be developed in conjunction with the legislative development process.

2.82 The Board notes that the consolidation regime was implemented via four tranches over 2002 and 2003,²¹ with the last three tranches being enacted with retrospective effect back to the commencement of the regime on 1 July 2002. The first tranche contained the basic rules, and the others added to and built upon those basic rules.

2.83 The Board considers that the consolidation regime would have benefited if it had been introduced as a fully developed single package. The benefits may have included a more streamlined approach to introducing the regime, greater continuity and completeness in tax design consultations, greater efficiency in the use of Government resources and a more streamlined and coherent drafting of the consolidation rules.

2.84 In addition, the Board considers that the focus of tax design consultations should not be merely on issues expected to arise in the immediate years of the regime, but also issues expected to arise in later years. It appears that during the development of the consolidation regime, taxpayers and professional bodies primarily focused on issues that would be faced by groups when they first formed a consolidated group, with less emphasis on issues that would be later faced by these groups. The Board makes further comments on the implications of this in Chapter 3.

Interactions with the general tax law

2.85 Specific consideration should be given during the design and drafting stages as to how the new regime will interact with provisions in the general tax law. Although the policy principles supporting the new regime may be clearly understood by all stakeholders, substantial uncertainty can arise in determining interactions with other tax rules that have competing policy principles.

2.86 The sheer number of interactions can also give rise to substantial complexity in the design of interaction provisions in the new regime. Consideration should be given as to whether the drafting of the regime can be structured to facilitate interactions in a systematic way to provide greater simplicity and consistency in the tax law.

2.87 The Board addresses a number of specific consolidation interaction issues that have emerged since the introduction of the consolidation regime in Chapter 5.

Improving the relationship between government and non-government representatives

2.88 The Board notes that in recent years the Government has increased the amount of consultation it has conducted with stakeholders in developing and implementing

21 Act No 68 of 2002; Act No 90 of 2002; Act No 117 of 2002; and Act No 16 of 2003.

changes to the taxation law. These consultation processes would be further improved by giving greater clarity to the roles of government and non-government representatives in the tax design process. This should promote greater openness in communication and the sharing of ideas and concerns during the design of the new regime.

2.89 The Board notes that issues concerning the relationship of government and non-government representatives in the tax design process were considered by the Board in its post-implementation review of the Tax Design Review Panel recommendations. The Board made a number of recommendations in this review for more effective input from private sector experts in the tax design process. These recommendations are set out in the Board's report on this review, delivered to the Government in December 2011.

Revenue costings

2.90 The Board notes the significance of revenue costings for the Government in considering the introduction of new regimes into the Australian tax system which may bring substantial change to existing tax policy. Minor policy changes that are designed to improve the operation of the existing law can also have significant revenue implications.

2.91 In this context, the Board is of the view that greater transparency in relation to revenue costings would improve consultation processes on the design of new tax regimes. Greater transparency, such as in allowing revenue costing assumptions to be tested, should result in more accurate costing outcomes and be of benefit to both the Government and the community.

Implementation and care and maintenance

2.92 When significant changes to the taxation law are made to introduce a new regime, it is important that the new regime is implemented effectively and that care and maintenance is undertaken after its introduction. Therefore, when the resource implications of developing the new regime are being considered, Treasury and the ATO should take into account the need for effective implementation and ongoing care and maintenance of the regime. As part of this care and maintenance, implications for the regime must be fully assessed when changes to other parts of the tax law are designed and implemented.

2.93 Problems and issues that arise in relation to the operation of the regime must be identified, prioritised and resolved within a reasonable time frame. In this regard, the Board understands that, in some cases, decisions on proposals to improve the law are deferred indefinitely due to budgetary considerations or because there are other parts of the system that warrant more urgent attention or are of greater priority. As a result, issues can remain unresolved for significant periods of time. If a proposal to improve the regime that is consistent with policy directions cannot be implemented in the short

term, the Government could announce its broad support for the proposal, with an indication that it will be further considered once budgetary conditions and priorities change.

Post-implementation reviews

2.94 The introduction of a new regime should be followed by a post-implementation review within a suitable timeframe. This would need to take into account the size and particular characteristics of the regime.

2.95 In the case of the consolidation regime, a post-implementation review after two years would have been premature, given amendments to clarify the operation of the regime were still being made. A post-implementation review after about five years may have been more appropriate.

CHAPTER 3: POLICY FRAMEWORK FOR THE CONSOLIDATION REGIME

3.1 The 'single entity rule' is the cornerstone principle of the consolidation regime. It operates to treat a wholly-owned corporate group as a single entity for income tax purposes.

3.2 The single entity rule is supported by 'tax cost setting rules' and 'inherited history rules'.

3.3 As outlined in Chapter 2, the 'tax cost setting rules' apply to reset the tax costs of the assets transferred from a joining entity to the consolidated group based on the group's cost of acquiring the entity.

3.4 When a consolidated group acquires an entity, the tax cost setting rules apply in three steps:

- Step A – Calculate the economic cost of acquiring the entity (known as the 'allocable cost amount').
- Step B – Allocate the allocable cost amount to the assets of the acquired entity. This step resets the tax cost of the acquired entity's assets to reflect the consolidated group's cost of acquiring the entity. The new tax cost allocated to each asset is known as a 'tax cost setting amount'.
- Step C – Determine how provisions in the general tax law apply to the tax cost setting amounts allocated to the assets in the hands of the consolidated group (for example, a consolidated group claiming deductions under the tax depreciation rules based on the tax cost setting amount allocated to a depreciating asset).

3.5 The tax cost setting rules also apply when an entity leaves a consolidated group. The rules reconstruct the consolidated group's cost base in the membership interests of the leaving entity based on the tax costs of the assets and the value of liabilities which the entity takes out of the group.

3.6 The 'inherited history rules' are also outlined in Chapter 2. These rules determine the history that a consolidated group inherits from an entity which joins the group (the 'entry history rule'), and the history that an entity inherits when it leaves the group (the 'exit history rule').

3.7 When the consolidation regime was being developed, a 'clean slate approach' was considered whereby an entity would not bring any income tax history with it

when it joins a consolidated group, and would not take any income tax history with when it leaves a consolidated group. This approach mimicked outcomes where an entity acquires assets from a third party or sells assets to a third party. In these cases, the history of the assets in the hands of the vendor is generally irrelevant to the purchasing entity.

3.8 The clean slate approach was abandoned in favour of the current inherited history framework. This was because the main focus was placed on the high incidence of formations of existing wholly-owned groups into new consolidated groups in the early years of the consolidation regime. Where an existing wholly-owned group elects to form a consolidated group, an inherited history approach was seen as appropriate to ensure that the history of the group remains unaffected through a choice to consolidate. The adoption of the inherited history approach was particularly important for the purposes of ensuring, for example:

- private binding rulings issued by the ATO before the formation of a consolidated group continued to apply after the formation of the group;
- the acquisition dates of pre-capital gains tax (CGT) assets was not refreshed; and
- the acquisition dates of pre-13 May 1997 assets were not refreshed (which could affect the CGT cost bases of certain assets).²²

3.9 Although the inherited history approach is still relevant for formation cases, the fact that most large business groups have already entered the consolidation regime and the high incidence of mergers and acquisitions in the large business sector has meant that, in recent years, the number of entities joining existing consolidated groups has exceeded the number of new consolidated groups being formed.

3.10 In the 2010-11 income year, around 4,000 entities joined consolidated groups. The ATO estimates that at least 65 per cent of these were entities joining as a result of acquisitions (including the creation of new entities), rather than entities joining as a result of the formation of a new consolidated group. This pattern is broadly consistent over the past five income years providing evidence of a much greater prevalence of acquisition cases over formation cases in the consolidation regime. In the large business sector (turnover greater than \$250 million) around 2,000 entities joined consolidated groups in the 2010-11 year and over 90 per cent of these were acquisitions (including the creation of new entities), rather than formation cases.

3.11 This evidence suggests that an inherited history framework may no longer be appropriate for the majority of cases where entities join a consolidated group. Instead, the Board's Position Paper proposed that an 'asset acquisition approach' should be adopted (Position 2.1).

22 Section 110-40 of the ITAA 1997.

3.12 Under the asset acquisition approach, a consolidated group would be taken to acquire all the assets of a joining entity at the time the entity joins the group. The history which those assets had when they were held by the entity prior to joining the consolidated group will generally be disregarded. This is similar to the clean slate approach considered at the time the consolidated regime was being developed.

VIEWS IN SUBMISSIONS

3.13 The general consensus in submissions received by the Board was that the consolidation regime has led to increased business efficiency and integrity within the tax system for consolidated groups. Although the existing inherited history framework for the consolidation regime is, for the most part, working effectively, that framework has led to inappropriate outcomes arising in some cases.

The Joint Bodies agree with the Board's conclusion that the current inherited history framework operates effectively in the majority of cases to achieve the primary objectives of the consolidation regime.

However, there are some instances where unclear policy rationale has led to inappropriate outcomes and anomalies that need to be rectified.

Institute of Chartered Accountants in Australia / The Tax Institute

3.14 Some submissions argued that the consolidation regime could be improved by adopting an asset acquisition approach given that the more common transaction today is the acquisition by, rather than formation of, a consolidated group.

The CTA / MCA support the BoT's proposed asset acquisition approach as it would provide future clarity as to the objectives of tax outcomes in relation to the tax cost setting amounts allocated to assets of a joining entity, and in doing so would address a number of anomalous current issues. The asset acquisition approach would also substantially reduce tax differentials in respect of assets of a joining entity between transactions undertaken as an asset acquisition compared to an entity acquisition.

Corporate Tax Association / Minerals Council of Australia

We support the Board's view to adopt the asset acquisition model. An asset acquisition model would remove many of the uncertainties associated with the inherited history rule. It would also be expected to reduce compliance costs in the long-term.

CPA Australia

BOARD'S CONSIDERATION

Consideration of the business acquisition approach in the Board's review of the rights to future income and the residual tax cost setting rules

3.15 The Board considered the asset acquisition approach in the context of its review of the consolidation rights to future income and residual tax cost setting rules. As part of that review, the Board recommended that the residual tax cost setting rules²³ should be modified to apply a 'business acquisition approach'.²⁴ The Government has accepted that recommendation.²⁵

3.16 In undertaking that review, the Board determined that, when a consolidated group acquires an entity, it effectively acquires the assets of the entity in the context of acquiring a business, as distinct from separately acquiring each asset of the joining entity. Therefore, the Board concluded that the term 'business acquisition approach' describes this scenario more accurately than the term 'asset acquisition approach' that was used in the Board's Position Paper.

The current hybrid approach in the consolidation regime

3.17 In considering the appropriateness of introducing a business acquisition approach into the consolidation regime, it is important to acknowledge that both the inherited history approach and the acquisition approach already operate in the current consolidation rules.

3.18 The inherited history approach is embedded in the core rules of the consolidation regime in the form of the 'entry history rule' and the 'exit history rule'.²⁶

3.19 Under the 'entry history rule', a joining entity's history will be inherited by the consolidated group. Therefore, under the current law, a consolidated group inherits:

- certain tax attributes held by a joining entity, such as tax losses and franking credits transferred to the head company of the group;
- entitlements to certain deductions for expenditure incurred by a joining entity prior to it joining the group (such as an entitlement to deductions for expenditure incurred by the joining entity which was allocated to a project pool);
- the value of liabilities (other than certain taxation of financial arrangements (ToFA) liabilities²⁷) that a joining entity brings into the group; and

23 Subsection 701-55(6) of the ITAA 97.

24 Recommendation 2 of the Board of Taxation's Report on the *Review of the Consolidation Rights to Future Income and Residual Tax Cost Setting Rules*, May 2011.

25 See Media release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation and Tax Laws Amendment (2012 Measures No. 2) Bill 2012.

26 Sections 701-5 and 701-40 respectively of the ITAA 1997.

- the tax treatments covered by a private binding ruling issued by the ATO to the joining entity prior to it joining the group.

3.20 Although the entry history rule is embedded in the consolidation core rules, it is modified in the consolidation operative provisions when it comes to the treatment of assets under the 'tax cost setting rules'.

3.21 First, in allocating tax costs to the assets which a consolidated group will obtain from a joining entity²⁸, the tax cost setting rules apply both an entry history approach and an acquisition approach.

3.22 Under these rules, a consolidated group inherits the same tax costs that a joining entity had for assets that are 'retained cost base assets'²⁹ (reflecting an entry history approach). Retained cost base assets generally encompass Australian currency and rights to receive Australian currency. Some other types of assets are also treated as retained cost base assets in the case where a consolidated group is first formed, or in cases where majority-owned entities (that have been owned for a period of time) join a consolidated group.

3.23 For all other assets (referred to as 'reset cost base assets'³⁰), the tax cost setting rules reset the tax cost of these assets based on the consolidated group's cost of acquiring the entity. This reflects an acquisition approach, since the tax costs allocated to these assets approximates the tax costs which the consolidated group would have obtained if it had purchased the net assets of the joining entity.

3.24 Second, the tax cost setting rules which determine how provisions in the general tax law apply to the tax cost setting amounts allocated to assets³¹, also apply both an entry history approach and an acquisition approach. These rules are set out in a supporting provision of the consolidation regime.³²

3.25 The supporting provision states that, for the purposes of applying certain provisions in the general tax law to an asset, the consolidated group will be taken to 'acquire' the asset for an amount equal to the asset's reset tax cost amount (reflecting an acquisition approach). This means that, in applying the provisions in the general tax law to the asset, the history which the asset had in the hands of the joining entity is generally disregarded.

27 Attachment B to Media release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation and Tax Laws Amendment (2012 Measures No. 2) Bill 2012 - Schedule 2 proposes some changes to the operation of the ToFA rules for consolidated groups, including the treatment of liabilities held by a joining entity.

28 Referred to as Step B in paragraph 3.4.

29 Section 705-25 of the ITAA 1997.

30 Section 705-35 of the ITAA 1997.

31 Referred to as Step C in paragraph 3.4.

32 Section 701-55 of the ITAA 1997.

3.26 This acquisition approach applies for the following types of assets:

- depreciating assets (with some exceptions);
- qualifying securities;
- assets (and liabilities in some cases) subject to the ToFA regime; and
- assets that come within the scope of the residual tax cost setting rule (see Schedule 3 to Tax Laws Amendment (2012 Measures No. 2) Bill 2012).

3.27 The supporting provision also contains specific exceptions where, instead of an acquisition approach, the tax history of a joining entity's assets is inherited by the consolidated group (an entry history approach). This is the case for CGT assets (enabling consolidated groups to inherit pre-CGT treatment) and some types of depreciating assets.

3.28 Provisions outside of this supporting provision also operate as exceptions to the acquisition approach to make a consolidated group inherit the tax history of a joining entity's assets in certain cases (such as pre-July 2001 mining rights). Other provisions create further exceptions so that an entry history approach applies to certain types of assets (such as trading stock and internally generated assets) where a joining entity was majority-owned by the consolidated group.

3.29 Therefore, although the consolidation core rules only contain the entry history approach, the consolidation regime effectively applies a hybrid approach for the treatment of assets, incorporating both the entry history approach and the acquisition approach. This hybrid approach reflects certain policy decisions that have been made over time in respect of the treatment of the tax cost setting amount allocated to certain assets.

Giving formal recognition to the primacy of the business acquisition approach in the core rules of the consolidation regime

3.30 The Board is of the view that the operation of the consolidation regime would be improved if the guide material and the core rules were modified to formally recognise the existing hybrid approach for the treatment of assets (that is, to recognise the business acquisition approach along with the entry history approach in the core rules).

3.31 The Board considers that, for the purposes of determining the treatment of assets transferred to a consolidated group by a joining entity, the entry history rule should effectively operate as an exception to the business acquisition approach in the core rules. This would ensure that, going forward, the business acquisition approach would be the base on which policy options would be considered in relation to the treatment of these assets.

3.32 Having regard to the way the consolidation rules work when an entity leaves a consolidated group, the exit history rule would remain the base case and would not be supplemented by an additional core rule.

3.33 Even though the Board considers that the business acquisition approach should be adopted as the base case going forward for the treatment of the assets of a joining entity, the Board does not consider that it is necessary to alter the tax outcomes that arise under the existing exceptions to the business acquisition approach (discussed above at paragraphs 3.22, 3.27 and 3.28). The current tax outcomes for these exceptions have been determined as a matter of Government policy on a case by case basis as the consolidation rules have been amended, having regard to special policy considerations and revenue implications in particular cases.

3.34 However, the Board considers that the presentation of the law would be significantly improved if exceptions to the business acquisition approach that are located outside the core rules are rationalised and moved to a central location. This would make the law clearer for taxpayers and the ATO.

3.35 The Board therefore recommends that the business acquisition approach should be formally recognised in the core rules for the consolidation regime in relation to the treatment of assets transferred to a consolidated group from a joining entity. This should not result in any changes to:

- the current operation of the consolidation rules; or
- the current treatment of assets or liabilities under the consolidation regime.³³

3.36 The Board also recommends that high-level principles be included in the core rules which specify the primacy of the business acquisition approach and the circumstances where the entry history approach should apply. This will provide a clearer policy framework for the application of these two approaches to guide future amendments to the consolidation provisions.

3.37 Under these principles, the business acquisition approach should generally apply to a consolidated group for the purposes of:

- resetting the tax cost setting amount of 'reset cost base assets' that a joining entity brings into the group (where the former tax cost of the joining entity's assets will generally not be taken into account);
- disregarding the tax history of assets in non-majority owned acquisition cases; and
- determining the value of ToFA liabilities that a joining entity brings into the group.

33 The treatment of liabilities will be considered in a separate Board report to the Government, referred to in paragraph 1.9.

3.38 The entry history approach should generally apply for the purposes of:

- inheriting the tax history of assets in formation cases, or in cases where majority-owned entities (that have been owned for a period of time) join a consolidated group;
- inheriting certain tax attributes from a joining entity, such as the transfer of tax losses and franking credits to the head company of the group;
- inheriting certain deductions for expenditure incurred by a joining entity prior to it joining the group (such as deductions for expenditure incurred by the joining entity which was allocated to a project pool); and
- inheriting the tax treatments covered by a private binding ruling issued by the ATO to the joining entity prior to it joining the group.

3.39 In practice, the Government could always make exceptions to these principles, having regard to policy considerations and revenue implications in particular cases. Where exceptions are made, clear justification should be provided in the explanatory material of the amending legislation. Any new exceptions should be located, together with the existing exceptions, in a central location within the consolidation provisions.

Depreciating assets brought into a consolidated group by a joining entity

3.40 The Board notes that the Government has announced³⁴ that it will implement a proposal originally announced by the former Government affecting the rate of depreciation that applies to depreciating assets held by an entity that joins a consolidated group. In essence, if an entity acquires a depreciating asset, the rate of depreciation that the entity can apply is based on the effective life of the asset. If the entity chooses to apply the diminishing value method of depreciation, the rate of depreciation is based on the effective life increased by an uplift factor. For an asset that was acquired before 10 May 2006, the uplift factor is 150 per cent. For an asset that was acquired after 9 May 2006, the uplift factor is 200 per cent.

3.41 The Government's announcement is to prevent the 200 per cent uplift factor from applying where a consolidated group acquires an entity after 8 May 2007 that holds depreciating assets acquired before 10 May 2006.

3.42 The Board considers that the better policy outcome is for the 200 per cent uplift factor to apply in these circumstances, unless the joining entity is a majority-owned entity (in which case the 150 per cent uplift factor should apply). This policy outcome would be consistent with a business acquisition approach and with the original treatment of depreciating assets held by a joining entity. In this regard, the Board notes

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

that one of the objectives of applying the business acquisition approach to depreciating assets when the consolidation regime was implemented was to take away the benefits of accelerated depreciation that applied to depreciating assets held by a joining entity in some cases. Therefore, the Board considers that the Government should review its decision, but acknowledges that the Government may choose to implement its original decision having regard to revenue considerations.

Recommendation 3.1

The Board recommends that the core rules in the consolidation regime should be modified to:

- give formal recognition to the primacy of the business acquisition approach in relation to the treatment of assets transferred to a consolidated group from a joining entity;
- retain the entry history rule, but as an exception to the business acquisition approach; and
- include high-level principles which specify the general circumstances where the business acquisition approach or the entry history rule should apply.

The Board recommends that this modification to the consolidation core rules should not, by itself, result in any changes to:

- the current operation of the consolidation rules; or
- the current treatment of assets or liabilities under the consolidation regime.

The Board also recommends that the current exceptions to the business acquisition approach in the consolidation provisions should be rationalised and moved into a single location within the consolidation core rules.

CHAPTER 4: OPERATION OF THE SINGLE ENTITY RULE

4.1 The single entity rule operates to treat a consolidated group as a single taxpayer for income tax purposes by treating subsidiary members of the consolidated group as parts of the head company of the group.³⁵

4.2 The objective of the single entity rule was expressed in the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002:

The single entity treatment, coupled with the inherited history rules and special rules for setting the cost for tax purposes of assets of entities joining and leaving consolidated groups, will:

- simplify the tax system and reduce on-going compliance costs;
- promote economic efficiency by providing a taxation framework that allows Australian businesses to adopt organisational structures based more on commercial rather than tax considerations; and
- promote equity by improving the integrity of the tax system.³⁶

4.3 Examples of the implications of the single entity rule are that a consolidated group can lodge a single income tax return, losses made by a subsidiary in the group are automatically pooled together with income of other members to form the taxable income of the group, franking credits are automatically pooled in the group and assets transferred between members of the group are ignored because they take place within a single taxpayer.

4.4 Although the single entity rule produces appropriate outcomes in most cases, issues have arisen with the practical operation of the single entity rule in certain circumstances. This has led to a degree of uncertainty for taxpayers in applying the single entity rule and has resulted in cases of inconsistency and unfairness in its operation, causing both favourable and unfavourable outcomes for taxpayers. The primary areas of uncertainty relate to:

- intra-group assets and intra-group liabilities, including in particular:
 - the acquisition of intra-group assets and implications for intra-group liabilities;

35 The single entity rule only operates for 'head company core purposes' (section 701-1).

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

- the disposal of intra-group assets and implications for intra-group liabilities; and
- value shifting caused by the acquisition and disposal of encumbered assets subject to intra-group rights; and
- dealings by third parties with a consolidated group.

4.5 The Board's recommendations in this chapter outline policy principles which provide a framework to guide the development of rules that govern the tax treatment of intra-group assets and liabilities and the application of the single entity rule for third parties.

4.6 The Board notes that the Government has announced changes³⁷ to ensure the tax cost setting rules apply only to assets that are recognised for taxation purposes. The announced changes also ensure that, for an asset that is a contractual entitlement to future income held by a joining entity, the contract will be treated as a retained cost base asset with a tax cost setting amount equal to, broadly, the CGT cost base for the asset. The Board understands these announced changes will apply to intra-group assets.

4.7 In addition, the Government has asked the Board to review the current treatment of liabilities under the consolidation regime.³⁸ It is likely that any changes to the treatment of liabilities arising from that review will affect equivalent intra-group liabilities.

INTRA-GROUP ASSETS AND LIABILITIES

4.8 Intra-group assets arise primarily when contractual rights are created between members of the same consolidated group. These assets are disregarded by the head company of a consolidated group under the single entity rule. Examples of intra-group assets include rights relating to intra-group debt interests and intangible rights relating to intra-group assets (for example, options, rights or licences).

4.9 Intra-group assets can:

- be created within a consolidated group;
- be brought into a consolidated group through the direct acquisition of the asset by a member of the consolidated group;

37 Attachment B to Media release No 159 of 25 November 2011 issued by the then Assistant Treasurer and Minister for Financial Services and Superannuation and Tax Laws Amendment (2012 Measures No. 2) Bill 2012.

38 The treatment of liabilities will be considered in a separate Board report to the Government, referred to in paragraph 1.9.

- be brought into a consolidated group through the acquisition of the membership interests in an entity holding the asset (that is, an indirect acquisition);
- lapse or cease to exist within a consolidated group;
- be sold by a consolidated group through the direct disposal of the asset by a member of the consolidated group; or
- be sold by a consolidated group through the disposal of the membership interests in the member of the consolidated group which holds the asset (that is, an indirect disposal).

4.10 An intra-group asset held by a member of a consolidated group will generally be offset by an intra-group liability or obligation held by another member of that group.

4.11 The intra-group liability may be a liability that is recognised for accounting purposes, such as an intra-group loan payable which offsets an intra-group loan receivable.

4.12 Alternatively, the intra-group liability may be a legal or business liability or similar type of obligation that is not recognised for accounting purposes. For example, where a member of a consolidated group owns an asset and has an obligation to provide use of the asset under a licence agreement to another member of the consolidated group, the obligation to provide use of the asset would not generally constitute a liability that is recognised for accounting purposes.

ACQUISITION AND DISPOSAL OF INTRA-GROUP ASSETS

4.13 The Board's Position Paper summarised problems and uncertainties which arise in the current tax treatments that apply to the acquisition³⁹ and disposal of intra-group assets (apart from membership interests).

4.14 In relation to the acquisition of intra-group assets, the Board's Position Paper proposed that (Position 3.1):

- the tax cost of an intra-group asset⁴⁰ that does not have a corresponding accounting liability which is recognised elsewhere in the consolidated group should be recognised for income tax purposes;

39 An intra-group asset is acquired when it becomes intra-group by virtue of an entity joining the group, regardless of whether the asset was owned by the group or by the joining entity.

40 The tax cost of the intra-group asset will be equal to the actual cost of acquisition if acquired directly by the consolidated group, or will be equal to the tax cost setting amount of the intra-group asset if acquired indirectly by the consolidated group.

- this tax cost should be recognised when the consolidated group subsequently disposes of the asset or when the asset lapses intra-group; and
- the income tax history the intra-group asset had prior to coming into the consolidated group should be treated as irrelevant when the consolidated group subsequently disposes of the intra-group asset or the asset lapses.

4.15 In relation to the disposal of intra-group assets (apart from membership interests), the Board's Position Paper proposed changes to the operation of the 'intra-group liability adjustment'⁴¹ in the consolidation tax cost setting rules that applies when an entity leaves a consolidated group.

4.16 The Board also proposed that the intra-group liability adjustment should be modified so that (Position 3.2):

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

Views in submissions

4.17 Stakeholders supported the proposal that the tax cost of an intra-group asset acquired by a consolidated group should be recognised for income tax purposes.

4.18 However, submissions disagreed that the tax cost should only be recognised when the consolidated group subsequently disposes of the asset or when the asset ceases to be recognised on becoming an intra-group asset. This was on account of the additional compliance costs that would be imposed due to the need to track intra-group assets within the consolidated group.

4.19 To address the Board's concern that granting an immediate tax deduction or capital loss on acquisition of an intra-group asset could have revenue consequences that are unsustainable for the Government, some submissions proposed that the tax cost of intra-group assets be amortised over a period of time.

4.20 Although stakeholders generally agreed with the Board's position in relation to the disposal of intra-group assets, submissions raised a number of specific issues requiring clarification.

4.21 In particular, the Corporate Tax Association and the Minerals Council of Australia expressed concerns in their joint submission regarding the requirement that

41 Section 711-40 of the ITAA 1997.

an intra-group asset not have a 'corresponding liability' owed to it by a member of the old group.

4.22 Submissions also sought clarification as to when an intra-group asset would 'not have a corresponding accounting liability which is recognised elsewhere in the consolidated group', and some questioned the need for this condition.

The Board's consideration

4.23 The Board considers that the tax cost of an intra-group asset acquired by a consolidated group should be recognised for income tax purposes, whether the asset is acquired directly or indirectly by the consolidated group. This will ensure that real economic outlays of a consolidated group will be recognised for income tax purposes.

4.24 In determining when the tax cost of an acquired intra-group asset should be recognised, the Board explored three options:

- the ending/creation model – under this model the tax cost of an intra-group asset would be recognised at the time when the intra-group asset is brought into the consolidated group;
- the disposal model – under this model the tax cost of an intra-group asset would be recognised at the time when the intra-group asset is sold to a third party or lapses within the consolidated group; and
- the amortisation model – under this model the tax cost of an intra-group asset would be recognised over an amortisation period starting at the time when the intra-group asset is brought into the consolidated group.

4.25 The Board does not support the disposal model as it does not reflect the in-substance commerciality of the transactions undertaken by a consolidated group with a third party and requires intra-group assets to be tracked even though they are taken to cease to exist within the consolidated group. The disposal model may also give rise to integrity risks as consolidated groups may be able to manipulate tax outcomes by cancelling intra-group rights within the group to bring forward the time that the tax costs are recognised.

4.26 The amortisation model is not supported as it also requires intra-group assets to be tracked even though they are taken to cease to exist within the consolidated group and would add complexity to the law. As a result, the amortisation model may also give rise to integrity risks.

4.27 The Board has concluded that the ending/creation model provides a more robust policy for recognising the tax costs of intra-group assets. This model is consistent with the single entity rule principle and is simpler than the alternative models as it alleviates the need for consolidated groups to track intra-group assets within the group.

Acquisition of intra-group assets

4.28 Under the ending/creation model, an intra-group asset acquired by a consolidated group, whether directly or indirectly, will be taken to come to an end at the time the intra-group asset is brought within the consolidated group.

4.29 Consequently, the tax cost incurred by the consolidated group to acquire the intra-group asset, whether directly or indirectly, should be recognised in the same way that it would be recognised under the income tax law if a single entity paid the same amount to bring to an end obligations it owed to a third party.

4.30 Thus, for example, the acquisition of an intra-group licence from a third party should be treated in the same way that a single entity would be treated if it paid an amount to cancel its licence obligations to the third party. This would typically give rise to a deduction or capital loss for the entity depending on the character of the outlay.

4.31 In developing rules to implement the ending/creation model, some exceptions to the principle may be needed. For example, where the intra-group asset is a debt interest, application of the ending/creation model to the acquisition of the asset may cause unintended consequences to arise that may give consolidated groups better tax outcomes than taxpayers who have not consolidated. Therefore, the application of the ending/creation model to intra-group assets that are debt interests should be further considered during the development of rules to implement the model. Other exceptions should be considered on a case by case basis.

Disposal of intra-group assets

4.32 Under the ending/creation model, when an intra-group asset is sold by a consolidated group, whether directly or indirectly, the asset will be taken to be created at that time (that is, at the time the intra-group asset emerges from the consolidated group).

4.33 Where intra-group rights are directly sold to a third party, the ending/creation model will result in the transaction being treated as the grant of new rights to a third party for the purposes of determining the tax outcomes which apply under the CGT rules. Different CGT provisions would apply depending on the types of rights which are granted by the consolidated group.⁴²

4.34 For example, if lease rights are created over land within a consolidated group, the lease rights will be an intra-group asset and should be ignored under the single entity rule. If a third party then pays an amount to acquire these lease rights, the consolidated

42 For example, CGT event D1 (in relation to creating contractual or other rights), CGT event D2 (in relation to the granting of an option), CGT event D3 (in relation to the granting of a right to income from mining) and CGT event F1 (in relation to the granting of a lease).

group should be treated as granting new lease rights to the third party and should make a capital gain.⁴³

4.35 This will align the treatment of consolidated groups (treated as a single taxpayer under the single entity rule) with the treatment of taxpayers under the general tax law.

4.36 The Board considers that the income tax history which an intra-group asset has prior to coming into a consolidated group is irrelevant when the consolidated group subsequently disposes of the intra-group asset or the asset lapses. The adoption of the ending/creation model will ensure that the income tax history of an intra-group asset ceases to be relevant once the intra-group asset is acquired by a consolidated group and comes to an end.

The intra-group liability adjustment

4.37 Where an entity leaves a consolidated group holding intra-group rights (so that the intra-group rights are indirectly sold by the consolidated group to a third party), the intra-group liability adjustment applies to determine the relevant tax outcomes. This adjustment operates only where a member of the old group owes a 'liability' to the leaving entity⁴⁴.

4.38 The Board considers that the intra-group liability adjustment should not be restricted in its operation to cases where the intra-group liability is recognised as an accounting liability (as proposed in the Government's announcement on 13 May 2008⁴⁵). This would place too restrictive a scope on the meaning of 'liability' in the intra-group liability adjustment.

4.39 Instead, as proposed in its Position Paper, the Board recommends that the intra-group liability adjustment should apply to liabilities and other similar types of obligations owed by a member of the old group to the leaving entity.

4.40 In its Position Paper, the Board proposed that the intra-group liability adjustment should operate only when a leaving entity takes an intra-group asset which 'does not [emphasis added] have a corresponding liability owed to it by a member of the old group'. Submissions commented that this proposal was ambiguous and difficult to justify.

4.41 The Board has reviewed this position and agrees that the intra-group liability adjustment should also apply where an intra-group asset does have a corresponding liability owed by a member of the old group. For example, where a consolidated group indirectly disposes of an intra-group loan receivable, there will be a corresponding

43 Under CGT event F1.

44 Subsection 711-40(1) of the ITAA 1997.

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

liability owed by a member of the old group. In this case, the intra-group liability adjustment should apply to ensure that the market value of the intra-group asset is included in a leaving entity's allocable cost amount. Otherwise, the consolidated group could make a capital gain when, in substance, it enters into a transaction to make a new loan to a third party.

4.42 Submissions sought further clarification on the Board's position as to whether the intra-group liability adjustment applies correctly when a consolidated group sells an entity which holds rights in the form of an encumbrance over an underlying asset belonging to the consolidated group.

4.43 The intra-group liability adjustment has special rules which apply when a leaving entity holds the following types of encumbrances over an underlying asset belonging to the consolidated group: lease rights, licence rights, option rights and rights to income from mining.

4.44 The CGT rules apply a special tax treatment in respect of the creation of these types of encumbrances. When a taxpayer grants these rights to a third party over an underlying asset, any consideration it receives from the third party is generally treated as a capital gain for the taxpayer.⁴⁶ The capital gain is only offset by costs the taxpayer may incur on granting or creating the rights for the third party.

4.45 The imposition of a capital gain is appropriate in these circumstances because the cost base of the taxpayer's underlying asset is not reduced as a result of the grant of these rights.

4.46 Applying the ending/creation model, where a consolidated group receives a payment for disposing of an existing intra-group asset in the form of an encumbrance over an underlying asset, the consolidated group will be taken to have granted or 'created' new rights over an underlying asset to a third party for payment.

4.47 Given the general law will impose a capital gain on the creation of these intangible rights, the Board considers that the correct policy outcome is for a consolidated group to also make a capital gain when it 'creates' the same rights via disposing of intra-group rights to a third party.

4.48 The Board notes that the existing intra-group liability adjustment achieves these outcomes.

46 See CGT event D1 (in relation to creating contractual or other rights), CGT event D2 (in relation to the granting of an option), CGT event D3 (in relation to the granting of a right to income from mining) and CGT event F1 (in relation to the granting of a lease).

Interaction with other provisions in the income tax law

4.49 The Board considers that, as part of developing rules to implement the ending/creation model, consideration should be given as to how those rules will interact with other provisions in the income tax law to ensure appropriate tax outcomes arise.

4.50 An example is the interaction between the ending/creation model for intra-group assets and the tax rules governing foreign currency gains and losses.⁴⁷ Rules may need to be designed to ensure that, for example, when a consolidated group has a foreign currency denominated liability owing to a third party, and that liability becomes intra-group and is taken to 'end' where the consolidated group acquires the corresponding foreign currency receivable, the ending of the foreign currency denominated liability should trigger a foreign currency exchange event. The amount paid by the consolidated group to acquire the foreign currency receivable should be taken to be the amount paid by the group to extinguish its third party foreign currency liability.

Recommendation 4.1:

The Board recommends that the ending/creation model be applied to ensure that the tax costs of intra-group assets (apart from membership interests) acquired or disposed of by consolidated groups, whether directly or indirectly, are appropriately recognised. Some exceptions to the ending/creation model may be needed and should be considered on a case by case basis.

The Board also recommends that the intra-group liability adjustment should apply to liabilities and other similar types of obligations owed by a member of the old group to the leaving entity, regardless of whether or not the liability is recognised for accounting purposes.

VALUE SHIFTING RULES FOR INTRA-GROUP TRANSACTIONS

4.51 The Board's Position Paper identified that, where the single entity rule applies to ignore the taxation consequences of intra-group dealings within a consolidated group, value shifts may not be appropriately recognised in the tax system.

4.52 The Board therefore proposed (at Position 3.3) that additional integrity provisions be designed to address inappropriate outcomes that arise from consolidated groups using intra-group transactions to create value shifts.

47 Division 775 of the ITAA 1997.

Views in submissions

4.53 Although stakeholders generally agreed that integrity provisions would be required to address the cases raised in the Board's Position Paper, submissions were unanimous in expressing that caution be applied in designing any integrity provisions as these could impose significant complexity and compliance costs on consolidated groups, especially where they are required to track intra-group transactions.

4.54 A number of submissions, including the joint submission from the Institute of Chartered Accountants in Australia and The Tax Institute and the submission from Ernst & Young, also commented that integrity issues only appeared to arise in a limited range of circumstances, and that integrity rules should target these circumstances.

4.55 Pitcher Partners raised concerns that any additional integrity provisions which had too broad an application could significantly impact on consolidated groups in the middle market sector.

... we would be gravely concerned if these provisions were drafted in such a broad manner that they imposed compliance burdens on taxpayers in the middle market in relation to 'vanilla' transactions that do no more than 'tidy up' an entity prior to it leaving a consolidated group.

Pitcher Partners

The Board's consideration

4.56 The Board agrees that any integrity rules should be appropriately targeted to address the specific integrity risks which arise and should not result in unintended consequences where ordinary commercial transactions are entered into by these groups.

4.57 The Board also agrees that any integrity rules should not require consolidated groups to track intra-group transactions which would impose substantial compliance costs.

Disposal of encumbered assets subject to intra-group rights

4.58 From its investigations and based on stakeholder comments, the Board has concluded that integrity issues only arise when an encumbered asset whose market value has been reduced, due to the intra-group creation of rights over the encumbered asset, are sold by a consolidated group. This could arise if the encumbered asset is sold directly or indirectly. The Board therefore considers that any integrity rules should be specifically targeted to this case and should not affect other transactions which may result in value shifts within a consolidated group.

4.59 Where a consolidated group sells an encumbered asset that is subject to rights belonging to another member of the group, the group would make a reduced taxable

gain on sale of the encumbered asset. The reduction would typically be equivalent to the market value of the rights which the group retains.

4.60 If the consolidated group sells the encumbered asset directly to another entity, it could receive a market value cost base in the rights it retains.⁴⁸ If the consolidated group sells an entity which holds the encumbered asset, the consolidation rules will give the group a market value cost base in the rights it retains.⁴⁹

4.61 The Board considers it inappropriate for a consolidated group to benefit from making a reduced taxable gain on sale of the encumbered asset and at the same time be entitled to recognise a market value cost base in the rights it retains. The consolidated group effectively receives a double benefit in this circumstance.

4.62 The Board therefore recommends that integrity rules should be designed to address any double benefit which arises when an encumbered asset whose market value has been reduced, due to the intra-group creation of rights over the encumbered asset, are sold by a consolidated group, whether directly or indirectly.

4.63 The Board also suggests that consideration be given to whether an objective 'purpose test' should be incorporated into the design of the integrity rules. This may be appropriate if the integrity rules result in unintended consequences or substantial compliance costs for consolidated groups.

Acquisition of encumbered assets where rights become intra-group

4.64 The Board also investigated the tax outcomes that arise when a third party encumbered asset which is subject to rights held by a consolidated group is subsequently acquired by the consolidated group. This results in the rights held by the consolidated group becoming intra-group rights, and the consolidated group effectively acquiring full ownership over the unencumbered asset.

4.65 Under the current law, a consolidated group which buys an encumbered asset will never be able to recognise the tax cost it previously paid to acquire the rights which become intra-group.

4.66 The ending/creation model will allow the tax cost of such intra-group rights to be recognised at the time the rights are brought into the consolidated group and are taken to come to end. This will also ensure that the consolidated group does not need to track the existence of the rights within the group.

48 This depends on the operation of the deemed cost base rules in the CGT provisions (under Division 112 of the ITAA 1997).

49 Sections 701-20 and 701-60 of the ITAA 1997.

Recommendation 4.2

The Board recommends that integrity rules should be designed to address any double benefit which arises when an encumbered asset, whose market value has been reduced due to the intra-group creation of rights over the encumbered asset, is sold by a consolidated group, whether directly or indirectly.

EXTENSION OF THE SINGLE ENTITY RULE TO THIRD PARTIES

4.67 With some limited exceptions, the single entity rule does not apply to an entity outside a consolidated group (a third party) which deals or transacts with a member of the consolidated group.

4.68 Consequently, although a transaction between members of a consolidated group does not give rise to any income tax consequences for the group, the transaction may affect the income tax position of a third party who deals with the group. This can occur when a provision of the income tax law requires a taxpayer to have regard to the transactions, assets or liabilities of another party. If the other party is a consolidated group, the taxpayer may need to recognise transactions, assets or liabilities that are ignored by the group.

4.69 The Board's Position Paper concluded that the single entity rule should be extended to third parties in a broader range of circumstances, and that it would be preferable for this to be done on a principled basis rather than purely on a case by case basis.

4.70 The Board therefore proposed (at Position 3.4) that the single entity rule (together with other parts of the consolidation provisions) should be extended to third parties who are:

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

4.71 The Board also proposed that consideration 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.

Views in submissions

4.72 Stakeholders generally agreed with the Board's proposal as a broad principle. However, the majority of stakeholders stated that the single entity rule should not be extended to these types of third parties in all cases, but instead on a case by case basis.

In our view a general rule to extend the single entity rule either to all third parties or to the three categories noted above [shareholders, liquidators and related parties] is probably not warranted. Any extension of the SER should be implemented by specific rules relevant to the particular provisions concerned, in some central location in the Act for any modifications. This could be in Division 701.

Ernst & Young

4.73 Submissions also noted that the use of an 'associate' test to determine whether a third party is related to a consolidated group would be difficult to apply for taxpayers, and could result in substantial uncertainty.

4.74 Submissions identified a number of specific provisions in the tax law to which they considered the single entity rule should apply, or should not apply. Submissions agreed with the Government's announcement on 13 May 2008 that the single entity rule should extend to the operation of CGT event K6 (regarding pre-CGT shares and trust interests) and the operation of the CGT discount rules.

4.75 The Corporate Tax Association and the Minerals Council of Australia stated that the single entity rule should not extend to the operation of the non-resident CGT rules⁵⁰, as it would alter the current operation of the rules for existing groups owned by foreign entities.

4.76 Deloitte noted that taxpayers could manipulate tax results if the single entity rule applied to direct shareholders but not to indirect shareholders. This would be particularly relevant for the operation of the CGT discount and the operation of the non-resident CGT rules.

4.77 CPA Australia commented that extending the single entity rule for the purposes of the operation of Division 7A (regarding distributions to entities connected with a private company) should alleviate anomalies arising with the interaction of that division and the consolidation rules.

4.78 A few submissions commented that extending the single entity rule for the purposes of the small business CGT concessions would also be appropriate. Pitcher Partners noted that it would be appropriate for the single entity rule to apply to both direct and indirect shareholders in this case.

4.79 The Institute of Chartered Accountants in Australia and The Tax Institute noted that extending the single entity rule to shareholders of a MEC group will raise specific issues which would need to be addressed, particularly in the operation of the non-resident CGT rules and Australia's double tax agreements.

50 Division 855 of the ITAA 1997.

The Board's consideration

4.80 The Board agrees that, although the general principles it proposed in its Position Paper would be appropriate to guide the extension of the single entity rule to third parties, any extensions should be considered on a case by case basis with regard to specific provisions in the tax law.

4.81 The Board also notes the suggestions raised by stakeholders for the single entity rule to be extended to third parties under a number of specific tax provisions. The Board considers that these suggested extensions be considered in further public consultation before they are adopted, to ensure unintended consequences do not arise.

4.82 The Board therefore recommends that, as a guiding principle, the single entity rule should apply when a provision in the income tax law applies to a transaction between a consolidated group and a third party that is either a shareholder of the head company of the group, a liquidator appointed to a member of the group or a third party that is an associate of the group. That is, the relevant third party should be taken to deal with the consolidated group as a single entity for the purpose of applying the relevant income tax provision.

4.83 However, the application of this principle in specific cases should be assessed on a case by case basis having regard to the following factors:

- the appropriateness of the tax outcomes that arise;
- whether the third party would reasonably have knowledge that the entity it is dealing with is part of a consolidated group and the character that the transaction has for that group;
- whether the rule is difficult to apply in practice;
- the effect on the revenue; and
- any other relevant matters.

4.84 The Board considers that, to support clarity and simplicity in the law, cases where the effect of the single entity rule is taken to extend to third parties should be incorporated into a single location within the consolidation provisions.

4.85 The Board also considers that shareholders should be consulted to prioritise the determination of the circumstances in which the single entity rule should be extended. Prioritisation could be undertaken based on how commonly each circumstance arises in commercial practice, or based on the financial magnitude of the transactions concerned.

Recommendation 4.3

The Board recommends that, as a guiding principle, the effect of the single entity rule should be extended when a provision in the income tax law applies to a transaction between a consolidated group and a third party that is either a shareholder of the head company of the group, a liquidator appointed to a member of the group or a third party that is an associate of the group. However, the application of this principle in specific cases should be assessed on a case by case basis.

CHAPTER 5: INTERACTION BETWEEN THE CONSOLIDATION REGIME AND OTHER PARTS OF THE INCOME TAX LAW

5.1 The Board identified in its Position Paper a number of issues and uncertainties that arise as a result of the interaction between the consolidation regime and other parts of the income tax law.

5.2 These issues fall into five broad but overlapping categories:

- taxation of trusts;
- consolidation membership rules;
- international tax issues;
- CGT issues; and
- deferred tax assets and liabilities.

TAXATION OF TRUSTS

5.3 The Board's Position Paper identified two issues that arise as a result of the interactions between the trust provisions and the consolidation provisions:

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

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

5.4 To overcome the issues that currently arise when determining the net income of a trust that is a member of a consolidated group for part of an income year, the Board's Position Paper proposed (at Position 4.1) that the amount be determined:

- 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; and

- 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.

5.5 The Board also proposed 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 4.2).

5.6 Following the release of the Board's Position Paper, the Government announced that the trust provisions will be rewritten to overcome uncertainties that have arisen following the recent High Court decision in *Bamford*.⁵¹ As first steps towards updating and rewriting the trust income tax provisions, the Government released a discussion paper on 4 March 2011⁵² and a consultation paper on 21 November 2011.⁵³

5.7 As the issues relating to the determination of a trust's net income mainly arise because of the operation of the trust provisions, the Board recommends that these issues be considered as part of the rewrite of the trust rules.

5.8 In relation to the determination of these amounts prior to the finalisation of the new trust rules, the ATO has advised the Board that taxpayers have generally been using methods which achieve an appropriate outcome in determining the net income of a trust that is a member of a consolidated group for part of an income year.

Recommendation 5.1

The Board recommends that the issues relating to the determination of the amount of a trust's net income that is assessed to each beneficiary and/or trustee when the trust is a member of a consolidated group for part of an income year be considered as part of the rewrite of the trust income tax provisions.

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

5.9 When a consolidated group acquires a trust part way through an income year, it may adjust the price it pays to reflect any tax that the group expects to pay on its share of net income for the trust's non-membership period.

51 Media release No 025 of 16 December 2010 issued by the then Assistant Treasurer, in response to the decision in *Bamford v Commissioner of Taxation* [2009] FCAFC 66.

52 Discussion Paper - Improving the taxation of trust income, March 2011 - <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2011/trust-income-tax>.

53 Consultation Paper - Modernising the taxation of trust income - options for reform, November 2011 <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2011/modernising-trust-income-tax>.

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

5.11 In the Position Paper, the Board proposed that a consolidated group's tax liability in relation to the net income of a trust's non-membership period should be included as a liability in working out the allocable cost amount of a trust that joins a consolidated group (Position 4.3).

5.12 Stakeholders generally agreed with the Board's proposal in principle, but raised some technical issues about how the proposal could be implemented. For example, the Corporate Tax Association and Minerals Council of Australia suggested that:

- the definition of liability in this context should be the relevant share of net income multiplied by the corporate tax rate; and
- the liability should not be reduced by any tax attributes such as losses of the acquiring group that may apply to reduce this liability following the joining time.

5.13 In addition, the Institute of Chartered Accountants in Australia and The Tax Institute suggested that the deferred tax liabilities inherited by the head company should also be included in the calculation of the allocable cost amount.

5.14 The Board considers that these technical issues should be considered in the development of legislation to implement the recommendation, having regard to the outcomes of the Board's investigation of the treatment of liabilities under the consolidation regime.

5.15 The Board notes that, in implementing this recommendation, the outcomes of the rewrite of the trust provisions in the income tax law will also need to be taken into account.

Recommendation 5.2

The Board recommends that, subject to the outcomes of the Board's review of the treatment of liabilities under the consolidation regime, a consolidated group's tax liability in relation to the net income of a trust's non-membership period should be included in the calculation of the allocable cost amount of a trust that joins a consolidated group part way through an income year.

CONSOLIDATION MEMBERSHIP RULES

5.16 The Board considered the application of the consolidation membership rules as they relate to:

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

Applying the consolidation membership rules to trusts

Membership of a consolidated group — the trustee

5.17 To overcome difficulties that arise when a trustee remains outside the consolidated group or is a member of a different consolidated group, the Board proposed in its Position Paper that the consolidation membership rules be amended to treat a trustee, in its capacity of trustee of a trust that is a member of a consolidated group, as a member of the same consolidated group as the trust (Position 4.4).

5.18 Although some stakeholders expressed the view that the current law can be interpreted to achieve appropriate outcomes, others were of the view that the Board's position would overcome difficulties that arise when a trustee is a member of more than one consolidated group. They also submitted that the Board's proposal would provide certainty.

5.19 One submission also suggested that any amendments should specify that a change in trustee will not result in a trust joining or leaving a consolidated group.

5.20 One of the Board's criteria when conducting reviews is to ensure legislation is expressed in a clear, simple, comprehensible and workable manner. As there is some uncertainty about the operation of the current law, the Board recommends that the legislation be amended to clarify that, for the purposes of applying the consolidation provisions:

- a trustee, in its capacity of trustee of a trust that is a member of a consolidated group, will be treated as a member of the same consolidated group as the trust; and
- a change in trustee will not result in a trust joining or leaving a consolidated group.

Recommendation 5.3

The Board recommends that the tax law be clarified so that, for the purposes of applying the consolidation provisions:

- a trustee, in its capacity of trustee of a trust that is a member of a consolidated group, will be treated as a member of the same consolidated group as the trust; and
- a change in trustee will not result in a trust joining or leaving a consolidated group.

Membership of a consolidated group — beneficiaries

5.21 To overcome difficulties that arise when a trust is a member of a consolidated group, but the beneficiary of the trust remains outside the consolidated group, the Board proposed in its Position Paper that the consolidation membership rules be amended to ensure that a trust will only qualify as a member of a consolidated group if all the beneficiaries, including debt beneficiaries, unit holders or objects of a trust, are subsidiary members of the consolidated group (Position 4.5).

5.22 The majority of submissions generally agreed with the Board's proposal.

5.23 The Corporate Tax Association and Minerals Council of Australia do not support the Board's proposal on the basis that it is inconsistent with the treatment of companies and may be contrary to the outcomes of the review of managed investment trusts.

5.24 The Institute of Chartered Accountants in Australia and The Tax Institute generally agreed with the Board's proposal. However, they questioned whether debt beneficiaries should be excluded from the scope of the trust provisions. They also highlighted some technical issues that would need to be resolved. For example, if a debt beneficiary can become a member of a consolidated group, a key issue that will need to be addressed is the extent to which the debt beneficiary should be jointly and severally liable for a group liability under a tax sharing agreement. Pitcher Partners also expressed similar views.

5.25 The Board notes that the trust provisions are currently in the process of being rewritten. The Board therefore recommends that the treatment of debt beneficiaries should be reviewed in the context of the outcomes arising from the rewrite of the trust provisions.

Recommendation 5.4

The Board recommends that:

- a trust should qualify as a member of a consolidated group only if all members including beneficiaries, unit holders or objects of the trust, are also members of the consolidated group; and
- the treatment of debt beneficiaries of the trust should be reviewed in the context of the rewrite of the trust provisions.

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

5.26 In its Position Paper, the Board proposed that non-resident entities that satisfy the foreign hybrid rules should be eligible to become members of a consolidated group (Position 4.6).

5.27 All stakeholders supported this proposal. Although stakeholders claimed to be unaware of any integrity risks, the Board recommends that this position be reviewed in the event that the ATO identifies any integrity risks.

Recommendation 5.5

The Board recommends that there should be no change to the foreign hybrid rules. However, the Government should continue to monitor whether any integrity risks may arise.

INTERNATIONAL TAX ISSUES

Operation of the non-resident CGT rules

5.28 The Board's Position Paper outlined proposals to overcome the following concerns that arise as a result of the interaction between the consolidation regime and the non-resident CGT rules:⁵⁴

- moving Australian assets within a MEC group and then disposing of them without recognising a capital gain; and
- uplifting the cost base of Australian assets where there is no change in the underlying beneficial ownership of assets without recognising a capital gain.

54 Division 855 of the ITAA 1997.

5.29 Some submissions expressed the view that the general anti-avoidance rules⁵⁵ were sufficient to cater for these situations where necessary. However, as the Board previously quoted in its Position Paper, Justice Richard Edmonds noted the following in his article in *Lawyer's Weekly*:

It is not in the interests of the ATO to have to fall back, as a matter of last resort, on Part IVA and taxpayers certainly don't embrace such resort. Part IVA cases are never easy and the outcome is, in many cases, tinged with uncertainty.⁵⁶

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

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

5.31 The current interaction between the consolidation regime and the non-resident CGT rules enable a MEC group to use its structure and the consolidation rules to move assets within the MEC group and then dispose of them without recognising a capital gain or loss.

5.32 This has an impact on horizontal equity as it allows MEC groups to receive benefits at a cost to the taxation revenue which may create investment distortions. In addition, foreign owned entities that form a MEC group have an advantage over other Australian and foreign owned entities.

5.33 To overcome these concerns, the Board proposed to extend the principal asset test in the non-resident CGT rules so that it includes all the assets of a MEC group (Position 4.7).

5.34 In relation to the Board's proposal, some stakeholders expressed the view that:

- the current integrity provisions in the non-resident CGT rules (in Division 855) and the general tax anti-avoidance rules would apply to overcome the integrity issues raised;
- the proposal would significantly increase costs and add complexity as all of the assets of the MEC group would need to be valued; and
- the proposal would contradict the policy behind the non-resident CGT rules.

55 Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).

56 Justice Richard Edmonds, *Lawyer's Weekly - Law's taxing sham*, 12 March 2010, pages 14 and 15.

5.35 Ernst & Young expressed concerns that the proposal may create distortions and anomalous outcomes. They did not support a *'one-way' integrity rule that would only expand the reach of Division 855'* [italics added] on the basis that such a proposal would have significant implications for existing wholly-owned group structures.

5.36 Stakeholders also submitted that if the Board forms the view that the existing integrity provisions are insufficient, then:

- the Board's proposal should only be implemented if existing MEC groups are given the option of making, revoking or altering MEC group elections to excise nominated eligible tier 1 companies from their group; and
- consideration should be given to other possible solutions, including the modification of subsection 855-30(3) so that it takes into account asset transfers that occurred within the MEC group prior to the CGT event.

5.37 The Board has been advised that the non-resident CGT rules were introduced partly to address issues around the Alienation of Property Article in Australia's previous model tax treaty that departed from the OECD Model to include a general sweep up provision that preserved Australia's right to tax gains of a capital nature not specifically dealt with in the Article.

5.38 Australia's insistence on the inclusion of this sweep up provision caused some difficulties in treaty negotiations and created pressure for Australia to provide offsetting benefits, such as agreeing to reduce rates of withholding tax in respect of dividends, interest and royalties. Moving away from this position has reduced this pressure. Further, aligning with the OECD Model facilitated the introduction of integrity measures that protected Australia's taxing rights where non-resident interposed entities are used to avoid Australian CGT selling the interposed entity, rather than the Australian assets.

5.39 Whilst Australia's source country taxing rights might be able to be expanded on a treaty by treaty basis, the offsetting tax concessions might exceed any revenue gain. It would also take many years to negotiate such changes, particularly as other countries would not have an imperative to give up their resident country taxing rights.

5.40 In light of these considerations, the Board considers that the Government should undertake further work to review the interaction of the policy principles underlying the non-resident CGT rules and the MEC group rules, taking into account integrity issues concerning the appropriate taxation of Australian corporate groups.

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

5.41 Another concern that arises as a result of the interaction between the consolidation regime and the non-resident CGT rules is that consolidated groups that are wholly-owned by a non-resident entity and MEC groups can uplift the cost base of

Australian assets where there has been no change in their underlying beneficial ownership without recognising a capital gain.

5.42 Where an entity joins another consolidated group or MEC group, the cost base of the joining entity's assets can be uplifted even though the vendor is not taxable on the capital gain made on the disposal of the membership interests.

5.43 To overcome these concerns, the Board proposed to retain the tax costs of a foreign owned entity's assets where a foreign resident disregards a capital gain or capital loss under the non-resident CGT rules if there is no change in the underlying beneficial ownership of the assets (Position 4.8).

5.44 In relation to the Board's position, some submissions expressed the view that:

- the current integrity provisions in Part IVA should apply to overcome the integrity issues raised;
- the proposal has the potential to distort investment decisions which may impede business or asset restructures; and
- any additional integrity provisions would complicate commercially driven restructures and increase compliance costs.

5.45 Although submissions expressed these views, they also expressed the view that if the Board proceeds with the proposal, then:

- any limitation of the setting of the tax cost of the assets of the transferred entity on joining the new group should also apply in cases where a capital loss is disregarded under Division 855;
- the Board's proposal should apply only where relevant assets have been majority owned for more than 2 years;
- the tax cost of the membership interests of the acquired entity should be quarantined and recognised in the event that the entity leaves the group;
- the proposal should apply prospectively; and
- suitable transitional rules should apply to existing structures.

5.46 The joint submission received from the Corporate Tax Association and Minerals Council of Australia included the following suggestions:

... the non-resident vendor of the transferred entity may have acquired the transferred entity for a significant amount, and therefore if using this original cost as the ACA step 1 amount would result in the tax value of asset being stepped up above their existing tax values, then this stepped up reset tax cost base amount should instead apply.

Secondly, what is not acknowledged in this BoT proposal is that the tax-free status of the group's shareholding in the non-TARP transferred entity is being terminated by this transfer. Given that this tax-free status is likely to be an extremely valuable tax characteristic, it would be inappropriate and inequitable if some ongoing recognition was not obtained in regard to the termination of this attribute. To balance these equity concerns underlying Position 4.7, the CTA/MCA propose that some limited recognition continue to be provided in relation to the market value of shares in the transferred Australian subsidiary as at the transfer date, as follows.

- (i) If assets of the transferred subsidiary are subsequently directly disposed of, then, as per BoT Position 4.8, gains and losses should be calculated by reference to their pre-existing tax value (or their limited stepped up amount as per the previous proposal above).
- (ii) However, if an entity holding such assets is subsequently disposed of by the group, then the Division 711 exit cost base of shares in that subsidiary should be calculated by reference to what otherwise would have been the tax value of the relevant assets.

A similar 'outside basis' consolidation approach currently applies to certain formerly privatised assets and therefore it should be relatively straightforward to implement (refer section 705-47 and section 711-25).

5.47 The joint submission received from the Institute of Chartered Accountants in Australia and The Tax Institute suggested that the Board's proposal apply only where relevant assets have been majority owned for more than 2 years because:

... as part of a global acquisition it is not uncommon for a multinational group multinational group to acquire entities at the non-resident level and subsequently rationalise its ownership structures in relevant jurisdictions. The effect of Position 4.8 is that these groups would be disadvantaged as compared to the possible outcome that would have emerged had the Australian consolidated group made the acquisition from the third party (a position that is not always commercially possible).

5.48 In reviewing the comments received in submissions and deciding on an appropriate measure to address the concerns identified, the Board affirms its view stated in its Position Paper that the general anti-avoidance rules in Part IVA should not be relied upon as a primary measure to address these concerns. Instead, the Board considers that specific integrity provisions should be designed to address these concerns.

5.49 The Board does not support the suggestion that the tax costs of the transferred entity's assets be retained only where the relevant assets have been majority owned for more than 2 years, as it considers this would limit the intended scope of this measure. Instead, the Board considers a 12 month period would be more appropriate. This would enable the tax costs of the assets of a target entity that has been recently

acquired by a foreign entity to continue to be reset where the entity is transferred into a consolidated group owned by the same foreign entity.

5.50 The Board considers that this proposal would be simpler to implement and understand compared to other measures that would seek to quarantine the tax cost of the transferred entity and to only recognise the tax cost where the entity leaves the consolidated group. Such a measure may result in some consolidated groups never recognising the tax cost if the entity never leaves the group. It may also be open to artificial arrangements where the assets of the entity can be moved elsewhere in the group enabling the entity to be sold for nominal consideration, thereby triggering a capital loss.

5.51 Whilst the Board acknowledges the suggestion that the purchase price paid by the foreign parent for the transferred entity could be applied as the Step 1 amount when the membership interests in the entity are transferred into the consolidated group, the Board considers that designing rules to achieve this would also give rise to significant complexity.

5.52 The Board therefore recommends that where the membership interests in an entity that are transferred to a consolidated group are not regarded as taxable Australian property under the non-resident CGT rules, the consolidation tax cost setting rules should only apply to the transferred membership interests if:

- there has been a change in the underlying majority beneficial ownership of the membership interests in the entity; or
- there has not been a change in the underlying majority beneficial ownership of the membership interests in the entity, but those membership interests were recently acquired by the foreign entity (or the foreign group);
 - membership interests in an entity will be recently acquired if they have been majority owned by the foreign entity (or the foreign group) for less than 12 months.

Recommendation 5.6

The Board recommends that where the membership interests in an entity that are transferred to a consolidated group are not regarded as taxable Australian property under the non-resident CGT rules, the consolidation tax cost setting rules should only apply to the transferred membership interests if:

- there has been change in the underlying majority beneficial ownership of the membership interests in the entity; or
- there has not been a change in the underlying majority beneficial ownership of the membership interests in the entity, but the membership interests in the entity were recently acquired by the foreign entity (or the foreign group);
 - membership interests in an entity will be recently acquired if they have been majority owned by the foreign entity (or the foreign group) for less than 12 months.

Application of double tax agreements to consolidated groups

5.53 The Board's Position Paper suggested that it is unclear how Australia's double tax agreements apply to consolidated groups. In particular, there is some uncertainty about whether:

- Australia's double tax agreements apply to a consolidated group, its head company, subsidiary members or a combination of these (a treaty interpretation issue); and
- for double tax agreement purposes, the single entity rule applies to attribute the actions of subsidiary members of a consolidated group to the head company of the group (a single entity rule interpretation issue).

5.54 In view of these uncertainties, the Board proposed that the Government should undertake a review to clarify how Australia's double tax agreements apply to a consolidated group (Position 4.12).

5.55 After further consideration, the Board noted that no substantive areas of concern were identified in the course of its review in relation to the operation of Australia's double tax agreements for consolidated groups. The Board therefore considers that it is unnecessary for a review to be undertaken at this stage.

5.56 The Board recommends that the Government should continue to monitor the interaction between Australia's double tax agreements and the tax consolidation rules.

Recommendation 5.7

The Board recommends that the Government should continue to monitor the interaction between Australia's double tax agreements and the tax consolidation rules.

CGT ISSUES

Operation of CGT event J1

5.57 The Board's Position Paper identified concerns about the appropriateness of the outcomes that arise under CGT event J1⁵⁷ 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.

5.58 The particular circumstances which are problematic are where the CGT assets that had been subject to a roll over (the rolled over assets) are held by:

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

5.59 The Board's 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).

5.60 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.

5.61 Although submissions raise a number of alternative options as to how CGT event J1 could be amended, the Board has not been able to draw a conclusion on recommendations that would be suitable. The Board will undertake further analysis of these issues and expects to report to the Government on its recommendations regarding CGT event J1 by the end of 2012.

Interaction between the CGT roll-over rules and the consolidation regime

5.62 The Pitcher Partners submission identified problems that arise in the interaction between the CGT roll-over rules and the consolidation rules. Pitcher Partners raised these concerns in the context of small businesses and privately owned groups wanting

57 Section 104-175 of the ITAA 97.

to restructure as wholly-owned groups using CGT roll-overs in order to facilitate entry into the consolidation regime.

5.63 The Board acknowledges that these interaction problems can be an impediment for groups of all sizes that seek to use a CGT roll-over to form a consolidated group or to bring an entity into an existing consolidated group.

5.64 In investigating ways to address these interaction problems, the Board has identified a number of complexities. This is due to the availability of several different CGT roll-overs, different policy principles supporting the operation of these roll-overs in the general law, and the presence of some special rules that facilitate appropriate tax outcomes where the consolidation rules interact with certain CGT roll-overs in particular circumstances.

5.65 The Board will undertake further work to ascertain whether a principled approach can be developed to address the problems arising in the interaction of the CGT roll-over rules and the consolidation provisions. The Board expects to report to the Government on its findings by the end of 2012.

Deferred tax assets and liabilities

5.66 The Board's Position Paper noted that there are multiple issues, complexities and inequities that arise as a result of the current treatment of deferred tax assets and liabilities in the consolidation allocable cost amount and the tax cost setting process.

5.67 The Board sought stakeholders' views on options to address these issues.

5.68 On 25 November 2011, the Government requested that the Board investigate the treatment of liabilities under the consolidation regime as part of its post-implementation review.⁵⁸

5.69 Given the substantial overlap between the treatment of liabilities and deferred tax assets and liabilities in the consolidation allocable cost amount and the tax cost setting process, the Board has decided to consider the tax treatment of deferred tax assets and liabilities as part of its review of the treatment of liabilities in the consolidation regime. The Board expects to report to the Government on its findings for this review by the end of 2012.

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

CHAPTER 6: OPERATION OF THE CONSOLIDATION REGIME FOR SMALL BUSINESS CORPORATE GROUPS

6.1 The Board identified in its Discussion Paper and Position Paper that a number of difficulties exist for wholly-owned small to medium size corporate groups which enter the consolidation regime. The predominant issues for these corporate groups are the upfront cost and complexity associated with the formation of a consolidated group.

6.2 As a result of these difficulties, only a relatively small percentage of small and medium size corporate groups have entered the consolidation regime. This is notwithstanding that the consolidation regime was originally intended to be available to corporate groups of all sizes.

6.3 Drawing on the feedback received in submissions, the Board has considered further the issues faced by small to medium size businesses structured as wholly-owned corporate groups which are eligible to enter the consolidation regime, and has made recommendations for ongoing simplified formation rules for these groups to assist them with entering the consolidation regime.

6.4 The Board has also investigated additional issues faced by other small to medium size businesses which are not structured as wholly-owned corporate groups. In particular, the Board has considered the issues faced by micro-enterprise groups, with aggregated turnover of less than \$2 million.

6.5 In its Position Paper, the Board made proposals for the small business simplified formation rules to be made available to all wholly-owned corporate groups for a limited time. The Board has further considered these proposals in light of the views expressed in submissions.

STATISTICS ON SMALL BUSINESS AND CONSOLIDATION

6.6 The tax consolidation regime is generally available only to groups of entities which are wholly-owned by a single Australian corporate taxpayer (wholly-owned corporate groups).⁵⁹

6.7 Statistics show that although a significant number of small businesses are structured as wholly-owned groups, only a relatively small proportion of these have elected to enter the consolidation regime (see Table A below).

59 The main exception to this is rules which enable Australian entities which are commonly owned by an ultimate foreign entity to elect to form a MEC group.

Table A: Consolidation statistics for wholly-owned groups

Category by turnover levels ⁶⁰	Consolidated groups	Wholly-owned groups ⁶¹	Comment
Micro enterprise < \$2m	3,304	16,330	
SME \$2m to \$10m	1,819	5,402	} 9,044 wholly-owned groups with turnover of \$2 to \$50 million
SME \$10m to \$50m	1,956	3,642	
SME \$50m to \$100m	714	1,013	
SME \$100m to \$250m	769	918	} 3,106 wholly-owned groups with turnover of more than \$50 million
Large \$250m to \$500m	382	431	
Large \$500 to \$1,000m	256	282	
Large > \$1,000m	452	462	
Total	9,652	28,480	

Source: ATO

6.8 The statistics in Table A show a clear trend that the smaller the size of a wholly-owned group, the less the likelihood that the group has chosen to enter the consolidation regime:

- of the 16,330 micro-enterprise groups (those groups with less than \$2 million turnover), only 20 per cent have elected to form consolidated groups;
- of the 9,044 small to medium size enterprise groups with turnover of \$2 million to \$50 million, 42 per cent have elected to form consolidated groups; and
- of the 3,106 medium to large enterprise groups with turnover of more than \$50 million, 83 per cent have elected to form consolidated groups.

6.9 Submissions received in response to the Board's Position Paper commented that the consolidation regime should also cater for some small business groups that operate through structures that are not wholly-owned corporate group structures. These include, for example, entities which are not wholly-owned by a single company but are instead commonly owned by a group of individuals. Submissions suggested that rules could be designed to facilitate the reorganisation of these small business structures into wholly-owned corporate groups so as to enable them to form a consolidated group.

6.10 The Board had difficulty obtaining accurate data on the number of small business structures operating in Australia. However, as a proxy, a comparison can be made between the number of small business wholly-owned groups and the number of small business 'economic groups' (which comprise groups that are owned by an Australian holding entity with at least a 50 per cent interest) (see Table B below).

60 'Turnover levels' - this is ATO segmentation according to the sum of total business income taken from each group member's latest tax return lodged for the income years between 2009 and 2011. This is different to 'aggregated turnover' under the small business entity concessions, a term which includes the turnover of connected and affiliate entities.

61 'Wholly-owned groups' - ATO data comprises all groups which are wholly-owned by an Australian holding entity.

Table B: Proportion of economic groups in the form of a wholly-owned group

Category by turnover levels ⁶²	Wholly-owned groups ⁶³	Economic groups ⁶⁴	Comment
Micro enterprise < \$2m	16,330	56,352	18,883 wholly-owned groups with turnover of \$2 to \$50 million
SME \$2m to \$10m	5,402	13,023	
SME \$10m to \$50m	3,642	5,860	
SME \$50m to \$100m	1,013	1,332	3,694 wholly-owned groups with turnover of more than \$50 million
SME \$100m to \$250m	918	1,109	
Large \$250m to \$500m	431	479	
Large \$500 to \$1,000m	282	301	
Large > \$1,000m	462	473	
Total	28,480	78,929	

Source: ATO

6.11 These statistics reveal that only 29 per cent of micro-enterprise economic groups are structured as a wholly-owned group. This contrasts with 84 per cent of medium to large economic groups (with turnover of more than \$50 million) which are structured as wholly-owned groups.

6.12 This supports comments raised by stakeholders that small business groups commonly operate through structures that are not wholly-owned corporate group structures.

SIMPLIFIED FORMATION RULES FOR SMALL TO MEDIUM SIZED CORPORATE GROUPS

6.13 In its Position Paper, the Board proposed that ongoing simplified formation rules be made available for wholly-owned small business and medium sized corporate groups to assist them with entering the consolidation regime. These proposals were designed to address the low take up of consolidation among these groups caused by the upfront compliance costs and complexity of entering the consolidation regime.

6.14 The simplified formation rules the Board proposed were similar to the transitional concessions that were originally made available when the consolidation rules were introduced. The Board proposed (under Position 5.1) that:

- ongoing simplified formation rules be made available via an election to wholly-owned corporate groups with an aggregated turnover of less than \$100 million and assets of less than \$300 million in the prior income year;

62 Refer footnote 60.

63 Refer footnote 61.

64 'Economic group' – ATO data comprises all groups which are owned by an Australian holding entity with at least a 50 per cent interest.

- if a group elects to apply the simplified rules:
 - the existing tax costs of assets for all subsidiary members should be retained (a stick approach);
 - losses held by subsidiary members that are transferred to the consolidated group should be able to be utilised over three years; and
 - the election should apply to all subsidiary members of the group; and
- the simplified formation rules should not be available for MEC groups.

6.15 The Board sought stakeholder comments on these proposed simplified formation rules.

Views in submissions

6.16 Submissions were broadly supportive of the Board's proposed simplified formation rules, but highlighted a number of issues.

6.17 The majority of submissions identified that a \$300 million asset threshold test would impose a significant compliance burden on small businesses.

[T]he assets threshold turnover of \$300 million may require annual independent valuations since many SMEs do not prepare accounts in accordance with accounting standards. Currently, under the TOFA rules, assets are valued in accordance with commercially accepted valuation principles if accounts are not prepared in accordance with accounting standards. We do not consider that an asset threshold test is, therefore, consistent with Position 5.1 and it should not be introduced.

CPA Australia

6.18 Some submissions also suggested that flexibility should be offered to consolidated groups in choosing which simplified rules to apply to particular subsidiaries.

For those companies that elect the concession in relation to the tax value of assets, it may be more appropriate to then make the 'three year drip' treatment of losses elective rather than mandatory, because in some circumstances the available fraction treatment of losses may not be complex to calculate or disadvantageous.

Corporate Tax Association / Minerals Council of Australia

6.19 The Pitcher Partners submission also commented that a separate choice should be provided for subsidiaries that had been recently acquired to adopt a 'spread' treatment for their assets. This would ensure that an amount recently paid by the group to

acquire the subsidiary could be reflected in the tax cost of the subsidiary's assets through the normal tax cost setting process.

[A] choice to 'stick' or 'spread' on an entity by entity basis must, at the very least, be available for non-majority owned subsidiary entities that have been acquired within five years of the formation of the consolidation group.

Pitcher Partners

Board's consideration

6.20 The Board considers that the cost and complexity associated with acquiring the requisite knowledge to confidently apply the consolidation formation rules is too high for small business and medium sized corporate groups and their usual accounting and tax advisers. The Board therefore recommends that ongoing simplified formation rules should be made available for small to medium size corporate groups to assist them with entering the consolidation regime.

6.21 These simplified formation rules should enable small to medium size corporate groups to enter consolidation without the complexity of tax cost setting calculations (to set the tax cost of assets brought into the group) or the complexity of available fraction calculations (to set the rate at which losses can be utilised which are brought into the group). The simplified rules should also eliminate the need for these groups to incur substantial costs in obtaining market valuations or preparing audited financial accounts as a prerequisite to entering the consolidation regime.

Eligibility criteria

6.22 The Board considers that the \$100 million aggregated turnover threshold which it originally proposed is too high and does not adequately target those small to medium size corporate groups which should benefit from the simplified formation rules.

6.23 The Board is of the view that the vast majority of groups with aggregated turnover of between \$50 and \$100 million should be able to justify the cost of engaging tax advisers to assist in preparing consolidation entry calculations against the benefits of being in the regime.

6.24 The statistics also show an increased take up of consolidation for groups with turnover of \$50 to \$100 million (of 70 per cent) compared to the take up of consolidation for groups with less than \$50 million turnover (of 28 per cent). This suggests that groups with aggregated turnover of over \$50 million are already able to enter consolidation without the need for simplified formation rules.

6.25 The Board therefore recommends that the simplified formation rules should be made available to small to medium sized corporate groups with aggregated turnover of less than \$50 million in the prior income year. The Board notes that the targeting of the simplified formation rules to groups with less than \$50 million aggregated turnover

should also reduce the revenue cost associated with the introduction of the simplified rules.

6.26 The definition of aggregated turnover should be consistent with that under the small business entity concessions,⁶⁵ which includes the turnover of connected and affiliate entities. Although some submissions suggested that the test should apply to the turnover of the wholly-owned corporate group, the Board considered that this could be vulnerable to manipulation and that the aggregated turnover test would provide a degree of integrity for these simplified formation rules. The Board also considers that the aggregated turnover test under the small business entity concessions should already be familiar and understood by small to medium size businesses.

6.27 The Board agreed with comments raised by stakeholders that an asset threshold test would require independent valuations or the preparation of audited financial accounts, and would thus impose a significant compliance burden on small businesses. It therefore considers that an asset threshold test should not be incorporated into the eligibility criteria for the simplified formation rules unless, on further examination by the Government, this would allow very large businesses to obtain unintended benefits from these simplified rules.

6.28 The Board also notes that there may be some small to medium sized corporate groups whose aggregated turnover is just over the recommended \$50 million threshold. These groups will still be able to take advantage of the transitional consolidation simplified formation rules which the Board recommends should be available to all wholly-owned corporate groups for a limited period of time (under Recommendation 6.3 below).

Election to apply the simplified formation rules

6.29 The Board considers that, as a base case, small business and medium sized corporate groups which form a consolidated group should be able to make a single election to apply the simplified formation rules.

6.30 If a simplified formation rules election is made, the consolidated group should retain the existing tax costs of assets held by subsidiary members (the stick concession) and be entitled to apply the simplified loss utilisation rule.

65 Section 328-115 of the ITAA 1997.

6.31 In considering the operation of the simplified loss utilisation rule, the Board was of the view that this simplified rule should be made available only for losses which can be transferred into the new consolidated group on the basis of satisfying the continuity of ownership test (that is, 'COT transfer losses'). This is consistent with the original transitional loss rules which applied when the consolidation regime was first introduced.

6.32 On a consideration of preliminary revenue costs, the Board considered that its proposed three year utilisation period for COT transfer losses was not sustainable as part of an ongoing simplified formation rule. The Board therefore recommends that a five year utilisation period apply for COT transfer losses under the simplified loss utilisation rule. However, the Board acknowledges that, having regard to revenue considerations, the Government could adopt a different loss utilisation period.

6.33 Although stakeholders commented that the simplified formation rule should be made available on an entity by entity basis, the Board was of the view that this would add complexity to the operation of the simplified rules, and would defeat the intended purpose of the simplified rules as compliance saving measures.

6.34 The Board therefore recommends that where an eligible group forms a consolidated group and makes a simplified formation rules election, the stick concession should apply to *all* subsidiary members in the consolidated group which is formed and the simplified loss utilisation rule should apply to COT transfer losses from *all* entities in the group. This base case treatment may be modified where a consolidated group also makes an available fraction election or a recently acquired entity election, which are discussed below.

Flexibility for groups to elect to apply an available fraction method for losses

6.35 The Board considers that the majority of small to medium sized corporate groups wanting to take advantage of the simplified formation rules would only need to make a single simplified formation rules election to enable them to apply both the stick concession and the simplified loss utilisation rule.

6.36 However, some small to medium sized corporate groups may wish to depart from the base case election to apply an available fraction method for the utilisation of their COT transfer losses. This would require consolidated groups to undertake further calculations and will involve increased complexity, but would be beneficial in providing flexibility in the rules for the few groups that may be disadvantaged in applying the simplified loss utilisation rule. Stakeholders also identified that there may be cases where the available fraction may be easy to calculate.

6.37 The Board therefore considers that, where an eligible group has made a simplified formation rules election, it should be given a choice to make an 'available fraction election' under which the rate of utilisation of COT transfer losses from *all*

entities in the consolidated group should be calculated based on the ordinary available fraction rules.

Exception for recently acquired entities

6.38 The Board is of the view that an exception to the simplified formation rules election would be appropriate for entities which have been recently acquired by a group. In these cases, as was raised by submissions, sticking with the existing tax costs of assets held by a recently acquired entity may not reflect the amount recently paid by the group to acquire the entity.

6.39 Whether or not an entity has been recently acquired should be assessed based on whether the entity has been majority owned by the group for the previous three years. Where an entity has not been majority owned for the previous three years, it should be taken to be a recently acquired entity.

6.40 The Board considers that where an eligible group has made a simplified formation rules election, it should be given a choice to make a recently acquired entity election under which the tax cost of the assets of *all* recently acquired entities should be ascertained based on the ordinary consolidation tax cost setting process and the rate of utilisation of any losses transferred to the consolidated group from a recently acquired entity should be calculated based on the ordinary available fraction rules.

Subsequent joining of long-term majority-owned entities

6.41 The Board recognises that a number of small to medium sized corporate groups may have some entities which are controlled but are not wholly-owned by those groups. For such a group to be able to form a consolidated group relying on the 'stick approach' for all subsidiaries in the group, the group would need to wait until it acquires 100 per cent of the membership interests in all of its subsidiary members before electing to form a consolidated group.

6.42 The Board considers it would be beneficial for these types of groups to be able to elect to form a consolidated group up front relying on the formation concessions, but still be able to apply a 'stick approach' to a long-term majority owned subsidiary when it subsequently becomes wholly-owned at a later date and is brought into the consolidated group. This could be allowed where the subsidiary is majority owned by the group at the time it forms a consolidated group and has also been majority owned for over five years.

6.43 Therefore, the Board recommends that the Government should investigate whether rules should be introduced which enable small to medium size corporate groups to apply a 'stick approach' to long-term majority owned subsidiaries when they become wholly-owned by a consolidated group after the formation time.

Other considerations

6.44 The Board considers that where an eligible group makes any of the elections above (the simplified formation rules election, available fraction election and/or a recently acquired entity election), the elections should be made by the date the tax return is due for lodgement for the income year in which the consolidated group is formed. This timing is consistent with the choice to consolidate.⁶⁶

6.45 The Board considers that the simplified formation rules should not be available to foreign owned corporate groups that elect to form MEC groups. The Board considers that the upfront cost for these groups to engage tax advisers to assist with formation of a MEC group should generally be justified when compared with the benefits they receive inside the consolidation regime.

6.46 The Board considers that where a consolidated group makes a simplified formation rules election and the stick concession applies to an entity within the group, the Government should investigate whether the unrealised loss rules⁶⁷ apply appropriately to prevent any loss integrity issues from arising.

6.47 The Board also considers that, in combination with the Board's recommendation for the business acquisition approach to be formally recognised together with the inherited history rule in the consolidation core rules (Recommendation 3.1), the business acquisition approach should not apply to entities that retain the tax costs of their assets. Consequently, the history of these assets would be retained so that the tax status and outcomes in respect of these assets would remain unchanged.

6.48 Lastly, to assist small to medium sized corporate groups with applying the simplified formation rules, the Board considers that there would be benefit if changes to the tax law to implement the simplified formation rules could be located in one single area of the consolidation provisions.

66 Section 703-50 of the ITAA 1997.

67 Subdivisions 165-CC and 165-CD, and Subdivisions 715-A and 715-B of the ITAA 1997.

Recommendation 6.1

The Board recommends that:

- ongoing simplified formation rules should be available for wholly-owned corporate groups that have an aggregated turnover of less than \$50 million in the prior income year;
- a simplified formation rules election should be available for eligible groups forming a consolidated group, under which:
 - the existing tax costs of assets should be retained for *all* subsidiary members of the consolidated group which is formed;
 - the simplified loss utilisation rule should apply to COT transfer losses from *all* entities in the consolidated group which is formed;
 - : a five year utilisation should period apply for COT transfer losses under the simplified loss utilisation rule; and
 - the business acquisition approach should not apply to any assets which have their tax cost retained under this election;
- the Government should investigate whether rules should be introduced to enable small to medium sized corporate groups to apply a 'stick approach' to long-term majority owned subsidiaries when they become wholly-owned by a consolidated group after the formation time.

CONSOLIDATION AND MICRO-ENTERPRISE GROUPS

6.49 At the time of its introduction in 2002, the consolidation regime was intended to cater for all wholly-owned corporate groups. On this basis, former grouping concessions were repealed for all groups (such as provisions enabling the transfer of losses and the transfer of assets within a group) on the expectation that groups would instead enter the consolidation regime where tax losses are automatically grouped and intra-group transactions are ignored for income tax purposes.

6.50 However, the statistics above show a low entry by micro enterprise groups (with aggregated revenue of less than \$2 million) into the consolidation regime.

6.51 Evidence also indicates that the majority of micro enterprise businesses are not structured as wholly-owned groups which is necessary to enter consolidation, and would need to undertake group reorganisations if they wanted to form a consolidated

group. These group reorganisations would typically be undertaken using CGT roll-overs.

Views in submissions

6.52 In its submission, Pitcher Partners commented on problems faced by small businesses and privately owned groups not structured as wholly-owned groups. The submission noted that similar issues were covered by recommendations made in the Review of Business Taxation report in 1999.

As outlined in the RBT report ... privately owned groups will rarely consist of wholly-owned corporate groups. We believe that the solution to this problem is to either allow a more flexible set of arrangements (for example, a MEC type group for SMEs), or alternatively, to allow privately owned groups an opportunity to appropriately restructure their corporate entities to take advantage of the tax consolidation provisions. Both of these two suggestions were made by the RBT in 1999 [known as Recommendations 15.6(a) and 15.6(b)].

In our view, the second recommendation is the easiest to implement. Privately owned groups generally already have access to rollover provisions, such as Subdivision 122-A and 124-M. However, these provisions do not interact with the tax consolidation provisions for privately owned groups.

Pitcher Partners

6.53 The submission then elaborated on a number of problems in the interaction of the CGT roll-over provisions and the tax consolidation provisions that made it problematic for small businesses to restructure into a wholly-owned corporate group before forming a consolidated group.

Board's consideration

Appropriateness of the consolidation regime for micro-enterprise structures

6.54 From its investigations and based on discussions with the Expert Panel, the Board found that a large majority of micro-enterprises would not choose to enter consolidation even if problems with the interaction of the CGT roll-over rules were addressed and even if simplified formation rules were made available. This was for the following reasons.

- A large number of micro-enterprise groups operate through multiple discretionary trusts. In these structures, multiple silos of entities are each owned by a separate discretionary trust where family members are common objects of these trusts. This would not be available if these entities reorganised into a wholly-owned corporate group.

- A large proportion of micro-enterprise groups are structured to enable the flow-through of capital gains and dividends through trusts. These groups are not in a form eligible to enter the consolidation regime.
- The use of trusts and family trust elections already allow micro-enterprise groups to effectively pool tax losses on a group basis.
- Many micro-enterprise groups have no need to undertake intra-group asset transfers or intra-group transactions, and do not need to pool franking credits or foreign tax credits. Thus the benefits of the consolidation regime do not appeal to these groups.
- Many micro-enterprise groups do not to prepare audited financial accounts. The restructuring of such a group into a wholly-owned corporate group necessary for consolidation may result in the group having to prepare audited financial accounts.
- Notwithstanding the Board's recommendations for simplified formation rules for small businesses to assist with entry into consolidation, a number of micro-enterprise groups are still deterred from entering the consolidation regime due to the complexity and compliance costs associated with complying with the consolidation rules on an ongoing basis.

6.55 Some of these points are also expressed in CPA Australia's submission:

We note that many small to medium enterprises (SMEs) that were eligible to consolidate chose not to do so because of the complexity and uncertainty surrounding the consolidation rules. Further, since many SMEs have very small corporate groups with limited intra-group transactions, the compliance cost savings that would have been achieved through consolidation do not outweigh the additional compliance costs incurred in applying the rules.

CPA Australia

6.56 The Board therefore reached a view that the consolidation regime, although originally intended to cater for taxpayer groups of all sizes, would not generally be suitable for taxpayer groups in the micro-enterprise sector (with aggregated turnover of less than \$2 million).

Other considerations for micro-enterprise

6.57 Although the Board considers that the consolidation regime would not generally be suitable for taxpayer groups in the micro-enterprise sector, the Board is of the view that other tax rules may be necessary to cater for taxpayer groups in the micro-enterprise sector.

6.58 The Board notes that since the former grouping provisions were repealed in 2003, micro-enterprise groups have been prejudiced by not being provided with suitable tax

rules which adequately compensate them. This is particularly so given the repeal of grouping rules that enabled the transfer of losses.

6.59 The Board notes that making recommendations for the design of alternative tax rules suitable for micro-enterprise groups is outside the scope of the Board's current post-implementation review. The Board therefore recommends that the Government should investigate whether alternative tax rules should be introduced for micro-enterprise groups.

6.60 In considering the factors that should be taken into account by the Government in any investigation of this issue, the Board notes that the Review of Business Taxation report in 1999 previously identified a need for tax rules to be designed which cater for groups in the micro-enterprise sector. Specifically, Recommendation 15.6(a) stated:

That an alternative, more flexible, set of arrangements be made available for groups of trusts and companies, 'owned' by members of the one family, to be taxed as a single consolidated entity.

6.61 The Board also considers it may be an option for special rules to be designed to provide rules for micro-enterprise taxpayer groups which enable them to group losses without requiring them to enter the tax consolidation regime.

6.62 A few submissions to the Board's review also raise this as an option.

It is our recommendation that to develop a simplified consolidation regime for small business may itself be problematic. Rather, it may be more appropriate to allow grouping relief for small business entities (as defined within the ITAA 1997) which would enable assets and losses to be transferred or dividends paid within wholly-owned groups of such entities without tax impediments.

PricewaterhouseCoopers

In relation to this group of taxpayers, the Board could consider a number of alternatives, being either a simplified consolidation regime, an alternative regime being an entity flow-through taxation regime, or an alternative limited grouping regime (similar to that which operated before the tax consolidation provisions).

Deloitte

6.63 The Board therefore recommends that, given the unsuitability of the consolidation regime for micro-enterprise groups (with less than \$2 million aggregated turnover), the Government should investigate whether alternative tax grouping rules should be introduced for these micro-enterprise groups. As part of this process, the Government should consider whether existing micro-enterprise groups which have formed a consolidated group should be given a choice to opt out of the consolidation regime and into the new micro-enterprise tax grouping rules.

The Board acknowledges, however, that there will be a small percentage of micro-enterprise groups which will still seek to enter consolidation, notwithstanding the reasons outlined above (at paragraph 6.55). This is reflected in the fact that there are currently 3,304 consolidated groups in the micro-enterprise sector. The Board therefore considers that its recommended small business simplified formation rules (Recommendation 6.1) still be made available for any micro-enterprise groups that choose to enter consolidation.

Recommendation 6.2

The Board recommends that, given the unsuitability of the consolidation regime for micro-enterprise groups (with less than \$2 million aggregated turnover), the Government should investigate whether alternative tax grouping rules should be introduced for these micro-enterprise groups.

EXTENSION OF THE SIMPLIFIED FORMATION RULES TO ALL WHOLLY-OWNED GROUPS FOR A LIMITED PERIOD OF TIME

6.64 In its Position Paper, the Board proposed that the simplified formation rules which were proposed for small to medium sized corporate groups be extended as transitional rules to all wholly-owned corporate groups. Transitional rules were proposed for corporate groups eligible to form a consolidated group at the date of the announcement of the measure for a 12 month period. The Board also proposed that the transitional rules not be available to foreign owned corporate groups that elect to form a MEC group.

6.65 The transitional simplified formation rules were proposed in response to a number of larger wholly-owned corporate groups not having elected to enter the consolidation regime due to significant uncertainty with its operation and concerns about inequitable outcomes that can arise under the tax cost setting rules in certain circumstances.

6.66 Many of the uncertainties and problems present during the initial years of the consolidation regime were subsequently clarified in the *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, enacted in June 2010. However, by the time these clarifications were enacted, large corporate groups which had deferred entering the consolidation regime were out of time to use the original consolidation transitional rules which only operated during from 1 July 2002 to 30 June 2004.

6.67 The Board sought stakeholder comments on its proposed transitional simplified formation rules.

Views in submission

6.68 Submissions generally supported the Board's proposal for transitional simplified formation rules to be made available to all corporate groups for a limited time.

6.69 Although most submissions were in favour of a 12 month period for the operation of the transitional rules, a number of submissions suggested this would be too short and instead proposed a 24 month period of operation. Some stakeholders commented that the longer time period would be necessary given taxpayers would need to assess the tax consequences of a choice to enter consolidation relying on the transitional simplified formation rules.

6.70 One submission also questioned the need for MEC groups to be carved out of the transitional simplified formation rules.

Board's Consideration

6.71 The Board considers that it would be appropriate to enable all wholly-owned corporate groups to apply the simplified formation rules set out in Recommendation 6.1 for a limited period of time. That is, during a set transitional period, all wholly-owned corporate groups should be able to form a consolidated group and make a 'stick election', a 'COT transfer loss election' and/or a 'recently acquired entity election'.

6.72 The Board acknowledges that a 12 month transitional period starting from the date of announcement may not give taxpayers sufficient time to assess the impact of applying the transitional simplified formation rules. The Board therefore recommends that the 12 month transitional period should commence immediately after the income year in which the measures are enacted. This should give taxpayers and advisers sufficient time to determine whether to apply the transitional simplified formation rules.

6.73 In addition, as an integrity measure, the transitional simplified formation rules should be available only to those wholly-owned groups which are eligible to form a consolidated group at the date of any announcement of this proposal. However, as privately owned groups are not often structured as wholly-owned groups, the Board considers that it would be appropriate to allow the transitional simplified formation rules to be extended to either (a) entities in which these groups have a greater than 80 per cent interest at the date of announcement, or (b) entities within a family group⁶⁸ that are majority owned by any 'member' of the family group at the date of the announcement.⁶⁹

68 As defined in section 272-90 in Schedule 2F of the ITAA 36.

69 The simplified loss utilisation rules will not apply to entities outside the wholly-owned group.

6.74 The Board is of the view that costs associated with the formation of a MEC group are not a significant impediment for foreign owned corporate groups, and these generally have a degree of flexibility in how to form a MEC group. The Board therefore considers it unnecessary to extend the transitional simplified formation rules to MEC groups.

Recommendation 6.3

The Board recommends that:

- the small business simplified formation rules set out in Recommendation 6.1 should be made available as transitional simplified formation rules for all wholly-owned corporate groups which elect to form a consolidated group within a set time period;
- the transitional simplified formation rules should be available for consolidated groups which form in the income year immediately following the income year in which the measures are enacted, but should only be available to those groups which are eligible to form a consolidated group at the date of any announcement of this proposal;
- the formation concession should also be extended either to entities in which these groups have a greater than 80 per cent interest at the date of announcement, or to entities within a family group that are majority owned by any member of the family group at the date of the announcement; and
- the transitional simplified formation rules should not apply to foreign owned corporate groups that elect to form MEC groups.

APPENDIX A: LIST OF BOARD'S RECOMMENDATIONS

Recommendation 2.1

The Board recommends that the Government:

- implement a more systematic approach for addressing and resolving issues arising in the operation of the consolidation regime; and
- evaluate the state of the consolidation regime within five years of the implementation of the recommendations in this report to assess the extent to which problems and issues continue to arise that may point to the need to address on-going structural problems with the regime.

Recommendation 3.1

The Board recommends that the core rules in the consolidation regime should be modified to:

- give formal recognition to the primacy of the business acquisition approach in relation to the treatment of assets transferred to a consolidated group from a joining entity;
- retain the entry history rule, but as an exception to the business acquisition approach; and
- include high-level principles which specify the general circumstances where the business acquisition approach or the entry history rule should apply.

The Board recommends that this modification to the consolidation core rules should not, by itself, result in any changes to:

- the current operation of the consolidation rules; or
- the current treatment of assets or liabilities under the consolidation regime.

The Board also recommends that the current exceptions to the business acquisition approach in the consolidation provisions should be rationalised and moved into a single location within the consolidation core rules.

Recommendation 4.1

The Board recommends that the ending/creation model be applied to ensure that the tax costs of intra-group assets (apart from membership interests) acquired or disposed of by consolidated groups, whether directly or indirectly, are appropriately recognised.

Some exceptions to the ending/creation model may be needed and should be considered on a case by case basis.

The Board also recommends that the intra-group liability adjustment should apply to liabilities and other similar types of obligations owed by a member of the old group to the leaving entity, regardless of whether or not the liability is recognised for accounting purposes.

Recommendation 4.2

The Board recommends that integrity rules should be designed to address any double benefit which arises when an encumbered asset, whose market value has been reduced due to the intra-group creation of rights over the encumbered asset, is sold by a consolidated group, whether directly or indirectly.

Recommendation 4.3

The Board recommends that, as a guiding principle, the effect of the single entity rule should be extended when a provision in the income tax law applies to a transaction between a consolidated group and a third party that is either a shareholder of the head company of the group, a liquidator appointed to a member of the group or a third party that is an associate of the group. However, the application of this principle in specific cases should be assessed on a case by case basis.

Recommendation 5.1

The Board recommends that the issues relating to the determination of the amount of a trust's net income that is assessed to each beneficiary and/or trustee when the trust is a member of a consolidated group for part of an income year be considered as part of the rewrite of the trust income tax provisions.

Recommendation 5.2

The Board recommends that, subject to the outcomes of the Board's review of the treatment of liabilities under the consolidation regime, a consolidated group's tax liability in relation to the net income of a trust's non-membership period should be included in the calculation of the allocable cost amount of a trust that joins a consolidated group part way through an income year.

Recommendation 5.3

The Board recommends that the tax law be clarified so that, for the purposes of applying the consolidation provisions:

- a trustee, in its capacity of trustee of a trust that is a member of a consolidated group, will be treated as a member of the same consolidated group as the trust; and
- a change in trustee will not result in a trust joining or leaving a consolidated group.

Recommendation 5.4

The Board recommends that:

- a trust should qualify as a member of a consolidated group only if all members including beneficiaries, unit holders or objects of the trust, are also members of the consolidated group; and
- the treatment of debt beneficiaries of the trust should be reviewed in the context of the rewrite of the trust provisions.

Recommendation 5.5

The Board recommends that there should be no change to the foreign hybrid rules. However, the Government should continue to monitor whether any integrity risks may arise.

Recommendation 5.6

The Board recommends that where the membership interests in an entity that are transferred to a consolidated group are not regarded as taxable Australian property under the non-resident CGT rules, the consolidation tax cost setting rules should only apply to the transferred membership interests if:

- there has been change in the underlying majority beneficial ownership of the membership interests in the entity; or
- there has not been a change in the underlying majority beneficial ownership of the membership interests in the entity, but the membership interests in the entity were recently acquired by the foreign entity (or the foreign group); and
 - membership interests in an entity will be recently acquired if they have been majority owned by the foreign entity (or the foreign group) for less than 12 months.

Recommendation 5.7

The Board recommends that the Government should continue to monitor the interaction between Australia's double tax agreements and the tax consolidation rules.

Recommendation 6.1

The Board recommends that:

- ongoing simplified formation rules should be available for wholly-owned corporate groups that have an aggregated turnover of less than \$50 million in the prior income year;
- a simplified formation rules election should be available for eligible groups forming a consolidated group, under which:
 - the existing tax costs of assets should be retained for *all* subsidiary members of the consolidated group which is formed;
 - the simplified loss utilisation rule should apply to COT transfer losses from *all* entities in the consolidated group which is formed;
 - : a five year utilisation should period apply for COT transfer losses under the simplified loss utilisation rule;
 - the business acquisition approach should not apply to any assets which have their tax cost retained under this election; and
- the Government should investigate whether rules should be introduced to enable small to medium sized corporate groups to apply a 'stick approach' to long-term majority owned subsidiaries when they become wholly-owned by a consolidated group after the formation time.

Recommendation 6.2

The Board recommends that, given the unsuitability of the consolidation regime for micro-enterprise groups (with less than \$2 million aggregated turnover), the Government should investigate whether alternative tax grouping rules should be introduced for these micro enterprise groups.

Recommendation 6.3

The Board recommends that:

- the small business simplified formation rules set out in Recommendation 6.1 should be made available as transitional simplified formation rules for all wholly-owned corporate groups which elect to form a consolidated group within a set time period;
- the transitional simplified formation rules should be available for consolidated groups which form in the income year immediately following the income year in which the measures are enacted, but should only be available to those groups which are eligible to form a consolidated group at the date of any announcement of this proposal;

- the formation concession should also be extended either to entities in which these groups have a greater than 80 per cent interest at the date of announcement, or to entities within a family group that are majority owned by any member of the family group at the date of the announcement; and
- the transitional simplified formation rules should not apply to foreign owned corporate groups that elect to form MEC groups.

APPENDIX B: ANNOUNCED MEASURES THAT WERE SUBSUMED INTO THE BOARD'S REVIEW

The following table provides a list of unenacted measures that were announced by the Government prior to June 2009 which were subsumed into the Board's post-implementation review.

Announced measure	Date of announcement	Proposed start date	Board's report
Entry history rule and applying the 200% diminishing value rate	13 May 2008	8 May 2007	Covered in Chapter 3: Policy framework for the consolidation regime
Extending the single entity rule to discount capital gains and CGT event K6	13 May 2008	8 May 2007	Covered by principles in Chapter 4: Operation of the single entity rule
Beneficiaries of a trust and the sharing of net income	13 May 2008	Start of the 2007/08 income year	Covered in Chapter 5: Interaction between the consolidation regime and other parts of the income tax law

APPENDIX C: CONSOLIDATION ISSUES RAISED IN SUBMISSIONS OUTSIDE OF THE BOARD'S REVIEW

The following consolidation issues raised in submissions are outside the scope of the Board's review:

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

- practical issues that arise when a public trading trust or a corporate unit trust becomes the head company of a consolidated group;
- clarification of the treatment of amounts paid under earnout arrangements in the entry allocable cost amount calculation;
- interactions with FOREX and ToFA provisions; and
- treatment of intra-group transactions that straddle the time an entity joins or leaves a consolidated group.

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

APPENDIX D: LIST OF SUBMISSIONS

SUBMISSIONS IN RESPONSE TO THE BOARD'S DISCUSSION PAPER

BDO (Australia) Limited

Blake Dawson

Corporate Tax Association and the Minerals Council of Australia

CPA Australia

Deloitte Touche Tohmatsu

Group of 100

Institute of Chartered Accountants in Australia and The Tax Institute

MGI Melbourne

PricewaterhouseCoopers

SUBMISSIONS IN RESPONSE TO THE BOARD'S POSITION PAPER

Corporate Tax Association and the Minerals Council of Australia

CPA Australia

Deloitte

Ernst & Young

Institute of Chartered Accountants in Australia and The Tax Institute

Pitcher Partners

Raytheon Australia