



Australian Government

The Board of Taxation

26 June 2012

**The Hon David Bradbury
Assistant Treasurer and
Minister Assisting for Deregulation
Parliament House
CANBERRA ACT 2600**

Dear Minister

**POST-IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE
CONSOLIDATION REGIME**

We are writing to provide you with the Board of Taxation's report on the post-implementation review into certain aspects of the consolidation regime.

On 3 June 2009, the Government announced that it had asked the Board to undertake a post-implementation review of certain aspects 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.

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

The Board has made a number of recommendations regarding these aspects of the consolidation regime.

First, the Board recommends that formal recognition should be given to the primacy of the business acquisition approach in relation to the treatment of assets transferred to a consolidated group from a joining entity.

Second, the Board recommends that an 'ending/creation model' should apply as the overarching principle for the treatment of intra-group assets (apart from membership interests) that are acquired or disposed of by a consolidated group. This should provide a more consistent treatment of intra-group assets in the consolidation regime.

Third, 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.

Finally, the Board recommends simplified rules for small to medium sized business groups to reduce the complexity and high compliance costs they face when entering the consolidation regime.

In addition to making recommendations on these key aspects of the consolidation regime, the Board considered it important to make a number of high-level reflections on the consolidation regime as a whole. These are contained in a separate chapter in the report where the Board outlines its reflections on the consolidation regime and lessons which can be learnt for the design and implementation of future tax regimes.

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 uncertainty in the operation of the consolidation regime and its implementation has brought some difficulties, including the difficulty of predicting the revenue consequences of changes to the regime. The Board therefore considers it important that sufficient resources within Treasury, the Australian Taxation Office and the Office of Parliamentary Counsel be allocated to the care and maintenance of the regime.

The Board also considers that a further evaluation of the consolidation regime could be undertaken within five years of the implementation of the recommendations contained in the Board's report to determine whether structural changes are needed to improve the regime's operation. The Board does note that, without a systematic maintenance program in the meantime, the likelihood of the need for fundamental repair of, or change to, the system in the future will increase.

On 25 November 2011, the Government asked the Board to investigate the treatment of liabilities under the consolidation regime and whether the consolidation tax cost setting amount for assets should be capped. These issues are complex and are still being investigated. Therefore, the Board has decided to defer its advice on these issues for inclusion in a separate report to the Government, which it expects to deliver by the end of 2012.

Lastly, it has recently come to the Board's attention that certain foreign owned tax consolidated groups (known as multiple entry consolidated groups (MEC groups)) may inappropriately obtain more favourable taxation outcomes than Australian owned consolidated groups. Further details are in the attachment to this letter.

The Board is concerned that, if this issue is left unaddressed, it has the potential to become a widespread practice and could pose a significant threat to the revenue. Thus, the Board suggests that the Government review the operation of MEC groups to determine whether any changes should be made.

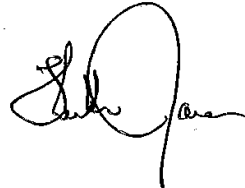
The Secretary to the Treasury, Martin Parkinson PSM, the Commissioner of Taxation, Michael D'Ascenzo AO, and the First Parliamentary Counsel, Peter Quiggin PSM, have reserved their final views on the issues canvassed in the attached report for advice to Government.

A copy of this letter is also being provided to the Deputy Prime Minister and Treasurer.

Yours sincerely

A handwritten signature in black ink, appearing to read "Jordan".

Chris Jordan AO
Chairman
Board of Taxation
(Enc)

A handwritten signature in black ink, appearing to read "Keith James".

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

Issues concerning MEC groups

MEC groups are a type of tax consolidated group comprising a group of Australian entities which are not wholly-owned by a single Australian holding company, but are wholly-owned by an ultimate foreign holding company. The foreign holding company will have multiple entry points into Australia: this means, in essence, that the foreign holding company has an Australian presence through two or more foreign owned Australian resident 'sister' companies. One of the Australian sister companies is nominated to be the head company of the MEC group for tax consolidation purposes. The group can choose which of the other Australian sister companies are to be members of the group. The MEC group will also include any wholly-owned Australian subsidiaries of these sister companies.

When a sister company joins a MEC group, the tax costs of its assets are not reset (because the sister company is effectively treated as part of the head company of the group). However, the tax costs of assets held by any wholly-owned Australian subsidiaries of a sister company that joins a MEC group are reset.

The introduction of the tax consolidation regime was recommended by the Review of Business Taxation in 1999. The Review recommended that the MEC group provisions, which are more flexible than the consolidation provisions for Australian owned consolidated groups, operate as a transitional measure to accommodate existing corporate group structures which did not have a single Australian holding company. This addressed concerns that existing groups could have incurred significant income tax and stamp duty liabilities if they had been required to restructure.

The Review further recommended that no new foreign owned sister companies be allowed to join an established MEC group. This would have meant that a new entity could become a member of the MEC group only if it was an Australian resident, and all its shares were acquired, directly or indirectly, by an existing sister company that was a member of the group. That is, the new member of the MEC group would have had to be a subsidiary member of the group.

However, in developing the legislation to implement the tax consolidation regime, the former government agreed to make MEC groups a permanent feature of the regime. As a result, new foreign owned Australian resident companies are able to join an established MEC group (as sister companies). This is one feature that gives MEC groups a lot of flexibility when compared to ordinary tax consolidated groups.

The Board emphasises that it has not come to any conclusion that MEC group structures are inherently tax-driven. Like Australian owned consolidated groups, MEC groups enable corporate groups to get the benefits (including certain cost of compliance benefits) of being taxed as a single entity.

Nevertheless, the Board is concerned that MEC groups are able to obtain unintended taxation outcomes in some circumstances.

An example of an unintended outcome is that, by using a MEC group, a foreign resident entity may seek to convert what would otherwise be a business profit from the sale of an asset that is taxable in Australia into a tax exempt capital gain by taking the following steps:

- The foreign holding company of an established MEC group incorporates a new sister company that becomes a member of the established group.
- The asset is transferred from an established member of the MEC group to the new sister company without any income tax consequences (due to the single entity rule that is a central feature of the consolidation regime).
- The foreign holding company sells its shares in the new sister company (and therefore effective ownership of the asset) to a foreign resident third party without paying Australian tax (arguing that this sale gives rise to a gain of a capital nature and that the rules applicable to foreign residents operate to exempt from tax capital gains on the disposal of assets other than, broadly, real property).

A second example is that a MEC group can effectively transfer liabilities out of the group as part of an arrangement under which it makes a gain that is not subject to tax. When an entity leaves an Australian owned consolidated group, the group may make a capital gain if, broadly, the value of the leaving entity's liabilities exceeds the tax costs of its assets. The rules which trigger this capital gain apply when a sister company leaves the group provided that at least one share in the sister company is held by another member of the group. However, if all of the shares in the sister company are held by foreign residents, the rules which trigger this capital gain do not apply; this is an anomalous outcome.

There are potentially other avenues available to MEC groups that result in them getting unduly favourable taxation outcomes. A key factor contributing to this is the interaction between the flexible MEC group provisions and the rules that, broadly speaking, exempt foreign residents from capital gains tax on the disposal of assets other than real property.

The Board is not aware whether these practices are widespread at this stage, although indications are that some transactions have been put in place in recent times. If the practices were to become prevalent, they could lead to a potentially significant adverse impact on the Australian tax base, particularly given the size of some foreign owned consolidated groups.

The Board also understands that although the general tax anti-avoidance rules are available, there is difficulty for the Australian Taxation Office in applying these rules to address cases where MEC groups have obtained unintended taxation outcomes as described above. The Board therefore suggests that the Government review the operation of the rules for MEC groups to determine whether any changes should be made.

In this regard, a range of approaches could be explored for removing or reducing the advantages that MEC groups obtain over Australian consolidated groups.

One approach could be to require all existing MEC groups to adopt an Australian head company within a reasonable period of time and to prevent any new MEC groups from being established following the date of any announcement. Under this approach, all wholly-owned groups that consolidate for income tax purposes would need to have a single Australian resident holding company and would be treated equally.

A second approach could be to prevent any new foreign owned sister companies from being able to join existing MEC groups, and to prevent any new MEC groups from being established, following the date of any announcement. This approach, which is consistent with the recommendations of the Review of Business Taxation, would significantly reduce the ability of MEC groups to obtain advantages over Australian consolidated groups.

A third approach could be to review the operation the provisions that exempt non-resident entities from Australian tax (Division 855 of the *Income Tax Assessment Act 1997*) to ensure that they do not result in unintended outcomes for MEC groups.

Finally, a fourth approach could be to design specific anti-avoidance rules to prevent MEC groups from obtaining unintended advantages over Australian consolidated groups.