

# Greenwoods & Freehills

## Tax Brief

19 March 2010

### Consolidating Consolidation

The *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* (“**the Bill**”) was introduced into Parliament on 10 February 2010. Schedule 5 of the Bill contains an array of changes to the Consolidation provisions, primarily affecting the tax cost setting process when a group is formed, or entities join or leave a group.

Many of the changes are retrospective, and potentially advantageous to taxpayers. The most significant of these changes are described below. A brief description of all of the changes is provided in the attached table.

If taxpayers revisit their tax cost setting calculations and would be put in a better position as a result of these amendments in relation to:

- prior years for which an assessment has been made; and
- the 4 year amendment period has expired in relation to that year;

then taxpayers will have 2 years from the commencement of the Bill to amend those tax returns to obtain those benefits.

### Tax cost setting amount for rights to future income and revenue assets

Under current law, the head company of a consolidated group is not deemed to have incurred expenditure of an amount equal to the tax cost setting amount allocated to assets of a subsidiary member that consist of rights to future income and revenue assets. The law is silent on how these amounts should be treated.

Under the existing Australian Taxation Office (“**ATO**”) interpretation, the amount allocated to revenue assets may be used to calculate a specific profit to be included in a taxpayer’s assessable income under s.6-5, but the amount cannot give rise to a deduction or loss on revenue account.

#### ***Rights to future income***

Under the amendments, the tax cost setting amount allocated to assets that are rights to future income on a subsidiary member joining a consolidated group can be claimed as tax deductions by the head company as, and when, assessable income is derived in relation to that right. Previously, such amounts could have been expected to be deducted over the life of the

asset. This matching to assessable income effectively “front-ends” the deductions and would appear advantageous to taxpayers.

Examples of such assets given in the Explanatory Memorandum include:

- the right to income under a long term construction contract;
- the right to deferred management fees derived by a retirement village operator;
- the right to unbilled income for the supply of gas;
- trailing commissions earned by a financial services broker; and
- land development rights.

However, where a joining entity that was wholly-owned by the head company at the time the right was created joins the head company’s group on the formation of that group, the amendments will require the tax cost setting amount of that joining entity’s rights to future income assets to be their existing tax cost. In most cases, this will be zero – meaning the benefit that “acquired” assets achieve (as described above) would not be available for such “home-grown” assets.

If a head company has allocated a tax cost setting amount to assets which are rights to future income on the basis that they are reset cost base assets, those calculations should generally be re-done on the basis that such “homegrown” assets are retained cost base assets, as other assets may then achieve higher tax costs.

Finally, it would appear that taxpayers will need to quarantine assessable income derived from those right to future income assets which are retained cost base assets (i.e. “homegrown” assets) in calculating the amount of the tax cost setting amount of right to future income assets which are reset cost base assets (i.e. “acquired” assets) that is deductible.

### ***Revenue assets***

The law will also be amended to confirm that the head company incurs expenditure equal to the tax cost setting amount allocated to revenue assets. This change could have significant impacts for those taxpayers which claim deductions on acquisition of revenue assets (e.g. consumables).

### ***Effective date***

The above amendments are effective from 1 July 2002 (i.e. from the introduction of consolidation).

## **No double counting - ACA**

The allocable cost amount (“ACA”) calculation that a head company performs in setting the tax cost of a joining entity can be adjusted more than once in relation to a single attribute of that joining entity.

For example, the joining entity may have a tax loss that has reduced the frankable retained profits that accrued to the head company (thus reducing the joining entity's ACA at Step 3) and which also reduces the ACA of the joining entity at Step 5 (as the loss is also one that accrued to the head company). Thus, a single tax loss has caused the joining entity's ACA to be reduced twice.

A new amendment will be inserted into the ACA provisions that will allow the taxpayer to only adjust the ACA under the "most appropriate" (as determined by the taxpayer) adjustment provision.

This amendment may give significant benefit to those taxpayers that reduced a subsidiary member's ACA under Step 1 or 2 for a reduction in the reduced cost base of shares in or loans to that subsidiary due to a loss being transferred from that subsidiary member (pursuant to Subdivision 170-C), where that loss also reduced the retained profits of the subsidiary member that could otherwise have been franked (and thus was included in Step 3).

#### ***Effective date***

The taxpayer may elect for the above amendments to be effective from 1 July 2002, otherwise they apply compulsorily from 10 February 2010.

### **CGT event L3: Impaired Debts**

Currently, if the ACA that a head company calculates for a subsidiary member is less than the total of the face values of the retained cost base assets of the subsidiary member (e.g. cash and receivables), then the head company will derive a capital gain under CGT event L3 equal to that shortfall.

The above scenario can occur quite often where a head company acquires an entity with assets consisting of impaired (or doubtful) debts.

The law will be amended such that the tax cost of such impaired debts can be reduced to the extent that a CGT event L3 gain would otherwise arise.

By reducing the tax cost in those impaired debts to avoid the immediate CGT gain, the head company is likely foregoing any bad debt deductions which would otherwise arise on extinguishment of the debt. However, this change removes a significant anomaly faced by some debt-purchasing businesses.

#### ***Effective date***

The taxpayer may elect for the above amendments to be effective from 1 July 2002, otherwise they apply compulsorily from 10 February 2010.

## **Exit ACA calculation: Leaving time liabilities**

Under current law, if the amount of a liability was taken into account in calculating a subsidiary member's ACA upon its entry into a consolidated group, and that liability remains in the subsidiary member on its exit, the amount of the liability taken into account in calculating the exit ACA of the subsidiary member is adjusted to equal the amount that was used in the entry ACA calculation.

This has caused a number of interpretational and practical issues, including whether you have to track individual elements of an accounting liability (e.g. every single entitlement to employee leave included in an employee leave provision). This has given rise to particularly difficult and costly compliance issues.

The amendments will make clear that:

- where an amount of a liability taken into account on entry is "paid down" by a subsidiary member while it is a member of the group, that liability is not on hand at the leaving time (and thus does not, to that extent, need to be matched to the amount of the liability used at the joining time); and
- if a liability is an employee leave provision or other provision contingent on a future event (e.g. foreign exchange provisions):
  - where the liability was categorised as a current liability on the subsidiary member joining the consolidated group - should the subsidiary member leave after 12 months, the adjustment is not required;
  - otherwise - should the subsidiary member leave after 4 years, the adjustment is not required.

### ***Effective date***

The above amendments are effective from 10 February 2010 (i.e. for disposals of subsidiary members that occur on and after 10 February 2010).

## **CGT straddle transactions**

This measure was first announced on 8 May 2007, and effectively overturns existing ATO tax determinations.

### ***Entry-sell***

Under current law, the ATO is of the view that where an entity contracts to sell a CGT asset, and then joins a consolidated group between time of contract and settlement, due to the CGT timing rule the CGT event is taken to have happened to the joining entity, and not the consolidated group, at the time the contract was entered into. The ATO also considers that the capital gain is calculated by reference to the joining entity's "historical" cost base of the asset rather than the joined consolidated group's reset tax cost base.

Under the Bill the law will be amended such that the CGT event will be taken to occur at the time the contract is settled. Accordingly, any CGT gain or loss will be that of the joined group, and not the joining entity.

Whilst the Bill is silent on the point, it follows that, in calculating its CGT gain or loss, the head company of the joined group should be able to use the uplifted CGT cost base in the asset (achieved via the entry ACA process) the joining entity brings into the group.

In theory, this should result in no CGT gain for the joined group. However, the entry tax cost setting process does not always achieve a full step up in cost base to the market value of the relevant asset. Any shortfall as between tax cost base and market value may create a deferred tax liability for the joined group, and also a CGT gain on the disposal of the relevant asset, which should be considered when pricing the acquisition of the joining entity.

### ***Exit-sell***

Under current law, the ATO is of the view that where an entity contracts to sell a CGT asset while a subsidiary member of a consolidated group, and the contract settles after the entity has left the consolidated group, due to the CGT timing rule the CGT event is taken to have happened to the head company, and not the entity that left the group.

Under the Bill the law will be amended such that the CGT event will be taken to occur at the time the contract is settled. Accordingly, any CGT gain or loss will be that of the entity that left the group, and not the consolidated group.

The above scenario does give rise to potential double taxation where the leaving entity is not acquired by another consolidated group, as the old consolidated group will effectively be taxed on the underlying gain on the relevant asset via the exit ACA process, and the leaving entity will also pay tax on that gain when the contract settles.

Another issue arises where the head company is selling a subsidiary member, but wishes to retain some of the assets held by that subsidiary member, and thus enters into a contract to acquire the asset from the subsidiary member while it is still a member of the group. It is imperative that the contract settles prior to the subsidiary member's leaving time, otherwise the head company will be effectively taxed on the sale of the asset when the subsidiary member leaves the group. This should be kept in mind where subsidiaries are divested, but part of their business is retained by way of pre-leaving time restructure.

### ***Effective date***

The above amendments are effective from 8 May 2007 (i.e. for CGT events that occur on and after 8 May 2007).

## **Group restructures**

Currently, when a consolidated group converts to a multiple entry-consolidated group (“**MEC group**”) (or vice versa), the entities are taken to have left one group, and joined another – meaning the cumbersome exit and entry tax cost setting process is required to be performed for all members of the group (which may trigger CGT event L5 gains and potentially adverse ACA ‘skewing’ consequences).

In addition, any tax losses of the old group must satisfy the ownership or same business tests before they can be transferred to the new group, and the new group’s utilisation of these transferred losses will be subject to ongoing available fraction limitations, often with significantly reduced available fractions due to a technical glitch in the consolidation provisions.

The new group conversion provisions aim to ensure that there will be minimal tax consequences on group conversion and in most aspects the tax attributes (including asset tax values) of continuing group entities will remain unchanged, which should make group restructures more attractive.

### ***Effective date***

The taxpayer may elect for the above amendments to be effective from 1 July 2002, otherwise they apply compulsorily from 27 October 2006.

## **Non-membership equity interests**

This measure had not previously been announced.

Presently, amounts that are taken into account for “equity-like” instruments in the entry and exit ACA calculations are limited to instruments that constitute:

- membership interests for tax purposes (e.g. ordinary shares); and
- liabilities for accounting purposes (e.g. some redeemable preference shares).

However, instruments that are not membership interests for tax purposes, and not liabilities for accounting purposes, are not currently taken into account. Examples of such instruments include certain convertible notes.

The law is to be amended as follows:

- In calculating the entry ACA, the entry ACA will be increased by, broadly:
  - the amount that would be the non-share capital account balance of the joining entity for all of its issues of non-membership interests that are also not debt interests where those interests are not held by members of the joined group; and
  - should members of the joined group hold such interests, their cost base in those interests.
- In calculating and allocating the exit ACA:

- the exit ACA will be reduced by, broadly, the amount that would be in the leaving entity's non-share capital account in respect of non-membership equity interests it has on issue to entities that are not members of the consolidated group the leaving entity is exiting; and
- should members of the old group hold non-membership equity interests in the leaving entity, the exit ACA will need to be allocated to those interests, as well as membership interests, in the leaving entity.

These proposed amendments have already been reported to have had an impact with Seven Network Limited increasing its deferred tax liability by \$207 million in relation to its Seven Media Group joint venture with US private equity firm KKR.

### ***Effective date***

The taxpayer may elect for the above amendments to be effective from 1 July 2002, otherwise they apply compulsorily from 10 February 2010.

## **Choices**

Under the current law, it is necessary for taxpayers to make the election to form a consolidated or MEC group (including via a conversion event) in the "approved form".

The ATO has applied the "approved form" requirement extremely strictly, with the result that, in the opinion of the ATO, many consolidated and MEC groups have not been formed on the intended date due to minor technical or clerical errors in the relevant notification form.

The law is to be amended such that the election need only be made "in writing". The requirement to notify the ATO is still in force, but the election to form a consolidated or MEC group will no longer be via lodgement of the notification form. Rather, taxpayers can elect via company resolution, or some other internal document, which can be kept on file (i.e. the document evidencing the choice need not be given to the ATO).

The due date for making the choice is still the same – i.e. the day on which the income tax return for that income year is due for lodgement.

Finally, and more controversially, the law will be amended to make clear that the ATO **will not** have a discretion to extend the time for making the choice. This came as a surprise to some, as Treasury and the ATO had indicated during the consultation process that an amendment to make clear that the ATO did have such power was going to be inserted into the Bill.

Accordingly, it is still as important as ever to be aware of your options regarding the formation of consolidated/ MEC groups and make such formation choices in a timely manner.

### ***Effective date***

The above amendments are effective from 1 July 2002 .

### **No ability to change stick and spread elections**

Despite the potential for the above amendments to have profound implications on tax cost setting calculations and allocations performed when consolidated groups were formed, the Bill will not provide the vast majority of taxpayers with a chance to change the “Stick” and “Spread” choices that have already been made.

For completeness, taxpayers with a substituted accounting period that formed a consolidated group in the 12-month period after 30 June 2003, but not on the first day of their income year starting in that period, have a limited ability to change “Stick” elections to “Spread” elections. Such ability only arises if the amendment in the Bill that allows them to include unfrankable retained profits in their tax cost setting calculations for a subsidiary member provides a benefit.

### **Other notable changes**

#### ***Removal of CGT event L7***

CGT event L7 currently gives rise to a capital gain (or loss) for a head company where a liability that was taken into account in calculating a subsidiary member's entry ACA is satisfied for an amount that is less (or more) than the amount of that liability at the subsidiary member's joining time. This provision, like the leaving time liability measure above, gives rise to significant compliance costs, as each of those liabilities is required to be tracked.

Under the amendments, CGT event L7 is abolished as of 1 July 2002 (unless CGT event L7 occurred to a head company before 10 February 2010, and the CGT event gave rise to a capital loss).

#### ***Paring back of loss multiplication rules for widely-held companies***

For many widely held groups, the scope of the loss integrity provisions of Subdivision 165-CD are to be significantly reduced as from 1 July 2002. These amendments will have consolidation impacts in overcoming the inequitable erosion of capital losses that may otherwise have arisen on the disposal of subsidiaries; but also, these amendments can apply more generally where Subdivision 165-CD may otherwise have operated to erode reduced cost bases in inter-entity debt and equity interests (including deemed adjustments in calculating a joining entity's entry ACA).

Generally, by way of these amendments, a widely held company will not be taken to have a ‘relevant equity interest’ or ‘relevant debt interest’ (being interests that could otherwise be impacted by a Subdivision 165-CD

adjustment) in a 'loss company'. However, this concession will not apply if another entity has a controlling stake in the loss company and a direct or indirect equity interest in, or a debt owed by, the widely held company where this interest is within the Australian tax net.

Therefore, for most **Australian listed entities** Subdivision 165-CD should have ceased to be relevant on the divestment of a wholly owned subsidiary since 1 July 2002.

The application of this Subdivision 165-CD exemption will in some cases also apply to MEC group entities where the **ultimate overseas holding company is widely held**.

For further information, please contact

#### **Sydney**

Richard Hendriks

[richard.hendriks@gf.com.au](mailto:richard.hendriks@gf.com.au)

phone 61 2 9225 5971

#### **Melbourne**

Ken Spence

[ken.spence@gf.com.au](mailto:ken.spence@gf.com.au)

phone 61 3 9288 1451

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited

ABN 60 003 146 852

Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Facsimile (02) 9221 6516 Telephone (02) 9225 5955

Liability limited by a scheme approved under Professional Standards Legislation  
510067153