BTR/Section15 -

15

CONSOLIDATED GROUPS

Taxing entity groups on a consolidated basis

Recommendation

15.1 General principles for 'consolidation'

That consolidated income tax treatment for groups of entities ('consolidation') be introduced, based on the following six principles listed in *A Platform for Consultation* but subject to the modifications effected by Recommendations 15.2-15.6:

(i) consolidation is optional, but if a group decides to consolidate, all its wholly owned Australian resident group entities must consolidate;

(ii) consolidated groups of wholly owned Australian entities with a single common head entity be treated as a single entity;

(iii) repeal of the current grouping provisions;

(iv) losses and franking account balances of entities entering a consolidated group generally be able to be brought into the consolidated group;

(v) losses and franking balances remain with the consolidated group on an entity's exit; and

(vi) consistent with Recommendation 15.5, the tax values of assets and liabilities on exit be established according to the asset-based model.

The six principles and their rationale are discussed in Chapters 26 and 27 of *A Platform for Consultation*. An understanding of that discussion is necessary to obtain a full appreciation of Recommendations 15.1 to 15.6.

Introducing a consolidation regime will involve significant change. The motivation for embarking on such significant change stems from the high compliance costs and high tax revenue costs (and concomitant complex anti-avoidance provisions) associated with the current tax treatment of company groups — in particular, the company grouping provisions, the section 46 rebate for inter-corporate dividends and the various provisions that attempt to deal with the dual tax values for CGT purposes of company assets and the equity in the company itself.

These costs and complexities are referred to in *A New Tax System* and discussed in some detail in Chapter 25 of *A Platform for Consultation*. Consolidation, and the associated removal of the current grouping provisions, are essential, for example, to address in a comprehensive and structural way the costs and complexities associated with the multiplication of tax losses through the company chain based on one economic loss. In the absence of a consolidation regime, current costs and complexities of company group taxation would be superimposed on trusts under the consistent entity tax regime.

The Review sees consolidation as offering major advantages to entity groups —in terms of both reduced complexity and increased flexibility in commercial operations (driven by intra-group transactions being ignored for tax purposes). Associated short-term transitional costs are well worth the long-term benefits from this reform.

In *A Platform for Consultation*, the Review sought input from the consultative process by presenting alternative options for dealing with particular issues. A range of other issues was raised during consultation. These issues are dealt with in Recommendations 15.2 to 15.6.

Recommendation
15.2 Modification of general principles

Certain ownership interests disregarded and trusts inclusion test provided

(a) That Principle (i) of Recommendation 15.1 be modified so that:

(i) some categories of ownership interests (for example, certain employee shares and finance shares) be disregarded when determining whether an entity is wholly owned by a group; and

(ii) discretionary and hybrid trusts are included in a consolidated group on the basis of an 'objects' test in lieu of the 'wholly owned' test — and distributions made to beneficiaries outside the group (other than by the head entity) be subject to a final tax at the top marginal rate of individual tax (plus Medicare levy).

Missing Australian head entity compensated for

(b) That Principle (ii) be modified so that, as a transitional measure, Australian resident subsidiaries:

- **existing at the date of announcement, and**
- **wholly owned by a foreign company,**

be allowed to consolidate if:

(i) **they do not have a common Australian resident head entity;**

(ii) **one of the subsidiaries that is directly owned by a non-resident company is nominated as a 'virtual' head company; and**

(iii) **suitable tax value adjustments are made to account for permanent tax-preferred income on the sale of any of the Australian subsidiaries that are directly owned by a non-resident company.**

Rollover relief retained where non-resident entities involved

(c) **That Principle (iii) be modified to retain capital gains rollover relief — incorporating tax value adjustments for assets with unrealised losses — for wholly owned groups where assets are transferred between:**

(i) **non-resident entities; or**

(ii) **a non-resident entity and the head entity of a consolidated group.**

Consolidated groups able to choose timing of use of carry-forward losses

(d) **That Principle (iv) be modified to allow consolidated groups to choose the amount of carry-forward losses that are deducted in a year.**

Certain categories of ownership interest

Some categories of minority 'outside' ownership interests do not substantively impair the character of an entity as being a wholly owned subsidiary entity within a group. Examples of such interests are employee shares that qualify for tax deferral on discounts, or finance shares. It would be inconsistent with the 'wholly owned' rationale if such interests had the effect of disqualifying an entity from inclusion in a consolidated group.

Discretionary and hybrid trusts

The 'wholly owned' principle will not always be relevant in determining whether a discretionary trust or hybrid trust is to be included in a consolidated group. This is because discretionary trusts and hybrid trusts have objects (beneficiaries) that do not have a beneficial interest in the income or capital of the trust until the trustee exercises a discretion in their favour (hybrid trusts also have beneficiaries that have fixed interests in the income or capital of the trust). Consequently, it is not possible to know at a particular time who will ultimately attract entitlements to income and capital of these trusts — and thus who 'own' the trusts.

The 'wholly owned' principle can be applied where all the objects of a discretionary or hybrid trust are entities in a consolidated group. In this situation, it is clear that the 'wholly owned' principle has been satisfied and the trust should be included in that consolidated group. However, where this is not the situation, the Review considers 'ownership' of trusts with a discretionary component should be based on an 'objects' test. An 'objects' test will be easy to apply and to comply with. It will also provide certainty in its application.

This will mean that a discretionary trust will be included in a consolidated group if a member of the group is an object of the trust. Similarly, a hybrid trust will be included in a consolidated group if all of the fixed interests in the trust are held by members of the consolidated group and at least one member of the group is a discretionary object of the trust.

However, a trust will not have to be included in a consolidated group if it can be shown that the control of the trust and the group is exercised by different taxpayers. Control would be determined having regard to the potential influence of the relevant entities, individuals and associates of entities and individuals, either acting alone or together.

Where a trust with discretionary objects is part of a consolidated group but is not the head entity of the group, any distributions made by that trust to objects outside the group will be subject to a final tax (Chapter 26 of *A Platform for Consultation*, pages 548 and 551). Such distributions will be subject to a final tax at the top marginal rate for individuals plus Medicare levy (in line with the family trust distributions tax in the existing trust loss measures).

Australian subsidiaries of foreign entities with no common resident head entity

Currently, there are wholly owned company groups in Australia with no common Australian head entity between the non-resident parent and the Australian resident subsidiaries. Requiring these groups to restructure to establish a common resident head entity could trigger Australian income tax liability, stamp duty liability and foreign tax liability. The alternative is not to restructure, but then groups would not be able to consolidate and would be denied access to the equivalent of the grouping concessions currently available to them (involving loss transfer and CGT rollover relief for asset transfer).

As a transitional measure to overcome these problems, existing groups that do not have a common resident head entity will be allowed to consolidate without restructuring. There will be two main requirements of these transitional arrangements: a specific measure relating to permanent tax-preferred income; and the establishment of a 'virtual' resident head company.

Tax-preferred income

The key issue in allowing groups that do not share a common Australian head entity to consolidate is the taxation of permanent tax-preferred income — tax-preferred income that is not clawed back on disposal of the associated assets, such as some R&D expenditure, CGT indexation and tax-exempt income. The issue relates to Australian resident companies (that are directly owned by a non-resident company) at the commencement of the consolidation regime. When the Australian company is subsequently disposed of by the non-resident, the general consolidation tax value rules — Recommendation 15.5 — apply to increase the tax values of the membership interests in the exiting company by the profits earned in the company while in the consolidated group, including tax-preferred income. These profits are reflected in the tax values of the assets in the exiting company which are, in turn, reflected in the tax value of the membership interest being sold.

Regardless of whether the head entity of the group is Australian or non-resident, the head entity is not taxed at the time of sale on the tax-preferred profits reflected in the tax value of the head entity's interest in the existing company. But if the head entity is non-resident the subsequent distribution of the tax-preferred income (reflected in the non-resident's sale proceeds) may not be subject to Australian tax.

To overcome this problem, the tax values of the membership interests in the exiting company (calculated according to the general consolidation tax values rules) will be reduced to reflect the exiting company's permanent tax-preferred income.

However, the permanent tax-preferred income of the exiting company cannot be separately identified once the company is consolidated with other Australian resident subsidiaries. It will be necessary, therefore, for part of the consolidated group's total permanent tax-preferred income to be allocated to the exiting company.

Broadly, the exiting company's portion of the group's permanent tax-preferred income will be determined by:

- apportioning the group's taxed profits by the ratio of the exiting company's realised profits to the group's realised profits to determine the exiting company's taxed profits; and
- subtracting the exiting company's taxed profits determined in this way from the exiting company's total realised profits.

These calculations rely largely on information on asset tax values and only apply when an Australian resident subsidiary that is directly owned by a non-resident company is disposed of.

'Virtual' resident head company

Only wholly owned Australian resident companies of a foreign company that satisfy the current grouping provisions as at date of announcement will be able to form a consolidated group without having an Australian resident head entity. For the wholly owned group to consolidate, one of the entry level Australian resident companies that is directly owned by a non-resident company will have to nominate as the 'virtual' resident head company. The virtual head company would then be responsible for lodging tax returns, holding the pool of losses and franking credits and complying with other requirements imposed on an Australian head entity of a consolidated group.

Once these groups consolidate, their ability to move towards a single Australian head entity will be greatly assisted as assets can be transferred from one entity to another within the group without any Australian income tax consequences.

The transitional consolidation regime will also apply to acquisitions of entities by any of the Australian resident companies within the consolidated group. However, if the non-resident parent directly acquires an Australian resident entity after the date of announcement, that entity would only be eligible to be included in the consolidation group if it is brought in as a subsidiary of one of the existing consolidated Australian entities. Requiring a local parent company to be established by new entrants is required in several other countries.

Capital gains rollover relief

The Review considers there is a case for some continued capital gains tax rollover relief for asset transfers involving non-resident entities, as they are not eligible to consolidate under the proposed consolidation regime. Rollover relief is desirable for these asset transfers, as it allows Australian based multinationals to adapt their offshore structures in response to changing business conditions offshore.

However, providing rollover relief for 'loss' assets (assets with unrealised losses) may result in the duplication of losses for tax purposes. In addition, rollover relief can be used to facilitate arrangements designed to cascade losses through an entity chain to achieve multiple losses for tax purposes.

To prevent loss duplication and loss cascading, tax value adjustments will be required to be made where a loss asset is rolled over (which normally entails transfer with no change in tax value). The adjustments will be required to be made in certain circumstances to the tax values of any direct and indirect interests in the entity which rolls over the loss asset. 'Interests' would include membership and debt interests.

The amount of the adjustment will be equal to the amount of the unrealised loss attached to the loss asset. However, the requirement to reduce tax values may be negated to the extent that it can be demonstrated that the loss asset has not impacted on the market value of the interests in the entity.

Amount of carry-forward losses deducted in a year

The Review is proposing (Recommendation 11.5) that entities and consolidated groups be permitted to choose not to deduct carry-forward losses up to the full amount of the excess of their taxable income in a year. Carry-forward losses would still be reduced by the full amount of the net exempt income of an entity or consolidated group.

Recommendation

15.3 Carry-forward losses on entry into consolidation

That a consolidated group bring carry-forward losses of a subsidiary entity into the 'loss pool' of the group as follows:

'Continuity of ownership' test satisfied

(a) if all the carry-forward losses satisfy the continuity of ownership test:

(i) the portion of the losses relating to the group's interest in the entity at the time the losses were incurred be brought in immediately; and

(ii) any remaining portion of the losses be brought in over five years;

'SBT cap' for same business test losses

(b) if some of the losses do not satisfy the continuity of ownership test but satisfy the same business test (SBT) and the total SBT losses do not exceed the lesser of $10 million or 5 per cent of the cost of the equity in the entity (the 'SBT cap'):

(i) the continuity of ownership losses be brought in as in paragraph (a); and

(ii) any SBT losses be brought in over five years;

Options where SBT cap not satisfied

(c) in any other case — the group be able to choose to either:

(i) include the subsidiary entity in the consolidated group and have paragraph (b) apply, subject to a limit on the amount of SBT losses brought in equal to the SBT cap; or

(ii) leave the entity outside the consolidated group until such time as the SBT losses do not exceed the SBT cap, and then have paragraph (b) apply.

Recommendation

15.4 SBT modified for consolidated groups

That the SBT be modified for losses brought into a consolidated group so that, for losses incurred for income years commencing on or after 1 July 1999, the test be met with reference to the business carried on:

(i) immediately prior to the end of the year in which the loss was incurred;

(ii) throughout the year of change in continuity of ownership; and

(iii) immediately prior to entry into the consolidated group.

Six options for bringing carry-forward losses into a consolidated group were discussed in *A Platform for Consultation* (pages 558-564). The Review's recommendations adopt a combination of elements of Options 1 to 4 and 6, as well as proposals put forward during consultation.

Applying the existing carry-forward loss rules to a consolidated group poses difficulties, as recognised in *A Platform for Consultation*. Along with tax revenue implications, the main issue is to balance both the desire to bring all wholly owned entities into a group and the carry-forward loss rules. These rules prevent the losses of an entity being transferred into the consolidated group's loss 'pool' unless the entity was wholly owned by the group when the loss was originally incurred.

Recommendation 15.3(a) will allow an entity to bring into a consolidated group the portion of the loss which relates to the group's interest in the entity at the time the loss was incurred. For example, if an entity has a carry-forward loss of $100 and the group had a 60 per cent interest in the entity when the loss was incurred, the group could immediately bring $60 of the loss into the group once the entity became wholly owned by the group. This recommendation encompasses losses which are currently transferable within a group under the existing law when the entity is wholly owned by the group.

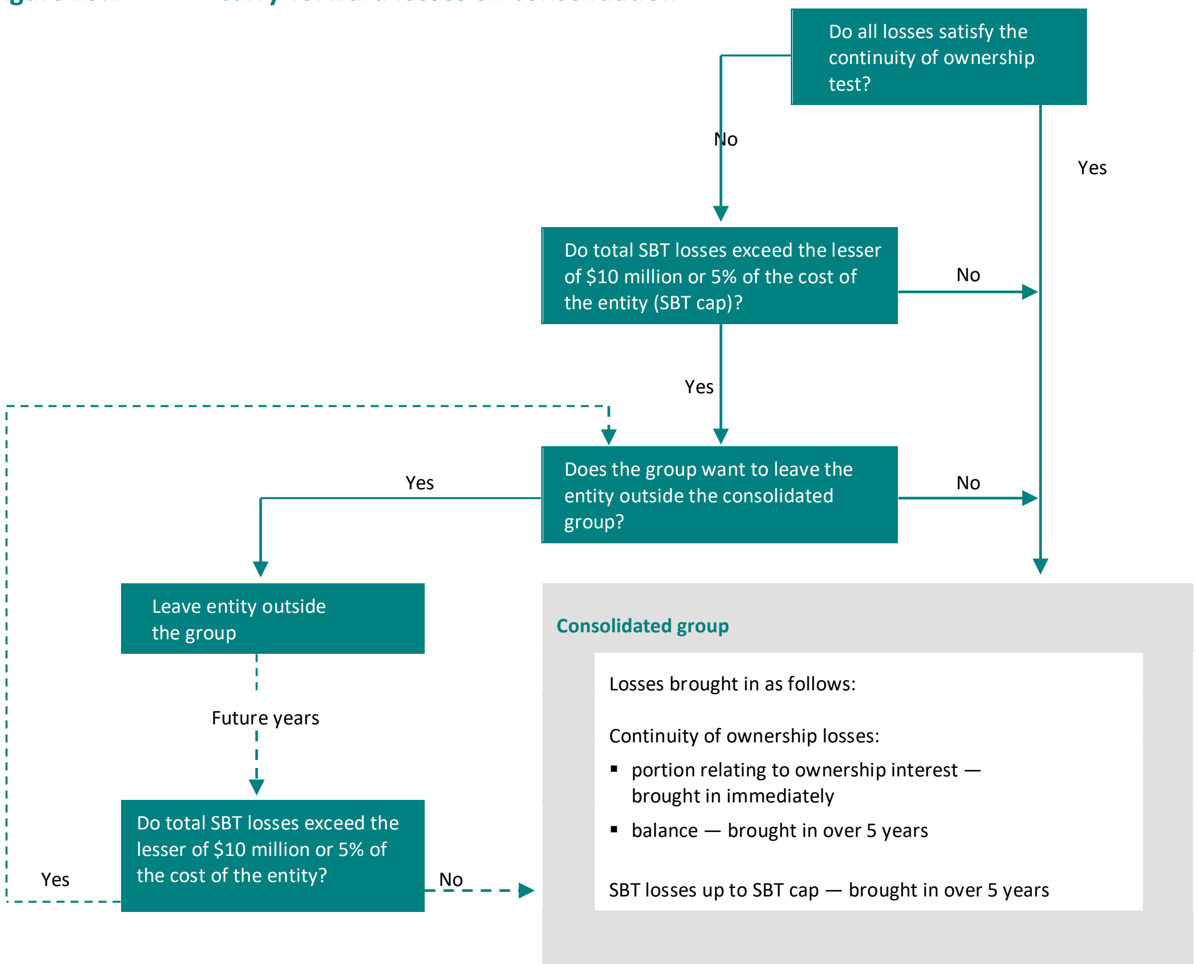
The proposal will also allow the portion of carry-forward losses which are not transferable under the existing law to be brought into a consolidated group. However, a five year limit is proposed on the rate of usage of the remaining losses. Using the example above, the remaining $40 loss would also be brought into the group with $8.00 per year being able to be claimed over five years.

Due to the very large amount of SBT losses in the tax system, it is not possible to allow all SBT losses into a consolidated group. The cost to revenue would be too large. Recommendations 15(3)(b) and (c) attempt to allow groups with substantial SBT losses the flexibility to choose whether to:

- consolidate an entity and be able to transfer at least a portion of those losses within the group; or
- leave the entity outside the group so as to utilise losses which may be lost or claimed over a longer period if consolidated.

Figure 15.1 provides an illustration of the treatment for carry-forward losses on entry into consolidation.

Figure 15.1 Carry-forward losses on consolidation



The various parts of the recommendation overcome concerns that groups would be discouraged from consolidating because they could not carry forward non-transferable losses. Under the proposals, groups will not only be able to carry forward the full amount of the losses in most cases, they will also have the benefit of being able to transfer the losses within the consolidated group, which is not available under the existing law. The only restriction on this benefit is the limit on the rate of usage of the losses and the SBT cap. However, this is balanced by the ability of groups to choose to leave an entity outside the group.

Recommendation 15.3 will apply both as transitional rules and as ongoing rules.

Recommendation 15.4 supports those rules by limiting the opportunities for loss trafficking by consolidated groups.

In *A Platform for Consultation* (page 561), the Review identified the large store of carry-forward revenue and capital losses. There would be a significant reduction in tax revenue if groups were able to access the full store of past losses immediately, including by reviving previously trapped losses or losses previously denied by the Commissioner of Taxation. This is especially relevant for new acquisitions by a consolidated group.

- Under the current SBT, the loss entity must satisfy the test at the time of the first change in majority ownership after the loss is incurred and when the loss is sought to be used.
- Under the consolidation regime, the loss entity will not have to pass the test when it seeks to utilise the loss — only at the time of consolidation.

Thus, without a stricter test, if an acquisition of an entity simultaneously results in both the first change in majority ownership and entry of the entity into the group, the losses would be able to be transferred to the group's loss 'pool' on entry, making the SBT ineffective. This would be inconsistent with the policy rationale for the SBT — which was generally to deny losses on change of majority ownership but allow a limited exception for mergers and the rebuilding of loss companies only while the same business was carried on by the entity.

To overcome these concerns, Recommendation 15.4 imposes a stricter SBT on consolidated groups. The stricter test requires the SBT to be satisfied at the time that the loss was originally incurred and the time that the loss entity is brought into the consolidated group. If groups do not meet this stricter test, the group will still have the option of leaving the entity outside the group until the losses are reduced to the level of the SBT cap.

Recommendation

15.5 Disposal of assets or equity by a consolidated group

Determining tax values for assets and liabilities

(a) That the values of assets and liabilities, including membership interests, disposed of by a consolidated group be determined according to the asset-based model (as defined in *A Platform for Consultation*, Chapter 27).

Transitional option for prior-owned assets

(b) That, provided the group consolidates before 1 July 2002, a group be able to apply a transitional option for the disposal of assets of an entity that was wholly owned by the group from 1 July 2000.

In Chapter 27 of *A Platform for Consultation*, the Review canvassed two models for determining the tax values for disposal of membership interests in a wholly owned subsidiary entity by a consolidated group:

- the entity-based model; and
- the asset-based model.

An understanding of the discussion in Chapter 27 is assumed here.

Ongoing model

The Review has decided against recommending the ***entity-based model*** because it would require special rules to deal with intra-group transfers of assets that an entity has on entry into a consolidated group. These rules would add to the complexity of the law and to compliance and administrative costs.

Upon consolidation, the ***asset-based model*** aligns the tax values for assets, including goodwill on the acquisition of subsidiary entities, with the tax values for membership interests. This is done on a practical basis that takes account of the existing tax values of assets and their market values. The procedure has the disadvantage that it requires valuation of all assets of subsidiary entities at the time a group commences consolidated treatment and all the assets of an acquired entity when a consolidated group acquires all of the membership interests of the entity.

However, for groups subject to the Accounting Standards, the additional valuation is limited. The Accounting Standards require that, on achieving control of an entity, the net identifiable assets and goodwill on acquisition be recorded at their cost of acquisition by reference to their individual fair values. Companies, other than small proprietary companies, are obliged by the Corporations Law to apply the Accounting Standards. Apart from this, the accounting bodies require that the Standards be observed where there are external users of the financial reports.

A major advantage resulting from the alignment under the asset-based model of tax values at formation or acquisition is that there are no tax compliance requirements for inter-entity transfers of assets within consolidated groups.

Goodwill on acquisition of an entity by a consolidated group is explicitly recognised on acquisition as an asset and its tax value, along with those of all other assets, is aligned with the tax values for membership interests in the entity on entry into consolidation. The disposal of goodwill will be subject to verification requirements that justify the amount of tax value claimed in connection with the disposal.

The proposed treatment has a broad degree of consistency with accounting treatment at the group level. In particular:

- intra-group transactions are disregarded; and
- gains and losses realised during consolidation are not duplicated upon the disposal of membership interests.

The focus group on consolidation favoured the asset-based model. Some submissions that favoured the entity-based model on simplicity grounds did not address the ongoing requirement under that model to make adjustments to tax values for membership interests in response to intra-group transfers of assets.

Transitional option

On transition, if they consolidate on or before 30 June 2002, groups will have the option of applying the asset-based model using existing asset tax values, including the cost of goodwill on acquisition of entities. This will avoid the need to re-value assets. Where this did not produce a satisfactory result for a group in relation to particular entities, the group may wish to value the assets of those entities and apply the model in its standard form. Some valuation data for this purpose could be available from public entities establishing cost bases for assets acquired before 20 September 1985, based on the values of those assets at 30 June 1999. (Public entities that fail to prove continuity of majority beneficial ownership since 20 September 1985 will lose CGT exemption in relation to assets acquired before that date. They will be given tax values for these assets equal to their market values as at 30 June 1999.) Nevertheless, it is recognised that the valuation requirement could impose a significant start-up cost for some groups.

Because of prior intra-group transactions (for example, transfers of assets or capital losses), tax values for membership interests in subsidiary companies may not be at their appropriate levels for resetting asset tax values on entry into consolidation. Where this occurs, tax values for such interests will have to be corrected prior to the transfer of tax values for membership interests to assets on entry into consolidation. For example, where an asset has been transferred in exchange for membership interests in the receiving company and a rollover claimed for the transfer (involving no change in tax value), the tax value for the interests will have to be changed from market value to tax value of the asset at the time of transfer.

Recommendation

15.6 Consolidated taxation for family-owned groups

Option to consolidate

(a) 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.

Transitional rollover relief

(b) That transitional rollover relief:

(i) be provided to enable those family groups that need to do so to restructure so that all fixed interests in group entities are directly or indirectly wholly owned by a head entity for the group; and

(ii) be available for the period from 1 July 2000 until 30 June 2002.

A Platform for Consultation, pages (548-551), discusses arrangements for allowing consolidated tax treatment for groups of family trusts and companies. The recommendation reflects the arrangements envisaged in that discussion.

The rollover relief proposed in Recommendation 15.6(b) will allow families two years from the commencement of the arrangements for consolidation to restructure their entity groups to satisfy the arrangements for consolidation.

Beyond the transitional issues, consolidation of family groups — either under the more flexible arrangements in this recommendation or under the standard arrangements — offer significant benefits. For example, intra-group transactions and restructuring are ignored for tax purposes, and losses are pooled. The complexities of the current trust loss provisions would be replaced by the consolidation arrangements.