6 MAY 2015

AUSTRALIAN TAX ALERT

EXPOSURE DRAFT ON TAX CONSOLIDATION INTEGRITY MEASURES

THE GOVERNMENT HAS RELEASED AN EXPOSURE DRAFT RELATING TO CHANGES TO THE TAX CONSOLIDATION REGIME. WHILE THE AMENDMENTS ARE PITCHED AS RESTORING THE INTEGRITY OF THE CONSOLIDATION REGIME, THE AMENDMENTS WOULD TRIGGER SOME OF THE BIGGEST CHANGES TO THE TAX CONSOLIDATION REGIME SINCE IT WAS INTRODUCED IN 2002.

Background

In 2009, the Board of Taxation was asked to undertake a post implementation review of certain aspects of the tax consolidation regime. In 2011 the Board of Taxation was asked to expand its review to specifically cover the tax treatment of liabilities and whether the tax cost setting amounts of assets should be capped.

After various stakeholder consultation, the Board of Taxation made several recommendations to the Government for changes to the tax consolidation regime. In the 2013-14 budget, the Government announced that it would proceed with some of these recommendations, including:

- Consolidated groups that acquire entities that hold deductible liabilities that are taken into account in setting the tax cost of assets, will include an amount in their assessable income equal to those deductible liabilities;
- Consolidated groups that acquire entities from related entities that are non-resident will not reset the tax cost of assets in circumstances where the disposal by the non-resident was not assessable (due to Division 855, which excludes non-Taxable Australian property from Australian capital gains tax); and
- Introducing an integrity measure that addresses double benefits that can arise when an asset's market value has been reduced due to the creation of rights over the asset within a tax consolidated group.

Deductible liabilities

The amendment with the widest application to consolidated groups is the change in the treatment of acquired liabilities that will give rise to deductions for the consolidated group. The policy concern relating to these liabilities is that if the value of the liability is included in the tax cost setting process for the assets of the entity, the entity receives a double benefit if it also received a deduction for that liability.

Previous amendments have dealt with similar concerns regarding double deductions for financial arrangements covered by the Taxation of Financial Arrangements (**TOFA**) regime in Division 230 (and other specific liabilities and therefore, these arrangements are carved out of the proposed amendment).

Set out below is a simple example that sets out the scenario sought to be caught by the new measures.

Example

As an example, a subsidiary of a consolidated group was established with $100 share capital and used the $100 to acquire land. It was then sold to another consolidated group when the land was worth $300, it had $100 cash (from profits) and the subsidiary had a liability for employee entitlements of $100. At the time of the sale the balance sheet of the subsidiary would be:

Assets		Liabilities and Equity	
Land	300	Employee entitlements	100
Cash	100		
DTA	30	Retained earnings	30
		Share capital	100
		Asset revaluation reserve	200
Total	**430**	**Total**	**430**

The net assets of the company (market value) are $330.

On selling the company, the original head company performs a Division 711 calculation to determine the cost base of the shares in the subsidiary, broadly as follows:

Step 1 - Terminating value of assets - $200

Step 4 - Accounting liabilities - $nil

Step 5 - Exit allocable cost amount - $200

Upon selling the company, the head company realises a gain of $130, made up of the profit on the land ($200), the cost of the liability (less $100) and the benefit of the DTA ($30).

Upon purchasing the company for $330, the new head company determines its allocable cost amount for the assets of the company broadly as follows:

Step 1 - Cost of membership interest - $330

Step 2- Accounting liabilities - $70 (calculated as the $100 liability less the tax effect of the future deduction for the liability)

Step 8 -Entry allocable cost amount - $400

The entry allocable cost amount is allocated first to cash ($100) then to the land ($300).

If the new head company later sells the land for $400 and settles the liability for $100 (using the cash at bank), it will generate a gain of $100 on the land and receive a $100 deduction for settling the liability, resulting in a nil tax position. However, from a commercial perspective, the company has received $100 that they are not taxed on.

To rectify what is perceived as a benefit available to consolidated groups that is not available outside consolidation, the exposure draft will include an amount in the new head company's assessable income equal to the amount that would be deductible if the new head company made a payment to discharge the liability just after the joining time.

If the liability is a current liability under accounting standards, it will be included over the 12 months after joining. Given a current liability for accounting standards is a liability that is expected to be settled within 12 months, the timing of the assessable income and deduction for the settling of the liability should broadly align. However, if it is not discharged within this time, timing differences may occur.

For non-current liabilities, the value of the liability is included as assessable income over the 4 years from the joining time. Depending on the nature of the liability, the timing of a deduction for the liability may not align with the inclusion of assessable income under proposed amendments.

Where the consolidated group owned shares in the joining entity prior to it becoming a 100% owned subsidiary (eg a creeping acquisition), it is necessary to distinguish between "owned" and "acquired" deductible liabilities based on the market value of the interests held at various time. Any owned deductible liabilities are excluded from step 2 altogether.

Practically this means that in determining the value to be placed on an acquisition, it will be necessary to undertake a review of the deductible liabilities that will be inherited and how they will be treated under the new measures. This treatment may affect the market value of the entity acquired because the purchasing entity will need to factor in that assessable income that will arise as a result of the deductible liabilities.

Unrealised forex gains and losses

Where a joining entity has liabilities that have an unrealised forex gain that would give rise to assessable income if the head company were to discharge the liability just after the joining time, the head company will get a deduction equal to the amount of the unrealised gain. Conversely, an unrealised forex loss will give rise to assessable income for the head company. The time of the deduction or assessable income is the same as set out above for deductible liabilities.

Any liability that is within TOFA is excluded from these provisions as the specific TOFA tax cost setting rules for liabilities apply.

Transitional rules

The amendments will apply to all entities that join a consolidated group under an arrangement that commenced after 7:30 pm 14 May 2013. Therefore, it will be necessary for all consolidated groups that have had share acquisitions after that time to revisit tax cost setting process undertaken at the time of the consolidation. This may lead to the need to rework the allocable cost amount calculations and changes in assets tax values, resulting in amended assessments for the intervening period.

Under the ATO administrative treatment, taxpayers will not have shortfall penalties applied and any interest will be remitted to the base rate if the taxpayer actively seeks amendments within a reasonable time after the amendments are enacted.

Securitised assets

In scenarios where an entity has securitised assets but is required to recognise a liability for accounting purposes in relation to that securitisation, upon entering a tax consolidated group the allocable cost amount for that entity will be inflated by the liability that is recognised, without an asset to allocate the tax cost to. This increases the allocable cost amount available to spread over other reset cost base assets and results in a windfall benefit for the head company.

Conversely, if a leaving entity has a liability relating to securitisation, the exit allocable cost amount will be reduced by that liability.

The proposed amendments will disregard liabilities that arise as a result of securitisation in determining the entry and exit allocable cost amount for entities joining or leaving a consolidated group which has an Authorised Deposit-taking Institution or financial entity as the head entity.

Transitional rules

Although the amendments generally apply retrospectively, the exposure draft contains complex transitional rules that in some instances depend on when the head entity "worked out" its allocable cost amount. This may give rise to some uncertainty for taxpayers as to which regime applies to particular transactions.

For example, if an entity joined a consolidated group under an arrangement that commenced before 13 May 2014 with liabilities of the type covered by the amendment and the head entity "worked out" its allocable cost amount before 13 May 2014, the amendments will not apply leaving the head company with the windfall gain. There is no definition of "worked out" and therefore, there would be uncertainty in relation to the meaning of this phrase (eg does the calculation need to be final, written down or not as at 13 May 2014?).

Non-resident "churning"

Where a non-resident company sells shares in an Australian resident company to a tax consolidated group, concerns have been raised that whilst the non-resident may be exempt from tax on the disposal under Division 855, the consolidated group is able to reset the tax base of the assets acquired, even if there has not been a change in the beneficial ownership of the joining company (eg the same foreign company owns all entities in the Australian group).

As a result, the exposure draft contains an integrity measure that "switches off" the cost setting provisions where there has been a sale by a non-resident where:

- A CGT event occurred because the non-resident disposed of the shares in the joining entity;
- A capital gain was disregarded because of Division 855;
- Section 701-10 (about tax cost setting) would otherwise apply;
- It is reasonable to conclude for the 12 months ending just after the joining time, a non-resident entity had an interest of 50% or more in the joining entity (the **Controlling Entity**); and
- If the Controlling Entity is not the selling entity, it is reasonable to conclude that the Controlling Entity had an interest of 50% in the selling entity at the time of the sale.

The most common scenario that will be captured by this measure is where an internal restructure results in a company that was previously owned by a foreign company in a group ends up being owned by an Australian consolidated group.

If the selling entity and the Controlling Entity are not related, the measure will not apply.

Taxpayers undertaking group mergers will need to consider whether the measures apply to any transfers. Although we note that the 12 month control requirement should provide time to restructure post-merger without attracting the rules if required.

TOFA

The amendments introduce cost setting rules for intra-group TOFA assets to ensure that only the gain or loss on the arrangement is brought to account rather than any principal (or similar) components. They seek to achieve this in a similar way to how non-intragroup liabilities are currently treated, by treating the relevant entity as having received a payment for the liability equal to the tax cost setting amount of the relevant intragroup asset.

The amendments will apply from the introduction of TOFA in 2009, however, if a taxpayer has lodged a tax return before 14 May 2013 and the Commissioner would not be able to amend the assessment if the amending legislation was disregarded, the Commissioner will be unable to amend the taxpayer's assessment.

This is designed to protect taxpayers who applied the law as it stood, but prevent taxpayers from subsequently taking advantage of a deficiency in the law.

Value shifting

When an entity leaves a consolidated group with an asset that constitutes a liability of the group, that asset's tax cost is set at the leaving time by reference to its market value at the time the entity leaves.

This gives rise to the possibility that value can be moved from assets that remain in the group through the creation of rights over those assets. If the entity holding those rights is then acquired by another entity, the right's tax cost setting amount is set at the market value of the right at the leaving time and no gain is recognised by the group, despite potentially moving the entire value of an asset out of the group.

For example, a subsidiary member of a group hold mining rights. The subsidiary member enters into an agreement which transfers substantially all the benefits of those mining rights to another member of the group. The member of the group that holds the benefit of the mining rights is sold, which under current law the recognition of the intra-group asset results in the shares being given a cost base which include the market value of the rights held by the leaving entity.

As a result, the following new cost setting rules will apply:

- For assets where the liability is:
  - not a debt; and
  - either:
    - both the holder of the asset and liability were members of the group when the liability arose; or
    - after the time the liability arose, a member of the group acquired it.

  the tax cost is set at nil.

- For assets where the liability is:
  - not a debt;
  - when the liability arose the entity owing the liability and the entity to whom the liability was owed were not members of the old consolidated group; and
  - the tax cost of the asset was set under section 701-10 at the time an entity joined the old group.

  the tax cost is set at the lower of:
  - the tax cost of the asset set through a previous tax cost setting process (ie when the asset was brought into the consolidated group); and
  - the market value at the leaving time where the liability is not a debt and either.

In the case of a right created over an asset that remains in a consolidated group, this means that if the right is created while both parties are members of the group, the tax cost of the right that leaves the group will be nil and the value removed from the group through that right will be taxed.

The value shifting amendments will generally apply to arrangements that commenced after 7:30 pm 14 May 2013, although there is some interaction with the TOFA amendments that could result in it applying earlier.

MORE INFORMATION

For more information, please contact:

James Newnham
Partner
T +61 3 9274 5346
james.newnham@dlapiper.com

Chris Neil
Senior Associate
T +61 3 9274 5323
chris.neil@dlapiper.com

Contact your nearest DLA Piper office:

BRISBANE

Level 28, Waterfront Place
1 Eagle Street
Brisbane QLD 4000
T +61 7 3246 4000
F +61 7 3229 4077
brisbane@dlapiper.com

CANBERRA

Level 3, 55 Wentworth Avenue
Kingston ACT 2604
T +61 2 6201 8787
F +61 2 6230 7848
canberra@dlapiper.com

MELBOURNE

Level 21, 140 William Street
Melbourne VIC 3000
T +61 3 9274 5000
F +61 3 9274 5111
melbourne@dlapiper.com

PERTH

Level 31, Central Park
152–158 St Georges Terrace
Perth WA 6000
T +61 8 6467 6000
F +61 8 6467 6001
perth@dlapiper.com

SYDNEY

Level 22, No.1 Martin Place
Sydney NSW 2000
T +61 2 9286 8000
F +61 2 9286 4144
sydney@dlapiper.com

www.dlapiper.com