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Tax insights

Tax Consolidation: Changes raise concerns for affected taxpayers

Snapshot

On 28 April 2015, the Federal Treasury released Exposure Draft legislation ('the ED') on 5 previously announced tax consolidation measures. Crucially, the measures are intended to apply retrospectively, from as far back as the 14 May 2013 Budget in some cases, and will have adverse impacts on taxpayers in many cases. The measures contained in the ED are complex and have changed quite dramatically from the brief Government announcement 2 years ago. We are concerned that the retrospective application of these measures is not an appropriate outcome for taxpayers.

We also have particular concerns in relation to the proposed treatment of deductible liabilities:

- The proposed measures relating to the treatment of deductible liabilities will impact the entry (and exit) tax cost setting amounts and determination of taxable income for affected taxpayers. This could impact the pricing of affected transactions, and, in respect of completed transactions, may also impact prior period financial statements;
- The extensive period of time taken to produce the ED has resulted in taxpayers lacking certainty as to the appropriate approach to adopt on these matters;
- There are some elements of the ED which were previously unannounced (such as, owned deductible liabilities being excluded from step 2 of the ACA calculation altogether, non-application of the rules where the deductible liability is

brought into and taken out of the group in the same year of income etc);

- The exemption for "owned" liabilities is poorly drafted and may result in unintended outcomes (eg. in scrip for scrip transactions); and
- The treatment of certain liabilities (eg. unearned income) has not been clarified in the ED.

Deloitte will be making a submission on the ED in relation to the above issues and other areas of concern.

Origin of proposed measures

The proposed measures have their origin in the post-implementation review of aspects of the tax consolidation regime undertaken by the Board of Taxation ('BoT'). The Assistant Treasurer released the BoT consolidation review reports (the BoT reports) in April 2013.

Summary

The ED contains measures addressing five key areas, each dealing with announcements made in the 2013 or 2014 Federal Budgets, as follows:

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- 'Deductible liabilities' - Changes to the treatment of certain liabilities ('acquired liabilities') of a joining entity to remove perceived double benefits / detriments which may arise in certain circumstances;
- 'Churning rule' - Removing the need to reset the tax costs of a joining entity's assets where the disposal of the shares in the joining entity resulted in a capital gain which was not subject to tax (e.g. where a gain on disposal was exempt under Division 855 of ITAA 1997 or a Double Tax Agreement);
- 'TOFA interactions' - Clarifying the treatment of intra-group arrangements which are subject to the taxation of financial arrangements (TOFA) regime; and
- 'Value shifting' - Adjustments to the values of certain intra-group assets and adjustments to step 3 of the leaving entity's exit calculation, upon an entity leaving a consolidated group in circumstances where the leaving asset's value may not have been appropriate.

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- 'Securitised assets' - Changes to the tax consolidation treatment of securitised assets upon joining and leaving a consolidated group.

Deductible liabilities

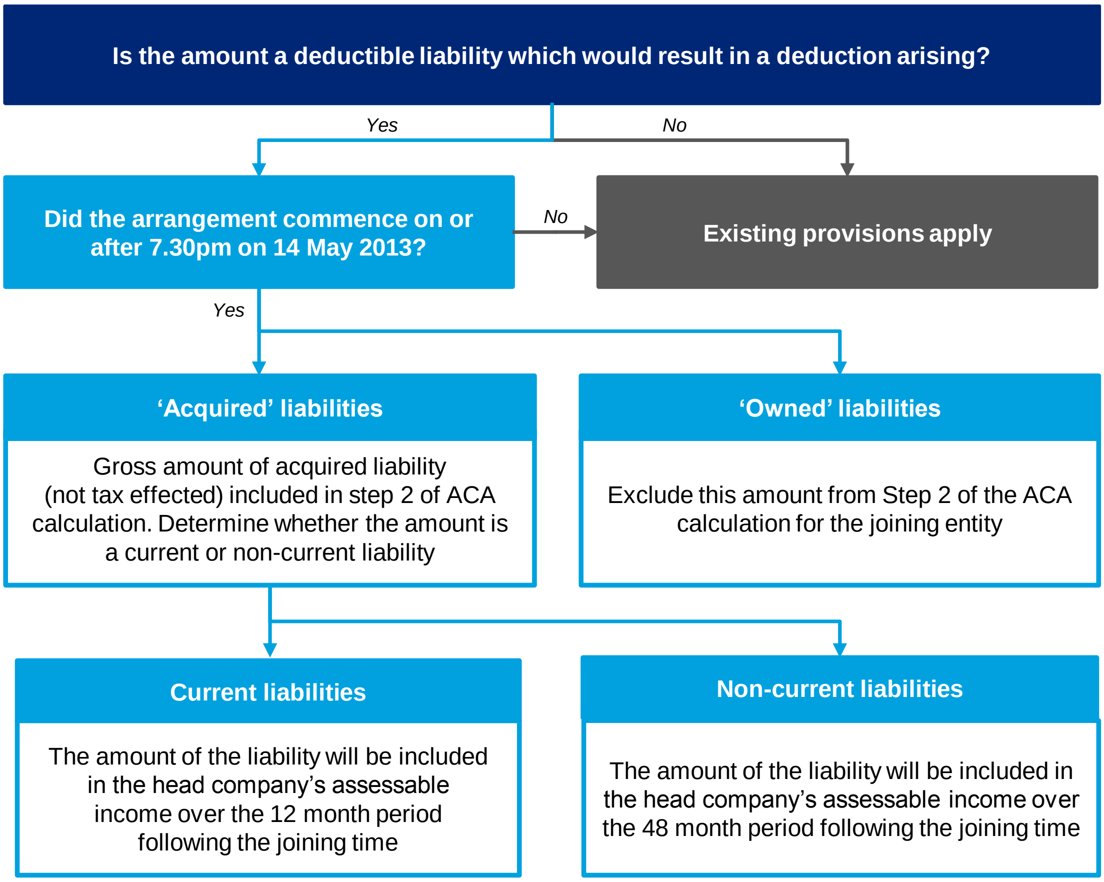
Consistent with the recommendation in the BoT report, the ED broadly proposes changes to the treatment of certain deductible liabilities for the purposes of the tax cost setting process under the tax consolidation regime. The measure is intended to address perceived benefits or detriments which may arise from these amounts being "double counted" during the tax cost setting process.
The Explanatory Materials ('EM') to the ED refers to such amounts being included as increases in the allocable cost amount ('ACA') (and thereby to some extent in the tax cost of the joining entity's assets), while also being deductible expenses of the group's head company when subsequent payments are made in respect of those liabilities.

The changes have potentially wide-ranging impacts, including:

- Changes to the ACA for a joining entity – in many cases leading to a lower ACA amount, a potential reduction in the tax cost setting amount of assets of the joining entity and flow-on impacts on a group's deferred tax balances; and
- Inclusion of assessable income amounts in respect of 'acquired liabilities', with the timing of the inclusion of such amounts set out in the ED (discussed below).

As the changes are intended to apply to arrangements that commence on or after 7:30pm on 14 May 2013, careful consideration should be given by taxpayers as to the impact of the proposals

Taxpayers should assess the potential impacts on ACA calculations, taxable income, deferred tax balances and financial statements arising from the proposed measures. Going forward, the impact of these changes should also be considered in respect of the pricing of transactions where the measures may apply.



Note: Some exclusions apply, including:

- *Certain liabilities of life and general insurance companies*
- *Liabilities subject to the TOFA regime*
- *Liabilities relating to certain retirement village contracts; and*
- *Deductible liabilities where the leaving entity leaves the group in the same year as joining*

In our view, the proposed measure will in certain circumstances, produce double tax outcomes. The measure is based on the assumption that the increase in the deductible liabilities step 2 amount is always pushed into revenue assets and takes no account of the fact that the proposals will have quite different impacts on certain industries.

For completeness, the legislation also ensures a deduction arises in respect of certain unrealised foreign exchange gains arising in respect of liabilities of a joining entity under specific events in Division 775 (see section 716-430) – this may be of relevance to taxpayers outside the scope of the TOFA provisions.

Foreign-owned groups and certain restructures

The ED also proposes changes to the tax consolidation outcomes arising in certain circumstances where a non-resident transfers its membership interests in an entity to an existing tax consolidated or MEC group (such that the entity will join that group) and Division 855 would apply to exclude any capital gain from the assessable income of the non-resident in respect of the transfer (referred to as the 'churning measure').

As with the deductible liabilities measure, the proposal aims to deal with perceived double counting benefits that may arise to taxpayers as a result of these transactions in some circumstances.

Broadly, the changes proposed in the ED will have the effect that the tax cost setting rules will no longer apply to reset the tax cost of the joining entity's assets.

These changes are also intended to apply to arrangements entered into from 7:30pm on 14 May 2013.

When does the rule apply?

The conditions which must be met for the churning measure to apply are set out below:

- An entity becomes a subsidiary member of a consolidated or MEC group and would ordinarily have the tax costs of its assets reset as a result;
- Another entity (referred to as the 'gain entity') ceased holding membership interests in the joining entity within 12 months of the joining time;
- A CGT event occurred when the gain entity ceased holding those membership interests, and a capital gain would have arisen for the gain entity from the CGT event but for the application of Division 855;
- Throughout the 12 month period an entity (referred to as the 'control entity') had a total participation interest in the joining entity of 50% or more; and
- If the control entity is not also the gain entity, it is reasonable to conclude that the control entity had a total participation interest in the gain entity of 50% or more.

Implications of changes

Where applicable, the rules 'turn off' the tax cost setting process where there has been no majority change in the economic ownership of the joining entity in the 12 month period prior to the joining time. Foreign-owned groups should still be able to restructure Australian acquisitions and reset the tax costs of an joining entity's assets, so long as such a restructure is undertaken within 12 months of that group having a majority interest in the joining entity. This time limitation should be noted in the context of proposed post-acquisition integration plans.

As noted above, it appears that the intention of the ED is that no cost setting process is to be undertaken. It would seem in these circumstances that issues relating to the cost-setting process (such as for example, potential CGT Event L3 capital gains, and CGT Event L4 capital losses) should not arise. However the draft legislation does not specifically elaborate on these matters and these issues may require further clarification.

Finally, the measure only applies in the context of the disposal of membership interests which would give rise to a capital gain. Where a disposal occurs by a non-resident and a capital loss would arise, the tax cost setting process will still be applied, in many cases resulting in a 'step down' in the tax cost setting amount of the joining entity's assets.

From a policy perspective, it is difficult to reconcile the position of a foreign-owned group in the position of a 'gain entity' (where cost setting is prevented), with the case where a disposal by a foreign-owned group gives rise to a loss (where a likely step down in cost setting amounts may arise). It is arguable that this 'one-sided' approach may further distort the outcomes arising under the tax consolidation regime.

Other Measures

The ED also contains a number of previously announced measures which are discussed briefly below.

Intragroup TOFA assets and liabilities

This measure aligns the tax cost setting rules relating to assets and liabilities which are subject to the TOFA provisions, such that the outcomes arising upon an entity leaving a consolidated or MEC group with such an asset or liability are appropriate and reflect the underlying economic substance of the arrangements.

Broadly, the measure aims to ensure that the tax cost setting amount of a TOFA asset in a tax consolidated group will equal the corresponding TOFA liability of the leaving entity.

These changes apply from the commencement of the TOFA regime. However, special provisions included in the ED prevent the amendment of returns lodged before 7:30pm on 14 May 2013 to prevent adverse impacts or windfall gains arising to affected taxpayers.

Alignment of intragroup asset and liabilities upon leaving

The ED also contains measures referred to as 'value shifting measures', which are in fact intended to address certain unintended outcomes arising in respect of certain intragroup assets and liabilities upon an entity leaving a consolidated or MEC group.

To achieve this, the ED proposes amendments to:

- The tax cost setting provisions to ensure a deemed market value cost base is received by the leaving entity only in respect of appropriate assets (broadly, debts or other financing related receivables); and
- The exit ACA calculation to ensure that the value of a liability of the leaving entity is set at the tax cost setting amount of the corresponding asset held by the consolidated or MEC group.

The proposed measure will apply to arrangements that commence on or after 7.30 pm on 14 May 2013.

Securitised assets

The amendments in relation to securitised assets are intended to address anomalies which may arise under the current law, upon entities joining or leaving a consolidated or MEC group. In particular, the ED focuses upon circumstances where an accounting liability exists, but a corresponding asset is not recognised under the tax consolidation provisions.

The ED proposes that where accounting liabilities arise in respect of securitised assets upon exit or entry of an entity from a consolidated or MEC group, and the group is classified as an ADI or financial entity, such liabilities will be excluded from the ACA calculation.

The measure is intended to apply to arrangements that take place after 7.30 pm on 13 May 2014

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