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Tax Insights

Tax consolidation measures introduced into Parliament

Snapshot

On 15 February 2018, the legislation containing the measures to improve the operation of certain entry and exit tax cost setting rules in the tax consolidation regime was finally introduced into Parliament as the Treasury Laws Amendment (Income Tax Consolidation Integrity) Bill 2018 (the Bill).

The Bill addresses the same six issues consulted upon in the 2017 Exposure Draft legislation (the 2017 ED) and draft Explanatory Memorandum (the 2017 EM) released on 11 September 2017, being:

- Changes in respect of **deductible liabilities**
- Changes in respect of **deferred tax liabilities**
- Certain transfers by a foreign resident of membership interests in a joining entity ('the **churning** rule')
- Clarifying the interaction with the **TOFA** rules in respect of intra-group financial arrangements
- Clarifying the treatment of **intra-group liabilities** owed to a leaving entity in the context of the exit tax cost setting rules; and
- Addressing issues when an entity holding **securitised assets** joins or leaves a consolidated group.

The Bill contains reforms designed to remove some of the inappropriate tax outcomes identified by the Board of Taxation (BoT) that may currently arise under the existing tax cost setting rules.

As expected, few changes have been made to the 2017 ED given the level of consultation that had occurred, including consultation on the previous exposure draft legislation released in 2015 (the 2015 ED).

Summary of start dates

The start dates of the various measures have not changed since the 2017 ED, with the date for the deferred tax liabilities measure now confirmed as 15 February 2018, being the date that the amending legislation was introduced into the House of Representatives.

Measure:	**Proposed start dates**
Deductible liabilities	1 July 2016
Deferred tax liabilities	15 February 2018
Churning rule	14 May 2013 15 February 2018 (Associate interests)
Certain TOFA arrangements	Commencement of TOFA
Intra-group liabilities owed to a leaving entity	14 May 2013
Securitised assets	13 May 2014 (ADIs) 3 May 2016 (All others)

Given the extensive consultation period, the introduction of the Bill is welcome in the sense of providing increased certainty on the impact and timing of the proposed measures. However, with limited changes from the 2017 ED, certain issues raised in the latest round of consultation have not been addressed.

Key developments from the 2017 ED

Amongst the limited changes, there are some welcome developments. In this context, with regard to deferred tax liabilities (DTLs), the 2017 ED requirement for taxpayers on exit to consider the corresponding treatment of DTLs on entry into the group has been removed.

Similarly, in respect of the churning measure, the consultation has resulted in:

- clarification that the measures will apply if the capital gain or capital loss is nil, and would otherwise have been disregarded (if there had been an amount of capital gain or loss),
- removal of the potential for double counting in calculating the sum of the total participation interests held by the control entity and its associates, and

- transitional measures in respect of the extension of the control test to cover the participation interests held by associates. Given that this aspect of the measure was broadened after the 2015 ED, the inclusion of interests held by associates will only apply to arrangements commencing on or after 15 February 2018.

It is also interesting to note that the Explanatory Memorandum (EM) to the Bill has refined its commentary (outlined below) with regard to deductible liabilities where the amount of the deduction ultimately claimed varies to that at the joining time.

Now that the wide range of application, commencement dates and transitional measures have largely been confirmed, care will need to be taken where transactions that took place in prior years are now affected, and where assessments need to be amended before the review periods expire.

In this context, and in addition to a reduction in the Allocable Cost Amount (ACA), a possible outcome of the exclusion of both deductible liabilities and DTLs from step 2 of the entry ACA calculation is the increased potential for a capital gain under CGT event L3, where there is insufficient ACA to allocate to retained cost base assets.

It now remains to be seen whether the other tax consolidation issues identified by the BoT as part of their post-implementation review are addressed. It is unsurprising that they have not yet been considered given the extended backlog of measures that the government has been seeking to introduce and pass in recent years.

Deductible liabilities

Current law

Broadly under the current law, deductible liabilities are included in a joining entity's entry ACA calculation, subject to certain adjustments. The BoT identified that this inclusion could arguably result in a double tax benefit for the head company of a tax consolidated group via:

a) the amount being taken into account in resetting the tax cost of the assets of the joining entity (resulting in, for example, higher capital allowance deductions and/or reduced capital gains); and
b) a deduction being allowed to the head company when the liability is later incurred or discharged.

Earlier proposals announced in 2013 were abandoned for simpler measures announced in the 2016-17 Federal Budget, which also had the consequence of delaying the start date for the changes.

Change now proposed and timing

The Bill confirms the proposed complete exclusion of deductible liabilities from the ACA entry calculation, with the exception of specifically listed liabilities such as Division 230 financial arrangements, certain liabilities of insurers and liabilities relating to retirement village contracts (as acknowledged by the BoT).

The deductible amount attributable to an accounting liability is calculated on the assumption that if, just after the joining time, the head company made a payment to discharge the accounting liability, that payment would result in an amount, equal to all or part of the accounting liability, being a deduction to the head company.

As is noted in the EM, given the above, the head company must determine, based on the relevant facts at the joining time, whether a deduction would arise in respect of all or part of the liability. Whilst this may be achievable for certain liabilities (e.g. certain employee provisions and an exchange loss on a foreign currency liability), it may prove difficult to determine for other liabilities and obligations.

Relevantly, example 1.1 in the EM to the Bill continues to note that the head company must assume that, just after the joining time, all the conditions for payment and claiming a deduction are met. It is debatable whether this is actually reflected in the legislation.

Critically, it would seem that the adjustment made at the joining time is not changed if, ultimately, the liability does not give rise to a deduction, or gives rise to a deduction of a different amount. A foreign exchange loss is a good example of where the deduction amount may change. This mechanism could also work to the benefit of a taxpayer if an amount is determined not to be deductible at the joining time, but becomes deductible at a later date.

In the context of the above, it is relevant to note that the EM to the Bill has omitted the explicit commentary in para 1.28 of the 2017 EM that the outcome does not change if, after the joining time, the liability does not give rise to a deduction or to a deduction of a different amount. The EM to the Bill also notes the ability, under the existing legislation, to correct errors in the tax cost setting calculations, although this point is made in the context of a deduction not arising "as a matter of law", as compared to the amount of the deduction changing.

The BoT report acknowledged that the potential double benefit issue generally relates to acquired deductible liabilities but the proposed measures do not distinguish between owned and acquired liabilities. This may be dealt with by the consequential amendment to step 3 of the ACA calculation (undistributed, taxed profits accruing to the joined group). To ensure that the ACA calculation is not reduced twice, new subsection 705-90(2B) is proposed to ensure that accounting liabilities not included in step 2 are also not taken into account when working out the undistributed profits of the joining entity (refer example 1.3 in the EM to the Bill).

Consequential amendments have also been made to the rules that previously addressed deductible liabilities and the bringing forward of timing differences (sections 705-75 and 705-80).

Once enacted, the measures will apply in relation to an entity that becomes a subsidiary member of a group under an arrangement that commences on or after 1 July 2016, consistent with the announcement in the 2016-17 Federal Budget.

As in the 2017 ED, no related changes are proposed for the tax cost setting of membership interests of an entity that subsequently leaves a group, on the basis that the current law is considered sufficient. Further care will be needed in preparing exit ACA calculations, since the process and calculation will need to distinguish between each of the following:

- deductible liabilities that came into existence while the entity was in the group;
- deductible liabilities that came into the group before 1 July 2016 and were included in the entry ACA;
- deductible liabilities that came into the group on or after 1 July 2016 but were not included in the entry ACA; and
- deductible liabilities that came into the group on or after 1 July 2016 but were included in step 2.

Taxpayers that have undertaken M&A transactions since 1 July 2016 in respect of targets with material deductible liabilities will need to consider whether the retrospective exclusion from the tax cost setting process was adopted, or whether any ACA amendments are now required.

Deferred tax liabilities

Current law

Broadly, deferred tax liabilities (DTLs) measure future tax liabilities that will arise due to temporary differences between accounting and tax. The current law includes DTLs in both entry and exit ACA calculations (as an accounting liability) in steps 2 and 4 respectively.

The review of DTLs as part of the ACA process was first raised by the BoT in 2010 in the context of their inclusion giving rise to a mismatch of commercial and tax outcomes for both the vendor and the purchaser, and integrity risks and uncertainties.

In an entry case, such a mismatch could arise because a DTL (relating to a reset cost base asset) included in step 2 of the ACA calculation is allocated to reset cost base assets which, when sold, could have the effect of reducing the future tax liability (on exit a similar mismatch could occur).

In the context of the above, ACA calculations are already required to be adjusted where an accounting liability of the joining entity would be different when it became a member of the joined group. In a practical sense, this adjustment primarily arose in respect of DTLs and sometimes led to complex, “iterative” calculations.

A measure was therefore announced in the 2016-17 Federal Budget to exclude DTLs from the tax cost setting process when an entity joins or leaves a tax consolidated or MEC group.

Change now proposed and timing

The measures in the Bill, once enacted, will mean the complete exclusion of DTLs from entry and exit ACA calculations, subject to a limited exception for DTLs relating to certain assets of life insurance companies.

In this context, a DTL is stated to be an accounting liability that is an amount recorded in a deferred tax liability account in accordance with the entity’s accounting principles for tax cost setting purposes.

The 2017 ED contained an exception whereby a DTL would not be excluded from an exit ACA calculation for a leaving entity where such a liability was included in the entry ACA calculation when the entity joined the group (i.e. the current rules would have continued to apply to such exit cases). Given the resulting complexities of ongoing exit calculations, this exception has been removed.

The measures, once enacted, will apply in relation to an entity that becomes a subsidiary member of a group, or ceases to be a subsidiary member of a group, under an arrangement that commences on or after 15 February 2018, being the day on which the amending legislation was introduced into Parliament.

Churning rule

Current law

Under the current law, when a joining entity is acquired by an existing tax consolidated or MEC group from a foreign resident, the normal entry tax cost setting rules would apply to reset the tax cost of the joining entity's assets. This will happen even though a capital gain or capital loss made by the foreign resident owner, when it ceases to hold membership interests, may be disregarded under Division 855.

Under this scenario it is possible that groups wholly-owned by a non-resident entity could receive an uplift in the tax cost base of relevant Australian assets where there has been no change in the underlying beneficial ownership and no recognition of a capital gain to the vendor.

The 2012 BoT report originally recommended that where membership interests in an entity that are transferred to a consolidated group are not 'taxable Australian property' under the CGT rules, the tax cost setting rules should only apply if:

- there has been a change in the underlying majority beneficial ownership of the membership interests in the entity; or
- there has not been a change in the underlying majority beneficial ownership of the membership interests in the entity, but the membership interests in the entity were acquired within the previous 12 months by the foreign entity (or the foreign group).

Change now proposed and timing

The measures in the Bill, once enacted, will have the effect that the entry tax cost setting rules will not apply to reset the tax cost of the joining entity's assets in identified scenarios.

Broadly, the conditions which must be met for the 'churning measure' to apply are:

a) A 'disposing entity' ceased holding membership interests in a joining entity during the period that started 12 months before the joining time and ended immediately after the joining time;
b) A capital gain or loss in respect of this CGT event was disregarded due to the operation of Division 855, or if nil, would have been disregarded; and

c) Throughout the 12 month period, it is reasonable to conclude that a 'control entity' held a majority interest in the joining entity (or the 'control' entity held a majority interest in the disposing entity if the two entities are not the same).

In determining the disposal of membership interests in the joining entity, membership interests in a higher level entity can be considered in some circumstances. This ensures that the rules will also apply where a tax consolidated group is acquired by another tax consolidated group or linked multiple entities are acquired by a tax consolidated group.

In a change to the 2017 ED, the measures in the Bill now remedy (in proposed subsection 716-440(2)) the potential for double counting in the calculation of the sum of the total participation interests held by the control entity and its associates.

Consultation has also resulted in transitional measures in respect of the extension of the control test to include participation interests held by associates. Given that this aspect of the measure was broadened after the 2015 ED, the inclusion of interests held by associates will only apply to arrangements commencing on or after 15 February 2018.

These measures will apply in circumstances of both a capital gain or a capital loss of the disposing entity. This was a welcome fix in the 2017 ED to the 'one-sided' approach in the 2015 ED in which a foreign-owned group in the position of a 'gain entity' (where cost setting was prevented) had a different treatment to a 'loss entity' case where a disposal by a foreign-owned group resulted in a likely step down in cost setting amounts.

Where applicable, the rules 'turn off' certain tax cost setting rules where there has not been a majority change in the economic ownership of the joining entity in the 12 month period prior to the joining time.

Notably these rules do not apply in all group restructure circumstances. For example, foreign-owned groups should still be able to restructure Australian acquisitions and reset the tax costs of a joining entity's assets, provided that such a restructure is undertaken within 12 months of that group obtaining a majority interest in the joining entity. This time limitation should be noted in the context of proposed post-acquisition integration plans.

The intention of the Bill is that no cost setting process is to be undertaken. It would seem that in these circumstances issues relating to the tax cost setting process (such as for example, potential CGT Event L3 capital gains and CGT event L4 capital losses) should not also arise. However, as with the 2017 EM, the EM to the Bill does not specifically elaborate on these matters.

As foreshadowed for some time, the proposed measures will apply in relation to an entity that becomes a subsidiary member of a group under an arrangement that commences on or after 7:30pm on 14 May 2013 (subject to the new transitional rule outlined above in respect of extending the control test to cover the participation interests of associates).

Interaction with TOFA

Current law

Under the current law, the tax values of an intra-group asset or liability that is part of a financial arrangement which is subject to the TOFA provisions (Division 230) is unclear when a subsidiary member leaves a tax consolidated or MEC group. As a result, the application of the TOFA provisions to those financial arrangements, post leaving, is also unclear.

Examples of such an asset or liability are an intra-group loan or an intra-group cash settlable swap.

Change now proposed and timing

The measures in the Bill deal with two aspects of the above limitations relating to an entity leaving a group:

- Setting a tax value for intra-group liabilities. Broadly, the relevant entity (leaving entity or head company) is taken to have the accounting liability from the leaving time for a payment equal to the tax cost setting amount of the "corresponding asset".
- Dealing with intra-group financial arrangements. Broadly, the rules operate such that the asset and liability created on exit have a value for Division 230 purposes that is aligned with, and based on, the asset's tax cost setting amount calculation.

These changes will apply retrospectively from the commencement of the TOFA regime. However, as foreshadowed, special rules will prevent the Commissioner amending income tax returns lodged before 7:30pm on 14 May 2013.

The measures in the Bill do not significantly differ from the treatment that was outlined in both the 2017 and the 2015 ED, and are directed at providing an appropriate outcome. Nonetheless, the changes are relatively complex and will need to be considered carefully in the context of intra-group financial arrangements that arise upon exit.

Value shifting measure

Current law

When an entity leaves a tax consolidated or MEC group holding an asset which is a liability owed by a member of the old group, the amount taken into account under the exit tax cost setting rules for the asset is:

a) the market value of the asset; or
b) in limited circumstances, an amount that reflects the tax cost of the asset.

A "value shifting" issue can arise if the market value of the asset "inflates" the exit tax cost setting amount (thereby reducing the gain made by the old group).

Change now proposed and timing

The measures in the Bill do not differ from the 2017 ED and, when enacted, will:

- modify the exit ACA calculation so that the amount included at step 3 for an intra-group liability owed to the leaving entity equates to the tax cost setting amount of the asset; and
- set the asset's tax cost setting amount at: (1) where the asset is a debt owed to the leaving entity, market value; (2) otherwise, as calculated in accordance with new section 701-60A.

This measure will ensure that the amount taken into account under the exit tax cost setting rules for the asset should be aligned with the tax cost setting amount for the corresponding asset of the leaving entity.

The proposed measures will apply retrospectively from 7.30 pm on 14 May 2013, with the changes relevant to the operation of the TOFA measures being retrospective to the commencement of the TOFA regime.

However, again, special provisions will prevent the Commissioner amending income tax returns lodged before 7.30pm on 14 May 2013.

The measures in the Bill do not significantly differ from the treatment that was outlined in the previous EDs, and are directed at providing an appropriate outcome. Nonetheless, the changes are relatively complex and will need to be considered carefully.

Securitised assets

Current law

In the context of securitisation arrangements, a mismatch can arise for tax consolidation purposes. This is largely driven by the application of the relevant accounting standards to the arrangement and the asset and liability recognised thereunder. For tax consolidation purposes, it may be the outcome that the accounting liability is recognised but the asset is not (on the basis it has no economic value).

The 2015 ED proposed that where accounting liabilities arise in respect of securitised assets upon the exit or entry of an entity from a consolidated or MEC group, and the entity is an ADI or financial entity, such liabilities should be excluded from the relevant ACA calculation.

The 2016-17 Federal Budget announced the extension of these changes to all taxpayers, with the 2017 ED proposing appropriate measures.

Change now proposed and timing

The Bill now confirms the previous announcements and, once enacted, will mean that identified liabilities arising from securitisation arrangements are disregarded for entry and exit tax cost setting purposes.

Where the joining or leaving entity is an ADI or financial entity, the measures will apply from 7.30pm on 13 May 2014.

The measures can also apply to earlier arrangements subject to various transitional rules designed to ensure that, where appropriate, the position previously adopted by the head company is maintained.

The measures will apply for all other joining and leaving entities from 7.30pm on 3 May 2016.

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