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Tax Insights

Long-awaited tax consolidation measures released

Snapshot

On 11 September 2017, the long-awaited Exposure Draft legislation (the 2017 ED) and draft explanatory memorandum (the 2017 EM) on improving the operation of some of the entry and exit tax cost setting rules in tax consolidation were released for public consultation, with the six issues currently addressed 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 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.

These measures address some of the concerns raised in the Board of Taxation's 2012-13 post-implementation review of the tax consolidation rules.

Submissions are invited on the 2017 ED until 6 October 2017 although it is unlikely that many further changes will occur given the level of consultation that has occurred to date.

Key points

Given its long-awaited anticipation, the release of the 2017 ED is certainly welcome, with the publication providing at least more certainty as to the impact and timing of the proposed measures that have been addressed to date.

However, given the wide range of application, commencement dates and transitional measures, care will need to be taken in practice where assessments need to be amended before the appropriate review periods expire and where the changes affect transactions in prior years.

The requirement on exit to consider the treatment of DTLs on entry into a group will also mean that taxpayers must retain and refer to the corresponding entry Allocable Cost Amount (ACA) calculations, even if the two events are separated by a significant number of years.

A possible outcome in practice 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 occurring, where there is insufficient ACA to allocate to retained cost base assets.

Alternatively, favourable outcomes for taxpayers may result where liabilities are not deductible at the time of joining, but can be deducted at a later stage.

It is hoped that the final round of consultation will be progressed swiftly since the commencement of the DTL measure in particular is dependent on the date that the Bill will be introduced into Parliament – for certainty in any ongoing M&A transactions, the sooner this occurs, the better.

It is also yet to be seen whether amendments to address any of the remaining issues that the BoT post-implementation review identified will ever see the light of day.

Background summary and timeline

The 2017 ED 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.

Notably, a number of other issues were also identified by the BoT as part of their post-implementation review that have not yet, over four years later, been addressed – perhaps unsurprising given the extended backlog of measures that the government has been seeking to introduce and pass in recent years.

To date, following the government release of a number of BoT reports in 2012 and 2013, different announcements were made at a number of Federal Budgets, with two sets of ED legislation also released:

Measure:	May 2013 Federal Budget	May 2014 Federal Budget	April 2015 ED released	May 2016 Federal Budget	Sept 2017 ED released	Proposed start date
Deductible liabilities	✓		✓	✓	✓	1 July 2016
Deferred tax liabilities				✓	✓	Day of amending legislation
Churning rule	✓		✓		✓	14 May 2013
TOFA arrangements	✓		✓		✓	Commencement of TOFA
Intra-group liabilities	✓		✓		✓	14 May 2013
Securitised assets		✓	✓	✓	✓	13 May 2014 (ADI) 3 May 2016 (All)

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 report addressing tax cost setting issues 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.

Proposed changes to the current law to address this issue were originally announced in May 2013 and contained in the 2015 ED. However, those changes (retrospective to May 2013) were complex and generated considerable debate as to their effectiveness.

From this, subsequent announcements in the 2016-17 Federal Budget delayed the intended start date for the changes, and took a simpler and very different approach to the proposed reforms. The measures that would have required deductible liabilities to be brought to account as assessable income over a number of years were abandoned.

Change now proposed and timing

The 2017 ED now proposes the 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 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 1 July 2016, consistent with the announcement in the 2016-17 Federal Budget.

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 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.

Interestingly, the EM also notes 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 draft legislation.

Critically, 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.

The BoT report acknowledged that the potential double benefit issue generally relates to acquired deductible liabilities but the proposed changes 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, changes to subsection 705-90(2B) are 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.

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

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 to cater for the proposed changes. Whilst this

outcome will likely be tested during the consultation process, further care will be needed in preparing exit ACA calculations, since the 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 to integrity risks and uncertainties.

In an entry case, such a mismatch could arise because the 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, has 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

Subject to the exception noted below, the 2017 ED proposes the complete exclusion of DTLs from the entry and exit ACA calculations. 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 proposed measures 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 the start of the day on which the amending legislation is introduced into Parliament.

The exception is that a DTL will 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 will continue to apply to such exit cases).

Given the timing of this amendment, DTLs will continue to be relevant to numerous exit calculations, where DTLs were included in entry ACA calculations.

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 regarded as '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 2017 ED changes should 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 '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;
- No capital gain or loss arose in respect of this CGT event due to the operation of Division 855; and

- 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.

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.

The 2017 ED will apply in circumstances of a capital gain or capital loss of the disposing entity. This is a welcome fix for 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 also 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 ED 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 the 2017 ED does not specifically elaborate on these matters and these issues may require further clarification.

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 2017 ED deals with two aspects of the above limitations relating to an entity leaving a group where Division 230 applies to the arrangement:

- 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.

Relevant to the above, the 2017 ED amends section 701-60 and inserts new section 701-60A, both of which deal with an asset's tax cost setting amount.

These changes will apply retrospectively from the commencement of the TOFA regime. However, special provisions included in the 2017 ED will prevent the Commissioner amending income tax returns lodged before 7:30pm on 14 May 2013.

The 2017 ED does not significantly differ from the treatment that was outlined in the 2015 ED and is 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:

- the market value of the asset; or
- 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 2017 ED proposes the following amendments:

- to 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
- to 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 measure will apply retrospectively from 7.30 pm on 14 May 2013. However special provisions prevent the Commissioner amending income tax returns lodged before 7.30pm on 14 May 2013.

As for the TOFA measures, the 2017 ED does not significantly differ from the treatment that was outlined in the 2015 ED and is 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 2016-2017 Federal Budget announced the extension of these changes to all taxpayers.

Change now proposed and timing

Broadly, the 2017 ED confirms the previous announcements by proposing 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 joining and leaving entities from 7.30pm on 3 May 2016.

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