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New Business Tax System (Consolidation) Bill (No. 1) 2002

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New Business Tax System (Consolidation) Bill (No. 1) 2002

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New Business Tax System (Consolidation) Bill (No. 1) 2002

Date Introduced: 16 May 2002

House: House of Representatives

Portfolio: Treasury

Commencement: Royal Assent, with the amendments having effect from 1 July 2002.

Purpose

To enable wholly-owned company groups to form, for tax purposes, a single entity which will be responsible for the tax affairs of the group.

Background

Consolidation refers to the concept where companies in a group which are wholly owned, and which satisfy certain other conditions, may elect to be treated as a single entity for tax purposes. While the consolidation regime covers areas also currently subject to grouping rules[1], consolidation represents a much more comprehensive system which will eventually replace the current grouping rules.

Consolidation has its origins in the August 1998 statement *Tax Reform – not a new tax – a new tax system*, but received greater substance in the *Review of Business Taxation, A Tax System Redesigned* (the Ralph Report).

The Ralph Report indicated that a major reason for the proposed changes was the removal of high tax compliance costs where each member of a group has to individually comply with tax laws while also passing losses and profits between members of the group of commonly owned companies. It was also indicated that a consolidation regime would allow members of the consolidated group greater flexibility in the way they could operate compared to the current grouping rules.[2]

The Ralph Report sets out a number of general principals to apply to a consolidation regime, including:

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- consolidation be optional but if a group decides to consolidate all wholly-owned Australian resident group entities must consolidate
- a consolidated group with a head entity be treated as a single entity
- the current grouping provisions be repealed
- losses and franking account balances be able to be brought into the consolidated entity, and
- losses and franking account balances remain within the consolidated entity on a member's exit.[3]

Within the general principles there are a number of modifications to take account of special circumstances, such as, for example, allowing trusts to be members of a consolidated group based on the object of the trust rather than it being wholly owned.

While the general principles and their modifications may be relatively straight forward, their translation into legislation gives rise to a great number of complications, particularly regarding the initial establishment of a consolidated group, such as who may be a member, who is to be the head entity and the value to be assigned to the various losses and franking balances of the members of the consolidated entity. The complications reflect the number of variables which may apply to different entities, such as different valuation methods, and are reflected in the history of the drafting of the Bill.

Following consultation regarding the detail of the Bill, the Treasurer released an Exposure Draft Bill on 8 December 2000, calling for further comments on the proposed legislation. It was envisaged that the consolidation regime would commence from 1 July 2000.[4]

After extensive further comments on the proposals, the Assistant Treasurer released further draft legislation and associated material on 7 February 2002, seeking comments by 15 March 2002. It was now envisaged that the regime would commence from 1 July 2002. When releasing the draft legislation the Assistant Treasurer stated:

> The ATO has taken into account the suggestions of business involved in the earlier consultation process and gone back to the drawing board to produce this revised package of materials.[5]

On releasing the draft material the Assistant Treasurer also announced a number of Consolidation Feedback Forums which ran during February and March 2002 to gather the views of business on the latest material.

Given the long period for public comment on the proposed legislation, the time given for Parliamentary scrutiny appears very short. While the Bill passed the House of Representatives on 29 May 2002 and, given that the measures are to apply from 1 July 2002, its passage through Parliament is envisaged during the remaining 2 sitting weeks before the end of the 2001-02 financial year.

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While there has been extensive consultation with the private sector regarding the measures contained in the Bill there has not been a general endorsement of the impact of measures contained in the Bill. For example, the Institute of Charter Accountants in Australia, while supporting the consultative approach to the drafting of the consolidation measures stated that:

> While consolidation potentially offers a better tax regime for corporate groups the cost of transition to the new regime will be significant so that businesses need time to determine the best way forward.
>
> In particular small and medium enterprises will need to consider their tax profiles carefully before opting to Consolidate, a decision which will also require them to make numerous internal system changes.[6]

While this Bill contains the structure necessary for the establishment of the consolidation regime, the Assistant Treasurer has stated that a further Bill will be introduced in June 2002 containing additional rules and that this will be followed by another Bill in the Spring sittings dealing with residual matters.[7]

As noted above, a recommendation of the Ralph Report was that the current grouping rules be abolished when the consolidation regime comes into force. The February 2002 Draft Bill proposed that the grouping measures would cease to be available on the introduction of the consolidation regime, effectively meaning that businesses would have to chose to consolidate or operate as independent entities from 1 July 2002. Following representations on the February draft Bill, the Assistant Treasurer announced that the current grouping rules would apply for a 12 month transitional period (until 1 July 2003) and that the rules relating to loss transfers and capital gains tax cost bases will continue to be available for a further 12 month transitional period (ie until 1 July 2004). These measures were seen as assisting small and medium sized businesses to transfer to the new consolidation regime.[8]

Main Provisions

General Effect

Schedule 1 of the Bill will insert a **new Part 3-90** into the *Income Tax Assessment Act 1997*. The proposed Part contains the rules dealing with consolidation and **proposed Division 701** contains 'Core rules'.

Subsidiary members of a consolidated group are to be treated as part of the head company of the consolidated group rather than as separate entities for determining the head company's liability for tax in a year or whether the head company has made a particular sort of a loss in the year. (Particular sorts of loss include an overall tax loss, film losses, net capital loss and various types of foreign losses.) (**proposed section 701-1**).

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When calculating the value of an asset for the head company, the prior history of the asset in the hands of the subsidiary member of the consolidated group is generally to be taken to be its history in the hands of the head company (**proposed section 701-5**). The value of the asset will generally be its tax cost (basically its depreciation value but see below for further detail), although some assets, such as a right to deductions, will not have their value set (**proposed section 701-10**).

If an entity ceases to be a member of a consolidated group, **proposed sections 701-20 and 701-25** provide for the valuation of the assets held by the head company to be returned to the associated entity. If the member leaves the group and does not become a member of another group the value of the assets for the head company is to be determined according their tax cost at the time of the subsidiary leaving the group. However, the head company will also be able to take into account any outstanding liability owed to a member of the consolidated group by the entity leaving the group when determining the value of the assets leaving the group. Trading stock of the subsidiary leaving the group is to be valued as the same amount for the head company, ensuring that there are no tax consequences relating to the trading stock although its actual value may have changed.

If an entity ceases to be part of a group for a period during a year, its profit or loss contribution to the group is to be determined according to the actual periods when it was or wasn't a member rather than on a pro-rata basis (**proposed section 701-30**).

If an entity ceases to be a member of a consolidated group, the history of assets deemed to be held by the head company will continue to apply to the assets as if the leaving member held those assets during the consolidation period (**proposed section 710-40**).

Proposed sections 701-55 and 701-60 deal with the setting of the tax cost of an asset. As noted above, where depreciation values apply to the asset this will generally be the tax cost, although there are provisions for adjusting the effective life of the asset to reflect its depreciation value at the time the tax cost is calculated. The tax cost of trading stock is to be the value for other tax purposes at the time, while the tax cost of liabilities owed to the head company by an entity leaving the group will be its market value at the time.

There are also a number of situations where there will be adjustments to reflect special arrangements between various entities, such as where the head company enters into an arrangement to pay for a service to be delivered to the group company, where there are disproportionate deductions allowed between the times before and after joining the group and to take account of any accelerated depreciation available (**proposed sections 701-70 to 701-80**).

Membership

Proposed Division 703 deals with the membership of a consolidation group. A consolidation group is to consist of a head company and all the subsidiary members of the group and will continue to exist until the head company ceases to be the head company or

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becomes a member of a multiple entry consolidated (MEC) group (this is a group where foreign ownership applies – see below) (**proposed sections 703-5 and 703-10**).

A head company must be an Australian resident which also has some or all of its income taxed at the company tax rate. If the head company is a wholly-owned subsidiary of another company which also satisfies these requirements, it must not be a member of a consolidated group or a group which is capable of being consolidated.

An entity may be a subsidiary member of a group if:

- it is a company, trust or partnership that is not an excluded entity (see below)
- if it is company, all or part of its income is taxed at the general company tax rate, it is not a non-profit company and it is an Australian resident (but not a dual resident)
- if it is a trust, it is a resident trust for tax purposes for the year in question, and
- it must be a wholly-owned subsidiary of the head company of the group. This will be where the holding entity and/or one or more of its subsidiaries hold all of the membership interests in the entity. There are special rules to allow employee shares to be disregarded and to take account of interposed entities in determining ownership (**proposed sections 703-15, 703-25, 703-30, 703-35 and 703-45**).

An entity will be excluded from being a subsidiary member of a group if:

- it is tax exempt under Division 50 of the ITAA97 (eg as it is a charity, educational institution etc)
- it is a company and:
  - it is a credit union and it is not a recognised large credit union
  - is a co-operative company which borrowed money from a government
  - is a pooled development fund at the end of the year, or
  - is a film licensed investment company, or
- it is a complying superannuation entity or a non-complying approved deposit fund or superannuation fund (**proposed section 703-20**).

Choice

The head company of a group on the day when it chooses to become a consolidated group may apply to the Commissioner for the group to be consolidated on that day. Such a choice is irrevocable and must specify a day after 30 June 2002. Such an application may be made by a company which is not a head company at the time of application (ie the

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group may anticipate later consolidation and make the application before the group actually consolidates) (**proposed section 703-50**). A group may also come into existence when a MEC group, which has foreign ownership, ceases to exist but the remaining structure complies with the consolidation rules in regard to both having a head company and eligible subsidiaries (**proposed section 703-55**).

The head company of a group will be required to notify the Commissioner of certain events, including when a member becomes or ceases to be a member of the group and when the group ceases to exist (**proposed section 703-60**).

MEC Groups

A MEC (multiple entry consolidated) group may arise where there is a foreign entity which has at least two wholly owned Australian subsidiaries (tier-1 company) which also have Australian resident subsidiaries. Under the proposals, the Australian subsidiaries may elect to become a consolidated group with one of the tier-1 companies becoming the head company (**proposed sections 719-5 and 719-10**).

For an MEC there must also be a top company, which is to be a foreign resident company which is not a wholly-owned subsidiary of another resident company, other than a prescribed dual resident company or a resident company which fails to meet the taxation requirements of a tier-1 company (see below).

A tier-1 company must:

- have all or part of its income taxed at the general company tax rate and not be taxed as an excluded company (see proposed section 703-20 above)
- be an Australian resident who is not a prescribed dual resident, and
- be a wholly-owned subsidiary of the top company and not a wholly-owned subsidiary of a resident company unless that company fails to meet the above two requirements (**proposed section 719-20**).

Members of a potential MEC group may apply to the Commissioner to become a MEC group on a specified day so long as none of the tier-1 companies party to the application are already members of a group. Such a choice cannot be revoked (**proposed section 719-50**). The application will have to specify which of the tier-1 companies is to be the head company (**proposed section 719-60**).

Current group concessions

As noted above, the current concessions applying to wholly-owned company groups will substantially cease to apply after a transitional period for the introduction of the consolidation regime. **Part 3 of Schedule 3** of the Bill deals with the restriction of the

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availability of the current grouping concessions. In relation to the CGT roll-over relief available between members of a company group, this will generally cease to be available after a consolidation event occurred after 30 June 2003. However, if the income year of the consolidated group occurs after 30 June 2003, the operative date will be extended to the earlier of the consolidation date and 1 July 2004. After the changes come into effect for an entity, CGT roll-over relief for the transfer of assets will only be available if both companies are members of a wholly-owned group and one of the companies is a foreign resident, effectively denying the relief to resident company groups (**items 20 to 23 of Schedule 3**).

Similarly, transfers of losses between wholly-owned members of a company group will be restricted from 30 June 2003, or their consolidation date, or 1 July 2004 for entities which have an income year ending after 30 June 2003. After the relevant date, if a group has not consolidated, losses will only be able to be transferred where both of the companies are members of a wholly-owned group and one of the companies is an Australian branch of a foreign bank (**proposed subdivision 170-B**).

The explanatory memorandum to the Bill states that the repeal of other existing grouping concessions, such as the inter-corporate dividend rebate, will be dealt with in later legislation.[9]

General

If the head company of a group fails to pay its tax liabilities as they fall due, the members of the group will be jointly and severably liable to pay the liability (**proposed Division 721**).

Proposed Divisions 705 and 707 contains rules relating to the value of assets and losses when these are transferred to the head company. The rules are of a technical nature and cover a vast range of circumstances. They will not be examined in this Digest.

Transitional provisions for the initial transfer to the consolidation regime are contained in **Schedule 2** of the Bill and relate to special rules for the calculation of loss values during the initial consolidation.

Specific anti-avoidance provisions relating to franking credit trading by membership of a group are contained in **Part 4 of Schedule 3** of the Bill. The measures reinforce existing measures in this area.

The Pay as you go instalment rules will be amended to make the head company liable for paying the PAYG instalments (**Schedule 4**).

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Concluding Comments

While the consolidation regime will no doubt result in lower administrative and compliance costs for larger company groups, with the Minister for Revenue estimating the savings to business to be 'around $1 billion over three years'[10], the estimated benefit for small and medium enterprises is difficult to judge. As noted above, the Institute of Charter Accountants has expressed concern about the potential cost to such enterprises and their need to consider if consolidation will be beneficial. The removal of most of the existing grouping tax concessions in effect leaves such business with the choice of incurring additional costs of consolidation or losing the benefits of grouping.

Endnotes

1 These rules allow concessional tax treatment in a number of areas for amounts passed within wholly-owned company groups including capital gains tax relief for the transfer of assets, inter-corporate dividend rebate for unfranked dividends, loss transfers and the transfer of excess foreign tax credits.

2 *Review of Business Taxation, A Tax System Redesigned,* pp. 517&8.

3 ibid., p. 517.

4 Treasurer, *Press Release*, 8 December 2000.

5 Assistant Treasurer, *Press Release*, 7 February 2002.

6 Institute of Chartered Accountants, *Latest News*, 17 May 2002.

7 Assistant Treasurer, *Press Release*, 16 May 2002.

8 Assistant Treasurer, *Press Release*, 16 May 2002.

9 Explanatory memorandum, p. 288.

10 Assistant Treasurer, *Press Release*, 7 February 2002.

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