The Senate

Economics Legislation Committee

New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

October 2002

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Chapter 1

Inquiry into New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

Background

1.1 The New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 (the Bill) was presented to the House of Representatives on 27 June 2002 by Mr Peter Slipper MP, Parliamentary Secretary to the Minister for Finance and Administration. The Bill was passed in the House of Representatives with 53 Government amendments on 28 August 2002 and introduced in the Senate on 16 August 2002.

Purpose of the Bill

1.2 In June 2002, the Parliament passed the *New Business Tax System (Consolidation) Act 2002* which introduced a new consolidation regime that would allow certain groups of entities to be treated as single entities for income purposes. The Bill builds on this legislation and amends a number of current acts. The provisions of the Bill are designed:

- to further implement the consolidation regime from 1 July 2002;
- to make consequential amendments in relation to imputation treatment of exempting entities and former exempting entities;
- to introduce a general value shifting regime (in place of existing share value shifting and asset stripping rules), applying mainly to interests in controlled companies and trusts that are not consolidated which meet control or common ownership tests; and
- to provide capital gains tax relief for a demerger in certain circumstances.

Reference of the Bill

1.3 In its report No. 8 of 2002, the Selection of Bills Committee recommended that the Bill be referred to the Senate Economics Legislation Committee to allow the Committee to explore the detail of the operation, revenue costs and compliance costs of the major measures in the Bill. On 18 September 2002, the Senate referred the Bill to this Committee for report by 22 October 2002.[1] The Committee agreed to bring forward the reporting date to 18 October.

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1 *Report No. 4 of 2002* of the Selection of Bills Committee, 19 June 2002.

Submissions

1.4 The Committee advertised the inquiry in the *Australian* on 25 September and on its web site. It also wrote to a number of government departments and agencies, organisations and individuals interested in the new business tax legislation, alerting them to the inquiry and inviting them to make a submission. In all the Committee contacted over 60 parties about the inquiry and received 17 submissions. These are listed in Appendix 1. The submissions are public documents.

Hearing and evidence

1.5 The Committee held one public hearing on this inquiry in Parliament House, Canberra, on Monday, 14 October. It took evidence from representatives from business and accountancy bodies as well as from officers from the Department of the Treasury and the Australian Taxation Office. Witnesses who presented evidence before the Committee are listed in Appendix 2.

1.6 Copies of the Hansard transcript are tabled for the information of the Senate. They are also available through the internet at http://www.aph.gov.au/hansard. Additional information provided to the Committee is also tabled with this report.

Acknowledgment

1.7 The Committee is grateful to, and wishes to thank, all those who assisted with its inquiry.

Chapter 2

The provisions of the Bill

The New Business Tax System

2.1 The New Business Tax System has a long history. In August 1998, the Government announced its overall tax reform strategy known as a new tax system. This package included detailed plans for comprehensive business tax reform which was to involve a framework of redesigned company taxation arrangements.

2.2 At that time, the Government expressed its intention to consult with business on the proposed reforms and appointed a review committee that was to start the process of consultation. The committee was to assess the design and the administration of the tax regimes affecting business to identify their main shortcomings and their impediments to productivity and innovation. It was also to make recommendations 'on the fundamental design of the business tax system, the processes of ongoing policy making, drafting of legislation and the administration of business taxation.'[1]

2.3 The overarching objective of the review was to design an Australian business tax system that would deliver higher levels of economic growth.[2] The report explained:

> Reform needs to be developed within the context of enhancing economic performance, and a well-functioning taxation system must be seen to be operating fairly, efficiently and transparently. It should provide certainty, be as simple as possible and generate compliance costs as low as practicable. The system must have integrity and be neutral as between taxpayers. Importantly, taxpayers must feel that all are paying their fair share and there is equity in the system.[3]

2.4 After producing a number of discussion papers, conducting public seminars and focus group meetings, and consulting with business and taxation experts, the committee produced its report in July 1999. The Committee was chaired by Mr John Ralph AO and became known as the Ralph Review.[4]

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1 *A Tax System Redesigned: More certain, equitable and durable,* Review of Business Taxation, Report, July 1999. (The Ralph Review), p. v.

2 The Ralph Review, p. 2.

3 The Ralph Review, p. 2.

4 Press Release, Treasurer of the Commonwealth of Australia, the Hon Peter Costello MP, No. 058, 21 September 1999.

2.5 Progressively, the Government, after extensive consultation with business, has introduced legislation based on the recommendations of the Ralph Review and in keeping with its commitment to implement business tax reform. On the whole business has supported the Government's approach to the staggered release of legislation. According to the Corporate Tax Association (CTA) 'it breaks the package down into more or less manageable bits and gives stakeholders something to work on in the meantime. It is certainly preferable to having to wait until the very last detail of the legislation has been finalised.'[5]

2.6 By the end of 2000, key elements of the package had been introduced and progress made in developing further aspects of the reform program. On 22 March 2001, the Treasurer put forward the Government's timetable for delivering the remaining elements of its business tax reform package. He noted that the Government had adopted in most cases:

> …the practice of releasing exposure drafts of legislation in order to identify issues of concern to the business community and to consult on implementation.[6]

2.7 He stated that an orderly phasing of further changes would assist business adjust to the new provisions and ensure that the benefits of the new tax system and business tax arrangements could be captured fully.[7] The Government's intention was to stage the implementation of the remaining business tax changes with the commencement date for several measures deferred from 1 July 2001 to 1 July 2002. The consolidation regime, the general value shifting rules and simplified imputation arrangements were among the measures to be deferred.

2.8 He also announced that the Government had given in-principle support for a demerger mechanism in the tax law to improve flexibility in business structures. He indicated that this matter would continue to be developed with some priority, including linkages with the consolidation regime.

2.9 During 2001 and the first half of 2002 further legislation on the New Business Tax System was passed. The most relevant for the purpose of this inquiry included the *New Business Tax System (Consolidation) Act (No. 1) 2002* and the *New Business Tax System (Imputation) Act 2002*.

2.10 The Bill before the Committee represents further progress in the implementation of the Government's business tax reform program.

Provisions of the Bill

2.11 The main provisions in the Bill are intended:

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5 Submission no. 1, p. 9.

6 Press Release, Treasurer, No. 016, 22 March 2001.

7 Press Release, Treasurer, No. 016, 22 March 2001.

- to introduce second stage measures of the new consolidation regime that commenced with the introduction of the New Business Tax System (Consolidation) Bill 2002 on 16 May 2002;
- to make consequential amendments to the current exempting and former exempting company provisions of the imputation system;
- to introduce a value shifting regime that will apply mainly to interests in controlled company and trust groups to prevent manipulation of tax rules by shifting taxable value between related parties—the legislation is intended to ensure that appropriate tax treatment is given to capital gains and losses generated through arrangements which cause shifts in value between assets; and
- to provide tax demerger relief at the investor and entity level to apply where a corporate or trust group is split into two or more entities.

2.12 Most commentators agree that this Bill is both substantial and complex.[8] However, as noted above, it is the product of both a long process of extensive consultation with business and ongoing review. The CTA submitted that:

> There has been an ongoing and effective consultation process between government officials and external stakeholders, which has helped to identify and address problem areas.[9]

2.13 Even so, submissions to this inquiry have underlined a number of areas of concern. For the purposes of this inquiry, the Committee will consider in detail only the provisions of the Bill that have generated interest or attracted comment.

2.14 The report deals with the four main elements of the Bill in the following order—the consolidation regime; the imputation system; the general value shifting regime, and the demerger provisions.

8 See comments by the CTA, submission no. 1; John Morgan, submission no. 3.

9 Submission no. 1, p. 1.

Chapter 3

Consolidation

Introduction

3.1 The Ralph Review recommended that consolidated income tax treatment for groups of entities be introduced. It recognised that the introduction of a consolidated regime would involve significant change but that the need for such reform stemmed from the high compliance costs and high tax revenue costs and concomitant complex anti-avoidance provisions associated with the current tax treatment of company groups.[1] The Review believed that consolidation would offer major advantages to entity groups in terms of 'both reduced complexity and increased flexibility in commercial operations (driven by intra-group transactions being ignored for tax purposes)'. It believed that associated short-term transitional costs would be well worth the long-term benefits from this reform.[2]

3.2 On 14 May 2002, the Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan, announced the introduction of a new consolidated regime as part of the next stage of the Government's legislative program for business tax reform. The new regime was to build on progress already made in implementing the program and was recognised as a major change in business tax law.

3.3 The Corporate Tax Association of Australia (CTA) maintained that:

> The treatment of a wholly-owned Australian resident group of companies as a single entity for tax purposes, combined with the repeal of the current grouping and capital gains tax (CGT) rollover provisions, represents the biggest single reform measure to come out of the *Review of Business Taxation* for corporate Australia.[3]

Aims of the Bill

3.4 Consistent with the findings of the Ralph Review, the new system is intended to assist in the simplification of the business tax system resulting in both reduced taxpayer compliance costs and ATO administration costs, improve the efficiency of business restructuring and strengthen the integrity of the income tax system.[4]

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1 Ralph Review, p. 517.

2 Ralph Review, p. 518.

3 Submission no. 1, p. 1.

4 Mr Peter Slipper MP, House Hansard, 28 August 2002, p. 6017. *Revised Explanatory Memorandum,* New Business Tax System (Consolidation) Bill (No. 1) 2002, pp. 4–5.

3.5 In essence, group consolidations are intended to facilitate effective tax restructuring for Australian businesses and to reduce compliance burdens once the initial set up is completed.

3.6 Parliament passed the *New Business Tax System (Consolidation) Act 2002* in June 2002 as the first stage in the implementation of the new consolidation regime. This regime allows certain groups of entities to be treated as a single entity for income tax purposes. It applies to a wholly-owned group of Australian resident entities that choose to form a consolidated group for income tax purposes. A consolidated group consists of:

- a head company; and
- all of the subsidiary members of the group.

3.7 As noted above, a consolidated group is to be treated as a single taxpaying entity for income tax purposes. The subsidiary entities lose their individual income tax identities and are treated as parts of the head company of the consolidated group for the purposes of determining income tax liability.

3.8 Under this scheme, wholly-owned entity groups will be allowed to choose to consolidate from 1 July 2002. There will be a transitional period that allows the existing grouping provisions to continue to operate in parallel with the new regime until July 2003.

3.9 Due to the weight and significance of this reform, the new regime is being enacted progressively. This Bill contains the second tranche of legislation that supplements the *New Business Tax System (Consolidation) Act 2002.* On 26 September, another tranche of business tax reform legislation was introduced into Parliament in the form of the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002. Further provisions are scheduled for introduction later this year and are to deal with remaining discrete and specialist areas of the consolidation regime, including rules relating to the life insurance industry.[5]

Tax cost setting rules and international aspects of consolidation

3.10 The provisions in this Bill dealing with consolidation cover the areas of tax cost setting rules and international aspects of consolidation The Bill introduces measures intended:

- to modify the cost setting rules that were introduced in the *New Business Tax System (Consolidation) Act 20*02;[6]

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5 *Revised Explanatory Memorandum*, New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 4. Press Release, Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan, C104/02, 27 September 2002.

6 *Revised Explanatory Memorandum*, New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, pp. 12–14.

- to introduce cost-setting rules for the formation of consolidation groups; and[7]
- to introduce transitional rules to reduce the compliance costs associated with forming a consolidated group.[8]

3.11 The provisions in this Bill also contain important measures dealing with international aspects of consolidation. These include measures to ensure that 'the foreign tax credit provisions work appropriately for a consolidated group, including allowing the head company to use excess foreign tax credits available to a subsidiary member at the time of joining'.[9]

Views on the consolidation provisions

3.12 The submissions that commented on the proposed consolidation regime endorsed the intention of the legislation. For example the Institute of Chartered Accountants (ICAA) supported the general concept that group consolidations would allow effective tax restructuring for Australian businesses and reduce compliance burdens once the initial set up is completed.[10]

3.13 According to the CTA:

> In the broader scheme of things, Consolidation represents a systemic and comprehensive response to the structural shortcomings in the current law that derive from the dual asset and equity CGT cost bases in assets, and the multiple layers of ownership that typically occur in corporate groups. It is first and foremost an integrity measure.[11]

3.14 Despite general support for the Bill, a number of submissions identified what they regard as weaknesses in the legislation. The issues covered areas such as:

- beneficial ownership;
- the Same Business Test (SBT);
- Tax Sharing Agreements (TSA);
- losses, capital injections and the available fraction;
- over-depreciation and dividends (S.705-50);
- allocable cost amount (ACA) and uniform capital allowances (UCA)—Div 702;

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7 *Revised Explanatory Memorandum*, New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 13.

8 Senator Ian Campbell, Parliamentary Secretary to the Treasurer, Senate *Hansard*, 16 September 2002, p. 4129.

9 Senator Ian Campbell, Parliamentary Secretary to the Treasurer, Senate *Hansard*, 16 September 2002, p. 4129; Mr Peter Slipper, Parliamentary Secretary to the Minister for Finance and Administration, House *Hansard*, 28 August 2002, p. 6017.

10 Submission no. 2, p. [1].

11 Submission no. 1, p. 1.

- substituted accounting periods;
- continuity of ownership;
- profits 'accrued';
- linked assets and liabilities;
- privatised assets subject to particular uniform capital allowance limitations;
- the treatment of losses notably where there is a part year pre-consolidation period which appears to be dealt with anomalously;
- clauses 701–35, which deal with a CGT event for pre-formation roll-over after 16 May 2002;
- costs of compliance especially for SMEs; and
- extension to transitional period.

3.15 Rather than include in the body of the report a discussion on these various matters, many of which are of a technical nature, they are set out in detail together with a summary of the evidence in Appendix 3.

3.16 The Committee, however, draws particular notice to the issue of the burden of compliance confronting SMEs in particular and the suggestion put forward by a number of submissions that an extension to the transition period be granted to SMEs.

Costs of compliance

3.17 The CPA accepted that consolidation legislation is 'necessarily complex' and that greater complexity is expected to lead to greater costs, particularly for SME taxpayers. It estimated that:

> even the most simple corporate groups will incur compliance costs in the order of $20,000 to $30,000 to consolidate.[12]

3.18 Mr Paul Drum, CPA, explained further at the public hearing that the feedback from CPA members was indicating that it would cost between $25,000 to $30,000 to work through the exercise on whether or not to consolidate.[13] He added:

> The answer at the end of the day might be no, you should not, but you still have to do the work to determine what best suits your group.[14]

3.19 The CPA cited valuation requirements as being particularly significant in the compliance costs for SMEs. (see Appendix 4)

3.20 The ICAA shared this view. It submitted:

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12 Submission no. 11, p. 1, Appendix A.

13 *Committee Hansard*, p. E2.

14 *Committee Hansard*, p. E2.

> An example of the size of the task is that when entering into the consolidations regime, the tax value of every asset a group of companies may change and therefore an analysis of every asset may be required including independent market valuations of these assets.
>
> Although the legislation offers a concession in relation to the compliance burden, allowing the enterprise not to undertake this analysis for every asset but to tax set values at their current value, tax practitioners will still have to undertake this analysis as, without doing this, they will not know the potential savings that they are forgoing. [15]

3.21 In light of what it deemed to be complex rules and the high cost of compliance, the CPA recommended that a 'carve out' be granted from these rules for SMEs and they be allowed the option to continue to comply with the existing law.[16]

3.22 Mr Mc Cullough, Department of Treasury, noted, however, that:

> As soon as you decide to carve anything out without providing an option and that thing is perceived to be a good thing, as many taxpayers submit it—consolidation—as soon as you decide to take a group out, that is an important decision. There will be a large number of people who will say—and I think the consolidation process has proved this—'we are currently not able to get the consolidation regime; we would like to'.[17]

Extension to transitional period

3.23 The ICAA described the process in preparing to enter the Consolidation regime as 'a massive undertaking'. It stated:

> To analyse all the consequences of this fundamental shift in the tax treatment of corporate groups is a process that even for small and medium enterprises may take hundreds of man-hours.[18]

3.24 Moreover, it noted that although the ATO has undertaken a series of training sessions, it has been insufficient given the nature of the changes that are about to occur. It stated further:

> The time left for the ATO to provide effective education of the process that businesses need to undertake to enter into the Consolidations regime is very short and there does not appear to be a concern regarding this fact.[19]

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15 Submission no. 2, p. p. [4].

16 Submission no. 11, Attachment, pp. [2, 3].

17 *Committee Hansard*, p. E36.

18 Submission no. 2, para 2.1.4.

19 Submission no. 2, para. 2.1.5.

3.25 The ICAA related the concerns of its members who were indicating that they 'do not think they will have the time to do everything they will have to do'.[20] Consequently, the ICAA submitted:

> Regarding small and medium enterprises, that the committee should recommend an amendment to the Bill allowing for a further extension to the transitional period. This extension to the year ended 30 June 2004 would allow agents the time [to] undertake the processes required.[21]

It further explained:

> We suggest the additional year apply for SMEs that have a turnover of less than $5 million. These are the entities that rely heavily on their tax agent or other tax practitioners for implementation of taxation changes and will not have designated internal tax resources. This should have no substantial effect on the operation of the Consolidation legislation. This would involve elements of the Consolidations legislation relating to the removal of the transfer of tax losses, intergroup dividend rebates and other similar provisions applying for SME from 1 July 2004 rather than 1 July 2003.[22]

3.26 Ernst and Young supported this recommendation that small businesses be granted a further transitional year to 30 June 2004 to access existing group concessions. It noted that:

> Small business groups and their advisers do not have the resources to analyse the rules fully at this stage and will benefit from the experience which larger groups, as early adopters, will have.[23]

Summary of criticism

3.27 Although submissions highlighted problems in this legislation, they were keen for the Bill to proceed.[24] Their intention was to identify shortcomings in the legislation and not to block its progress. Indeed, most submissions were asking for a speedy resolution to the problems. In criticising the Bill, Mr John Morgan informed the Committee that his intention was not to undermine support for the consolidation regime but rather:

> …to redouble our efforts to correct as much as we can as it is passed into legislation and then to have a comprehensive program of collecting and

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20 Ken Mansell, Senior Taxation Consultant, ICAA, *Committee Hansard*, p. E5.

21 Submission no. 2, para. 2.1.6.

22 Submission no. 2, para. 2.1.6.

23 Submission no. 8, para 2.5, p. [4].

24 See ICAA, submission no. 2, p. [6], which stated clearly that it did not believe that any of the issues it raised 'should stop the committee from recommending the Bill be passed'. See also Taxation Institute of Australia, submission no. 13, p. [1].

> fixing the further defects that will emerge over the first few years of its operation.[25]

3.28 Indeed, submissions generally accepted that the legislation would undergo further review and refinement.[26] The Taxation Institute of Australia noted that:

> As with the introduction of any new tax regime, it would be prudent to acknowledge that in a mature legislative environment there will be an ongoing need for further adjustments to these provisions beyond the immediate tranche of legislation.[27]

3.29 Some, however, sought firm assurances that the matters they raised would continue to be reviewed and be subject to further refinement to resolve the difficulties. The ICAA requested the Committee to:

> Confirm with the ATO the items that have been raised during the practitioner consultation process and ensure that the ATO are committed to ensuring these issues are rectified in future administrative concessions or legislative amendments.[28]

Committee view

3.30 The Committee appreciates that the proposed legislation will need further refinement and refers the Government to appendix 3 which details the areas of concern. It especially notes the concerns expressed by the ICAA and Ernst and Young on the demands being placed on small business to meet the requirements of substantial reform and the ATOs difficulties in implementing an effective education program for the new consolidation regime.

Cost to revenue

3.31 Mr Bob McMullan MP noted that the Opposition's support for the Ralph reform package was prefaced on the clear understanding that it would be revenue neutral. He noted in his speech during debate on the Bill that he was still waiting for the Treasurer to release the 'state of the balance sheet on the Ralph business tax reforms' to assess whether this initial agreement had been met.[29]

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25 Submission no. 3A, p. 1.

26 Mr Anthony Stolarek, Ernst and Young, *Committee Hansard*, p. E5 mentioned the 'inevitable administrative resolution and finetuning'.

27 Submission no. 13, p. [1].

28 Submission no. 2, para 2.2.3, p. [8].

29 Mr Bob McMullan, House *Hansard*, 28 August 2002, p, 6007.

3.32 The Explanatory Memorandum offered the following detail on the financial impact of the consolidation measure which is expected to cost approximately $1 billion over the forward estimate period.[30]

2001—2002	*2002—2003*	*2003—2004*	*2004—2005*	*2005—2006*
nil	$180 million	$370 million	$335 million	$280 million

3.33 In its report on the New Business Tax System (Consolidation) Bill (No. 1) 2002, tabled in June 2002, the Committee included additional information provided by Treasury that explained the revenue impact of consolidation. [31]

3.34 In turning specifically to the consolidation provisions contained in this Bill, the Explanatory Memorandum noted that they are 'integral to the consolidation measure which is expected to reduce ongoing compliance costs'. The measures are designed to ensure that:

- intra-group transactions are ignored for taxation purposes, so that taxation and accounting treatments are more closely aligned;
- administrative requirements, such as multiple tax returns and multiple franking account, losses, foreign tax credit and PAYG obligations are reduced; and
- integrity measures aimed at preventing loss duplication, value shifting or the avoidance or deferral of capital gains within groups do not apply within a consolidated group.[32]

3.35 The Explanatory Memorandum stated further:

> The consolidation regime will necessitate some initial up-front costs for groups as they familiarise themselves with the new law, update software and notify the ATO of a choice to consolidate. Large corporate groups may incur greater start-up costs in determining the market values of group assets. These costs will be alleviated by a transitional measure under which the group can elect (prior to 1 July 2003) to bring assets into the group at their existing cost bases. Groups that form after the transitional period may use the market value guidelines developed by the ATO to minimise compliance costs.[33]

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30 *Revised Explanatory Memorandum* p. 4.

31 Senate Economics Legislation Committee, Appendix 2 to *Report on New Business Tax System (Consolidation) Bill (No. 1) 2002*, June 202, p. 20.

32 *Revised Explanatory Memorandum*, New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 4.

33 *Revised Explanatory Memorandum*, New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 4.

3.36 The CTA did not accept that the official estimates were an accurate reflection of the likely impact of Consolidation on the utilisation of tax losses under the current state of the proposed law. It submitted, however, that;

> …it would be completely inappropriate for the Committee to now judge this measure in isolation of all the other RBT measures, many of which were revenue positive, and have already been introduced. Even if the revenue estimate turns out to be correct…busines will already have 'paid' for the implementation of Consolidation through various other trade-offs and compromises that represent the overall RBT package of tax measures.[34]

3.37 In summary, the CTA was of the view that the Consolidation regime in its proposed form would not represent a significant threat to the revenue in the short term. It stated further:

> In fact, we are strongly of the view that by further preventing loss duplication and loss cascading, as well as bringing to account depreciation recapture which could previously be avoided, the measure will have a significant positive impact on the revenue over the medium to long term.[35]

34 Submission no. 1, p. 3.

35 Submission no. 1, p. 6. See also *Committee Hansard*, p. E10.

Chapter 4

Imputation

4.1 On 30 May 2002, the Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan announced the Government's intention to introduce legislation to implement a new simplified imputation system. An imputation system governs how and when income tax paid by companies and certain other entities is imputed to their shareholders. The process is also known as franking.

4.2 According to the Minister, the new system:

> forms part of the Government's response to the Review of Business Tax recommendations to reform the imputation system and simplify the franking process for companies.[1]

4.3 By simplifying the imputation system, the new measures were designed to reduce compliance costs and provide more flexibility for companies in franking their dividends to shareholders.[2] The Minister explained that:

> Under the new legislation companies will be able to provide more certainty to shareholders about their likely franking policies in relation to future dividends.[3]

4.4 The imputation provisions which set out the core rules for a new imputation system were contained in the New Business Tax System (Imputation) Bill 2002, the new Business Tax System (Over-franking Tax) Bill 2002 and the New Business Tax System (Franking Deficit Tax) Bill 2002 which were passed in June 2002.[4]

4.5 The provisions in the Bill are consequential amendments arising from this recently enacted legislation. They are intended to ease the initial impact of the proposal to align the franking and income years of companies. They allow late balancing companies an extended transitional franking year starting on 1 July 2002 and ending on the last day of their 2002–2003 income year.[5]

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1 Press Release, Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan, No. C63/02, 30 May 2002.

2 *Explanatory Memorandum*, New Business Tax System (Imputation) Bill 2002, p. 4.

3 Press Release, Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan, No. C63/02, 30 May 2002.

4 All three were assented to on 29 June 2002.

5 Attachment 3, Press Release, Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan, no. C72/02, 27 June 2002.

4.6 The provisions allowing late balancing companies (and similar entities taxed like companies) the option of retaining their existing franking and income years or aligning them, however, are subject to specific rules.

4.7 Mr McMullan stated during the second reading debate that:

> These amendments ensure that entities effectively owned by non-residents and tax-exempt entities cannot trade the benefits of the franking credits. That seems to me to be a proposition worthy of support from all members of the House. It is the assessment—on examination, I think it is a correct assessment—that they will have a little or no revenue impact. They are sensible and uncontroversial measures and we will support them.[6]

4.8 The Committee received no additional comment on the imputation provisions in the Bill and therefore sees no impediment to the passing of these provisions.

6 Mr Bob McMullan MP, House *Hansard*, 28 August 2002, p. 6007.

Chapter 5

The General Value Shifting Regime

Introduction

5.1 The Ralph Review identified a number of deficiencies in the current law on value shifting of assets which it described as 'very complex and detailed, with resulting high compliance costs'. It explained further:

> As deficiencies in the rules are identified, they are patched, resulting in a steady stream of complex amendments. This is all because the current law is *ad hoc* without a solid base upon which to set value shifting rules.[1]

5.2 It recommended the implementation of general value shifting rules that would deliver significant integrity benefits to the new business tax system. It stated further:

> Equity and efficiency will be enhanced as taxpayers are taxed more consistently on transfers of value, whether these occur by way of conventional realisation or by value shifting. Generalised rules will also provide more consistent treatment for comparable value shifts across entities and transactions.[2]

Aims of the Bill

5.3 The measures in the Bill propose to introduce a general value-shifting regime (GVSR) applying mainly to interests in controlled companies and trusts that are not consolidated but that meet control or common ownership tests.[3] It was proposed as a complementary integrity measure to the Consolidation regime. The CTA explained that:

> Consolidation only prevents loss duplication and cascading within wholly owned groups which, at least in theory, leaves scope for value shifting outside of wholly owned structures. GVSR is intended to fill this gap.[4]

5.4 The regime is intended to replace the share value shifting and asset stripping rules currently in the income tax law which, as noted above, are deemed to be deficient in many respects. It is designed to prevent the manipulation of ordinary tax rules by shifting taxable value between assets by related parties.[5] It will apply to a

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1 Ralph Review, p. 262.

2 Ralph Review, pp. 262–3.

3 Ms Julie Bishop MP, House *Hansard*, 28 August 2002, p. 6015.

4 Submission no. 1, p. 8.

5 Press Release, Minister for Revenue and the Assistant Treasurer, the Hon Helen Coonan, No. C57/02, 14 May 2002.

wider range of entities, as well as embrace a broader range of activities.[6] The regime is to apply to arrangements and dealings involving entities that are not part of the same consolidated group, but are nonetheless related in some way.[7]

5.5 The provisions of the Bill also provide for loss integrity change to allow global asset valuation. Under the loss integrity reforms, assets will be valued globally in calculating unrealised losses, thereby further reducing compliance costs.[8] The global valuation approach is optional and according to the Explanatory Memorandum 'will not disadvantage taxpayers in terms of the current law'.[9]

5.6 The loss integrity change is expected to have 'a significant impact in reducing compliance costs in particular cases as the savings in valuation costs if assets are valued together rather than individually.'[10]

5.7 The Explanatory Memorandum acknowledged that initially a small to moderate increase in compliance costs for the GVSR was expected for most taxpayers affected by the measure. It maintained that in general, the *de minimis* rules and safe-harbours would assist to keep compliance costs down.[11]

5.8 Mr Peter Slipper MP explained that the compliance costs associated with this measure were 'a consequence of business coming to terms with the new legislation only, and no new notification or specific compliance costs associated with this measure are foreseen'.[12]

Views on the GVSR

5.9 A number of submissions held a very different view and expressed concern about the value shifting rules imposing increased corporate workloads.[13] Although

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6 *Revised Explanatory Memorandum*, New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 7.

7 Press Release, Minister for Revenue and the Assistant Treasurer, the Hon Helen Coonan, No. C57/02, 14 May 2002.

8 Ms Julie Bishop MP, House *Hansard*, 28 August 2002, p. 6015.

9 *Revised Explanatory Memorandum*, New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 6.

10 *Revised Explanatory Memorandum*, New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 7.

11 *Revised Explanatory Memorandum*, New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 6.

12 Mr Peter Slipper, Parliamentary Secretary to the Minister for Finance and Administration, House *Hansard*, 28 August 2002, p. 6017.

13 ICAA, submission no. 2, p. [9]; Council of Small Business, submission no. 9, p. [1]; CPA, submission no. 11, p. [5]; Taxation Institute of Australia, submission no. 13, p. [2]. See comments in Fiona Buffini and Ian Howarth, 'Fine-tuning for new tax regime', *Financial Review,* 28 June 2002.

they recognised that the current value shifting provisions were deficient, they argued that the proposed regime should be modified to ameliorate compliance costs.[14]

5.10 The main areas of concern were:

- the lack of consultation in the developmental phase of the legislation;
- the sheer complexity of the provisions; and
- compliance costs particularly for SMEs.

5.11 The ICAA supported the general concepts of the GVSR. It noted, however, that unlike other areas of the Bill, this package did not undergo the same level of practitioner consultation. It was presented to practitioners in a final form. In essence, the ICAA found the drafting of this section of the Bill over complicated. It stated:

> Those involved in drafting the measures have ignored principle based drafting techniques in favour of prescriptive law. This level of complication will no doubt result in an increase in costs of compliance.[15]

5.12 The Taxation Institute of Australia expressed its dissatisfaction with the formulation and drafting of the provisions for the GVSR in stronger terms. It submitted:

> Regrettably, unlike consolidation, the value shifting provisions have not benefited from being developed in a constructive environment. They are an overreation and represent a pinnacle of complexity in the tax law. It would be of concern should this type of drafting become a precedent for the drafting of other tax laws. Never has so much legislation been written for so few people dealing with such a limited issue.
>
> As to the issue of consultation, in two places in the Explanatory Memorandum…it is claimed that there was 'extensive consultation' and 'there was significant consultation with tax practitioners and industry professionals'. This rhetoric is just not supported by the facts. [16]

5.13 The ICAA pointed out that the value shifting provisions would largely affect the small to medium enterprise sector and hence they would be the ones most likely to be effected by the overly complex provisions. Mr Mansell, ICAA, told the Committee:

> The institute's concern is about having legislation that is as intricate and as detailed as this having to be analysed by the tax agent who works in a shop above another shop and who has his 700 clients; it is not legislation that the lower end members are going to be able to pick up and run with. When the tax experts have trouble working out what it means for the large corporates, I do not think it is possible for where it is really going to hit hard—small

14 CPA, submission no. 11, p. 1 and section C, Attachment.

15 ICAA, submission no. 2, p. [9].

16 Submission no. 13, p. [2].

> and medium—to use this legislation. It is not practical for them to understand it as it stands.
>
> We agree with the concept fully; we just do not think that in its current form that concept is clearly enunciated.[17]

5.14 The Council of Small Business Organisations of Australia also noted that the value system method appeared to be very complex for practitioners. It stated that while it supports new business tax systems that are 'simple, easy to use, time efficient and not excessively complex with low compliance cost', it was not sure that this legislation would meet that criteria.[18]

5.15 The CPA agreed that the GVSR provisions in the Bill were 'extremely complex and lengthy (being at least double the size of the existing value shifting provisions)' and maintained that there would be substantial compliance costs for taxpayers especially SMEs.[19]

5.16 Mr Michael Buckley, Department of the Treasury, acknowledged that the legislation is very comprehensive with extensive detail but told the Committee that 'it is an integrity measure and a structural response, and accordingly it does have to provide detail and certainty to taxpayers'.[20] He also accepted that there was less consultation on this measure than either the consolidation or demerge regimes. But again he explained that the value shifting measures were an anti-avoidance integrity measure not usually subject to extensive consultation.[21]

5.17 The Tax Institute of Australia also pointed to a number of specific problems with the GVSR. It maintained that its concerns about Division 723 could have been avoided if flaws in the design of CGT provisions had been addressed. It also noted a potential double taxation situation with the operation of subsection 725–240(5) which could adversely affect minority shareholders.

5.18 Without going into further detail about the perceived shortcomings in the provisions governing value shifting, the Committee notes ICAA's recommendation that:

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17 *Committee Hansard*, p. E12.

18 Submission no. 9, p. 2.

19 Submission no. 11, p. [5].

20 *Committee Hansard*, p. E 38. He expanded further on the reasons for detail in the legislation which 'set out the key principles of what a value shift is and what sorts of transactions are covered and dealt with by the provisions. Much of the complexity and intricacies in the provisions are related to the provision of safe harbours and exclusions on the face of the legislation…'

21 *Committee Hansard*, p. E38.

> A review of the provisions is recommended to streamline the legislation to make it easier for practitioners to apply the principles involved in the General Value Shifting regime.[22]

5.19 The Taxation Institute of Australia was also prepared to accept the Bill going forward but on the understanding that concerns would be addressed and attention given to making the rules comprehensible. It proposed that the provisions remain as they now stand providing an undertaking is given:

- to prepare and include an instructive guide to the value shifting rules that would clarify their operation; and
- to address the underlying major concerns (in particular those issues highlighted above in respect of double taxation and Division 723) with the current rules through legislative change coupled with true consultation.[23]

5.20 In suggesting that the value shifting provisions would benefit from the inclusion of a brief explanatory guide, the Institute explained that there was already a precedent in the tax laws for this type of instructive tool.[24]

5.21 Mr John Morgan, tax partner Freehills, was less accommodating in his approach to accepting the provisions covering the GVSR. He recommended that they be excised from the Bill and referred to the Board of Taxation for proper exposure to public consultation.[25]

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22 Submission no. 2, p. [10].

23 Submission no. 13, p. [3].

24 Submission no. 13, p. [3].

25 Submission no. 3C, p. 2. In a suppplementary submission following the public hearing Mr Morgan stated: 'I reiterated on the LCA's behalf my written submission that this measure should be excised and referred to the Board of Taxation for asessment on the basis that it replace existing value shifting provisions which are reasonably well targetted (by comparison) with enormously difficult provisions that will be highly intrusive into the general operation of entities outside of consolidation and effectively introduces a domestic transfer pricing regime sector'.

Chapter 6

Demergers

Introduction

6.1 The Ralph Review found that 'where an entity undertakes a reorganisation of its operations, leaving members in the same economic position as they were immediately before the reorganisation, there should be no taxing event.'[1] It explained that under current arrangements, members in an entity that reorganises its activities, splitting them into a number of separate entities, may face a range of tax consequences. The Ralph Review believed that this situation may discourage entities from restructuring their operations and may lead to a reduction in the overall efficiency of the economy. It maintained that the provision of relief would enable widely held entities to restructure their operations with a minimum of difficulty for members.

6.2 In keeping with this finding, the Government's proposal to provide tax relief for demergers was announced on 6 May 2002 and was to apply on or after 1 July 2002. The demerger reforms are intended to increase efficiency by allowing greater flexibility in structuring businesses, thereby providing an overall benefit to the economy.[2]

6.3 Generally, a demerger involves restructuring a corporate or trust group by dividing it into two or more entities, with the underlying owners holding one or more of those entities directly.[3]

The aims of the Bill

6.4 The Bill would allow capital gains tax (CGT) roll-over when a CGT event happens to original interests in a company or trust under a demerger and new or replacement interests are received in the demerged entity. The roll-over allows a capital gain or loss to be deferred.

6.5 The CGT relief and dividend exemption will facilitate the demerging of entities by ensuring that tax considerations are not an impediment to restructuring a business.

6.6 According to Senator Coonan the key features of the model include:

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1 Ralph Review, p. 619.

2 Press Release, Minister for Revenue and the Assistant Treasurer, the Hon Helen Coonan, No. C57/02, 14 May 2002.

3 See explanation offered in Press Release, Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan, No. C40/02, 6 May 2002.

- providing demerger tax relief where underlying ownership is maintained and the original entity divests at least 80 per cent of its ownership interests in the demerged entity;
- applying the measure to widely held and non-widely held companies and trusts;
- allowing capital gains tax relief at both the shareholder and entity levels; and
- providing an exemption from the existing dividend rules, subject to integrity rules.[4]

6.7 The minister stated that:

> Tax relief for demergers will increase efficiency by allowing greater flexibility in restructuring businesses, providing an overall benefit to the economy.
>
> The government has implemented this latest measure in business tax reform to enhance the competitiveness of Australia's business sector.[5]

6.8 According to WMC the legislation will ensure that 'the economic interests and liabilities of Australian companies and their shareholders are the same before and after a demerger'.[6]

Views on the demerger provisions

6.9 The demerger provisions in the Bill attracted comment following the announcement of details of the Government's policy on the provision of tax relief for demergers on 6 May 2002. Media reports indicated strong support for the reforms, although some tax experts expressed concern with the new rules.[7]

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4 Press Release, Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan, No. C40/02, 6 May 2002 and C57/02, 14 May 2002.

5 Press Release, Minister for Revenue and the Assistant Treasurer, Senator the Hon Helen Coonan, No. C40/02, 6 May 2002.

6 Submission no. 6, p. 1.

7 See comments by Mr Wayne Plummer in Allesandra Fabro, 'Uncertainty still clouds demergers', *Financial Review,* 5 July 2002. Mr John Gonsalves, Ernst & Young, was reported as saying that the measures were an improvement on the original Ralph proposals and retained the pre-CGT status of assets, a crucial issue. In Fiona Buffini, Ian Howarth and Bruce Hextall, 'Tax breaks to trigger spin-off rush', *Financial Review,* 7 May 2002. See also, comments by Mr Peter Poulos and Mr Wayne Plummer in Damon Kitney and Fiona Buffini, 'Tax break may see flood of demergers', *Financial Review*, 8 May 2002; Annie Lawson, 'More consider splitting in light of tax changes', the *Age,* 1 June 2002; Fiona Buffini and Ian Howarth, 'Fine-tuning for new tax regime', *Financial Review,* 28 June 2002; comments by Mr Peter Poulos and Mr Wayne Plummer in Allesandro Fabro, 'Demerger law near but key issues unresolved', *Financial Review,* 16 September 2002; 'Anxious wait for WMC', the *Canberra Times*, 17 September 2002; and Mark Fenton-Jones, Capital gains tax change lauded'*, Financial Review*, 6 August 2002.

6.10 Submissions to this inquiry also strongly supported the basis for introducing demerger relief.[8] The CTA stated:

> The proposed demerger measures go hand-in-hand with the scrip-for-scrip measures that have already been passed by the Parliament. Both take-overs and demergers assist in enhancing an efficient and effective domestic capital market. The proposed measures will increase efficiency by removing the very considerable tax obstacles the current tax rules put in the way of restructuring of business operations.[9]

6.11 WMC also saw the proposed demerger provisions as a logical extension of the scrip for scrip rollover measures,[10] while the CPA judged the measures as 'necessary and appropriately balanced'. Similarly, Mr Wayne Plummer, Partner, PriceWaterhouseCoopers, submitted that the demerger measures present a very commercial and practical solution to the need identified in the Ralph Review. He stated:

> They will allow companies to escape the shackles of inefficient corporate structures and release trapped value for their shareholders. They will provide benefits to the Australian economy in allowing our companies to achieve efficient corporate structures which are conducive to more focused management and shareholder investment decisions.[11]

6.12 Although all submissions to the inquiry that commented on the demerger proposals expressed the view that they were 'necessary to improve efficiency and equity in the operation of Australian capital markets', some identified problems in the legislation.

Extending demerger relief beyond widely-held entities

6.13 The Explanatory Memorandum acknowledges that the measures in the Bill go beyond the Ralph recommendations. It notes, however that after several consultation sessions with the relevant stakeholders, including industry and their representatives, it was determined that the Ralph recommendations would be too restrictive.[12] It further explains that the Ralph recommendations were expressed:

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8 CTA, submission no. 1; ICCA, submission no. 2; Mr Wayne Plummer, PriceWaterhouseCoopers, submission no. 4; CSR, submission no. 5; WMC, submission no. 6; Incitec Ltd, submission no. 7, p. 1; Ernst and Young, submission no. 8; CPA, submission no. 11; Taxation Institute of Australia, submission no. 13; Securities Institute of Australia, submission no. 15 'believed the measures to be 'a very worthwhile reform'.

9 Submission no. 1, p. 6.

10 Submission no. 6, p. [1].

11 Submission no. 4, p. 2.

12 *Revised Explanatory Memorandum*, New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 344.

> …in terms of a consistent entities regime, where all but a handful of entities would be taxed as companies. That regime has not been implemented. The demerger rules in this measure had to take account of the current regimes.
>
> By providing the concessions, taxation will not be an impediment to business reorganisation by way of demerger. Facilitating the demerger of entities in this way ensures that taxation does not unnecessarily drive the choice of structure in which a business should operate.[13]

6.14 Ernst and Young also noted that the Ralph Review proposed limiting the demerger rules to widely held entities. It argued, however, that:

> The expansion beyond widely held entities is supported by a strong array of integrity measures in the demerger rules. These surround the CGT concession, and the dividend concession, with the capacity of the ATO to declare certain unacceptable demergers under Section 45B to constitute taxable dividends.[14]

6.15 Incitec Ltd suggested that the demerger provisions relating to both proportionate holding of membership interests before and after a demerger and the cost base allocation rules are rigorous and have more than addressed concerns over non-widely held entities accessing demerger relief.[15]

6.16 The CTA noted in its submission that the kind of economic efficiency gains achievable as a result of demerger rules apply equally to the SME part of the economy. It was aware of a number of diversified closely-held businesses that would be interested in restructuring their operations should this measure be introduced. It concluded:

> We do not consider that any particular integrity concerns that would arise by applying the demerger provisions beyond widely-held entities. There are sufficient integrity measures in the proposed rules, including a revamped dividend streaming provision that relates to the distribution of profits.[16]

The 20% interest rule

6.17 Mr Peter Poulos, M&A Tax Partner, KPMG, noted that throughout the consultation process it was clear that Treasury and the ATO, consistent with the Government's stated position, intended that demerger tax relief be available to both broadly and narrowly held entities. In his opinion, the intention is not reflected in the Bill. Mr Poulos pointed out that the Bill provides that the relief is not available where

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13 *Revised Explanatory Memorandum*, New Business Tax system (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, p. 344.

14 Submission no. 8, p. [6].

15 Submission no. 7, p. 3.

16 Submission no. 1, p. 7.

the demerging entity has a corporate or trust share or unit holder with a greater than 20% interest in the demerging entity. He explained that:

> This restriction would prevent most entities from demerging, as most entities would typically have a corporate or trust share or unit holder with a greater than 20% interest. This problem has been partly addressed in the latest amendments by providing that listed entities can demerge notwithstanding that they have a corporate or trust shareholder with a greater than 20% interest.[17]

6.18 Mr Poulos, stressed, however, that:

> Non-listed entities remain unable to elect for demerger relief where they have a corporate or trust shareholder with a greater than 20% interest…it is quite typical for non-listed entities to have such a share or unit holder, more so than is the case for listed companies. [18]

6.19 According to Mr Poulos, under the Bill as it now stands, non-listed entities 'will typically be unable to elect for demerger relief' regardless of whether they are characterised as large, medium or small businesses. He submitted:

> It is inappropriate and unjust to deny demerger tax relief to entities simply on the basis that they are not listed. There is no apparent policy justification for excluding most non-listed entities from the ambit of the measures. Further, the Bill excludes most non-listed entities in an arbitrary manner, ie. those non-listed entities which by coincidence do not have a corporate or trust share or unit holder with a greater than 20% interest will still benefit from the relief.[19]

6.20 During the public hearing, Mr Poulos highlighted the importance of allowing this opportunity to demerge to a range of non-listed entities. In his view the proposed legislation would deny 'a massive section of the economy, including much of the innovative potential of the economy, the ability to access that demerger relief'. He told the Committee that 'that leaves us at a disadvantage relative to other dynamic economies around the world'.[20] He explained:

> Australia has moved a long way to try to foster innovation through a number of programs and measures to support venture capital. Extending demerger relief to the non-listed sector is really part and parcel of those reforms and one that is very important. Notwithstanding that we have had a technology

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17 Submission no. 10, p. 2.

18 Submission no. 10, p. 2.

19 Submission no.10, p. 2. Mr Poulos referred to comments by government that 'additional anti-avoidance measures *may be* appropriate for narrowly held entities.' He suggested that if there is a case for such additional anti-avoidance measures then such measures should be considered. He suggested 'the existing scrip for scrip roll-over provisions contain integrity measures for non-widely held entities and these measures apply to non-widely held entities in general'.

20 *Committee Hansard*, p. E19.

> correction in recent years, there are still thousands of start-up companies and early technology companies that, going forward, will realise their potential, to a degree, by benefiting from demerger relief.[21]

6.21 He recommended that the proposed demerger measures be amended to allow non-listed entities access to demerger relief irrespective of whether or not they have a share or unit holder with a greater than 20% interest.[22]

6.22 Ernst and Young also made reference to the 20% interest in the head entity rule. It submitted that:

> The identification of the Head Entity and the Demerger Group is limited by the inappropriate application of a **20% 'interest** in the Head entity' rule, which means that any company which is not widely held, and which has more than 20% of its equity held by another company, cannot engage in a demerger. This rule performs little if any useful function and Ernst & Young would support its refinement or removal.[23]

6.23 Mr Stolarek, Ernst and Young, also stressed the significance of the group that would be denied the benefits under the proposed demerger provisions. He told the Committee:

> What we can see is that the non-widely held sector of this economy speaks not just for private companies that are owned by one family and so on where one might have one's view about the integrity issues involved but also for some very substantial businesses that might have very substantial shareholdings but do not happen to be listed.[24]

6.24 Mr Plummer referred to two key exemption provisions—the flexibility to include a head entity from a demerger group and the ability to exclude certain instruments from the ownership tests (clauses 125–65(5) and 125–75(4)–(7)). The exemptions are designed to ensure that the demerger rules operate smoothly for publicly listed companies and trusts.

6.25 He maintained that small business would not benefit from these exemptions and hence a large number of businesses, including many family owned companies and trusts, would not be able to satisfy the conditions for demerger. Mr Plummer submitted:

> Any unlisted company or trust will fail to qualify for tax-free demerger if it has a substantial shareholder (ie holding more than a 20% interest) or if it has issued some form of ownership interest (such as options, rights, preference shares or convertible notes) which are not entitled to participate

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21 *Committee Hansard*, p. E15.

22 Submission no. 10, p. 3.

23 Submission no. 8, p. [9]. See also *Committee Hansard*, p. E14.

24 *Committee Hansard*, p. E15.

> in the demerger. Another entity which will not qualify for demerger relief is an incorporated joint venture (even one owned by listed company shareholders).[25]

6.26 In summary, Mr Plummer argued that the proposed legislation 'may be flexible and commercial, but it is a regime which will not be available to a large portion of Australian business'—that the restrictions are unnecessary as integrity or revenue protection measures.[26] He concluded that 'the economic and policy reasons for the introduction of tax-free demerger rules would suggest that these rules should be made available to the broadest possible range of companies and trusts.'[27] Jerrard & Stuk Lawyers endorsed these views.[28]

6.27 The Taxation Institute of Australia was also concerned with the limited scope of the provisions and the narrowing of the benefits which it deemed was inconsistent with the spirit of reform conceived in the Ralph Review and the Treasurer's press release.[29]

6.28 When questioned on the reasons for the inclusion of the 20 per cent rule, Mr John Anderson, Department of the Treasury, replied that:

> The legislation is based on the structural framework of defining a demerger group, defining a head entity and defining a demerging subsidiary. Off that runs the rest of the legislation.[30]

6.29 Pressed to identify the need for the 20 per cent rule, Mr Anderson told the Committee that, 'the 20 per cent comes from setting a minimum level so that, when you are demerging something, you have access to demerger relief.'

6.30 Based on this evidence presented at the public hearing, the Committee found that no case whatsoever has yet been established for the inclusion of the 20 per cent rule in the proposed legislation.

6.31 Following-up its evidence, Treasury in a written answer to a question taken on notice at the hearing, explained that:

> In light of representations that have been made to the Committee, the merits of suggestions to provide greater flexibility to groups containing no listed

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25 Submission no. 4, p. 4.

26 Submission no. 4, p. 4.

27 Submission no. 4, p. 5.

28 They submitted that: 'to enact the Bill without providing for non-widely held entities to exclude a > 20% owner as 'head entity' will prejudice many taxpayers—in particular those who have been preparing to demerge in good faith under the terms of the Announcement.' Submission no. 12.

29 Submission no. 13 pp. [3–4].

30 John Anderson, *Committee Hansard*, p. E41.

> entities (such as non-widely held groups) needs to be assessed to determine whether there is a justifiable case to amend the demergers legislation. This is best done following passage of the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, as suggested in the submissions.[31]

Employee share acquisition rules

6.32 Ernst and Young was concerned that Division 13A of the proposed legislation does not allow participants in employee share acquisition schemes access to demerger relief.[32] Mr Plummer, PriceWaterhouseCoopers, shared this view. He submitted that employees represent a significant class of shareholders for many Australian companies and was arguing for an amendment to Division 13A on the grounds that:

> A demerger may result in a tax liability for many employees (because the demerger results in a 'cessation time' under Division 13A). This is a particularly onerous result in circumstances where the employee has not received any cash, has not sold his or her shares and has not ceased employment with their employer.[33]

6.33 CSR expressed a similar opinion on the need for the legislation to cover shares owned under employee share plans. It submitted:

> …given the effort to encourage employee ownership of shares in their respective employer, it is not appropriate to then turn around and tax them in a demerger situation. This is notwithstanding the fact that there has been no change in their overall beneficial ownership of the assets, and they have not benefited in other ways.[34]

6.34 It suggested that any remedy should be back dated to 1 July 2002 but should not in any way frustrate the passage of this Bill.[35] This approach to not delaying the Bill was endorsed by Incitec.[36]

6.35 Mr John Longsdale, Department of the Treasury, told the Committee that the issue of employee share ownership schemes had been raised a number of times in consultation and had been recognised as important. He referred to statements by the Minister for Revenue and the Assistant Treasurer in which she noted that the Government was considering its response to the House of Representatives inquiry into employee share ownership in Australia.

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31 See Appendix 7 for full text.

32 Submission no. 8, p. [9].

33 Submission no. 4, p. 3.

34 Submission no. 5. p. 2.

35 Submission no. 5, p. 2.

36 Submission no. 7, p. 4.

6.36 The Committee is concerned that this matter of employee share ownership under the proposed demerger regime should have to wait for the Government to consider the issue in a broader policy context. The Committee stresses that this matter requires urgent attention.

Preserving the pre-CGT status for shareholders

6.37 Mr Plummer referred to proposed section 125–80 in the Bill that provides that shareholders who acquired their interests in the original entity before 20 September 1985 will be taken to have acquired their interests in the demerged entity before that date. He noted that questions have been asked about the appropriateness of maintaining this pre-CGT status given that the Ralph Review recommended otherwise. In his view, a true tax-free demerger regime should remove all the taxation impediments to demergers and hence regarded the proposed measure as important and appropriate.[37]

6.38 Nonetheless, he drew attention to what appears to be a drafting oversight which could present a material tax impediment for pre-CGT shareholders. In submitting that the legislation should be amended, he offered the following explanation :

> CGT Event K6 applies to tax pre-CGT shareholders on the disposal of their shares if the following general conditions are satisfied:
>
> (a) there has been a greater than 75% 'churn' of the underlying assets of the company since 20 September 1985; and
>
> (b) the company has not been a listed public company for the 5 year period prior to the shareholder selling their shares.
>
> Where these conditions are satisfied, the shareholder is theoretically subject to tax on their share of the inherent capital gains on all the underlying assets of the company.
>
> Even if the original entity is a long established listed public company and the demerged entity becomes a listed public company from the date of demerger, a pre-CGT shareholder will be potentially subject to this harsh taxing provision if they sell their shares in the demerged company within 5 years after the demerger.[38]

6.39 CSR also supported measures that would protect shareholder pre-CGT status again citing the basic principle that shareholders should be no worse off after a demerger. It was concerned that the application of CGT event K6 would effectively remove pre-CGT status. It submitted:

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37 Submission no. 4, p. 3.

38 Submission no. 4, pp. 3–4.

> Such an event is clearly not appropriate in a commercial demerger situation where the demerging entity has been listed on a stock exchange for the last five years.[39]

6.40 The CTA and Ernst and Young also supported provisions that would allow shareholders to continue their pre-CGT membership interests. Ernst and Young argued that it would be inappropriate and inequitable to have the demerger (which applies in relation to demergers that are effectively analogous to share splits) deny the pre-CGT advantages to investors.

39 Submission no. 5, p. 2.

Chapter 7

Conclusion

7.1 Evidence presented to this inquiry indicates strong support for the Bill.[1] According to the CTA:

> Business has accepted the overall rationale for making this major change to Australia's business tax system, and over the last three years or so we have been involved in a highly productive and constructive consultation process with ATO and Treasury officials aimed at progressing from a high level concept to a workable system.[2]

7.2 Even though a number of submissions pointed to shortcomings in the legislation that could be improved by amendments, they were emphatic in calling for no further delay in the passage of the Bill.[3] Indeed, many of the submissions to this inquiry stressed the importance of expediting this final stage in the progress of this legislation. They referred to the comprehensive consultation process that preceded the drafting of this legislation and now urge its speedy passage through Parliament.[4] Ernst and Young stated that 'it is vital for business that the measures should apply from 1 July 2002 as currently proposed, and that certainty be provided to the business community'.[5] The CTA reinforced this point:

> Because these measures all have an intended start date of 1 July 2002, there is now an urgent need for the legislation to be passed so that commercial transactions can proceed on the basis of law that is stable and certain.[6]

7.3 In particular, companies hoping to demerge expressed concern over any delay to the progress of this legislation.[7] Ernst and Young maintained that delay is 'causing road-blocks in the mergers and acquisitions arena—a vital component of Australia's competitiveness in international markets.'[8] Mr Wayne Plummer noted the number of

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1 See for example, CSR Limited, submission no. 5, p. 1; Incitec Ltd, submission no. 7, p. 1.

2 Submission no. 1, p. 2.

3 See for example PriceWaterhouseCoopers, Submission no. 4, p. 2.

4 See for example, CTA, Submission no. 1, p. 9. It stated that 'sufficient detail has now been in the public domain for a sufficient length of time to enable the first two Bills to be passed without further delay. The uncertainty that is being created by the delay in the unconditional passage of the Bills is now creating commercial difficulties in the business community.'

5 Submission no. 8, p. 1.

6 Submission no. 1, p. 1.

7 See *Committee Hansard*, p. E18.

8 Submission no. 8, p. [4].

companies currently planning for demerger and how critically important it was for them to have the legislation passed as soon as possible.[9] Incitec explained:

> We were involved in the process of consultation that led to the measures in the Bill and some subsequent technical corrections to the Bill. This is a process that we applaud as it has now produced legislation which we believe is relatively flexible, workable and, above all, will achieve the economic goals discussed above. This has been an extremely long period of consultation and therefore we do not understand the need to submit the measures to further review and consultation. [10]

7.4 It stressed that 'the delay caused by this further review would expose any companies who are in the process of, or seriously considering undertaking a demerger, to considerable additional costs.[11] WMC, which is also keen to undergo a demerger, submitted:

> WMC wishes to proceed with its demerger before the end of 2002, as it remains vulnerable to takeover and, having announced its intention to demerge almost 12 months ago, its shareholders are anxious to restore certainty to WMC's future by voting on the proposal without further delay.
>
> In order that WMC's demerger can be implemented this calendar year, it is essential that the proposed demerger relief legislation complete its passage through Parliament during the October session.[12]

7.5 WMC suggested that the demerger section be uncoupled from the current Bill and treated as a separate piece of legislation, if problems are identified with the other parts of the Bill that may delay its passage.[13] Ernst and Young supported this measure of carving out the section on demergers to give them immediate entry into law.[14] On the other hand, Mr John Morgan, Freehills, recommended that the GVSR, which he regarded as flawed, be excised from the Bill.

7.6 The Committee appreciates that the passage of the Bill has support. Nonetheless, it would be remiss of this Committee to disregard the various concerns that have been raised about certain aspects of this proposed legislation. The Committee has taken care to document these areas but has not brought forward specific amendments to address any of these perceived deficiencies.

7.7 The Committee understands that while the principles of the Bill have wide and strong support, the process of translating them into workable practices has been

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9 Wayne Plummer, Submission no. 4, p. 1.

10 Submission no. 7, pp. 2–3.

11 Submission no. 7, p. 3.

12 Submission no. 6, p. 2.

13 Submission no. 6, p. 2.

14 Submission no. 8, p. [5].

difficult and has required comprehensive consultation. It readily acknowledges that experts in the respective fields of tax law from the business community, the ATO and Treasury are working together to reach agreement on further improvements to the legislation. Many submissions praised the high quality of the consultative process undertaken by the Government.[15] Unfortunately, time has defeated their endeavours and the situation has arrived when the need for certainty and stability takes precedence over the importance of finetuning legislative drafting.

7.8 The Committee is reluctant to endorse legislation that it knows needs rectification. Nonetheless, it accepts that:

- the underlying principles of the legislation are sound, widely endorsed by business and have multi-party support in Parliament;
- the introduction of the legislation into Parliament was preceded by a lengthy, comprehensive period of consultation and review (though this does not appear to be the case with the GVSR);
- the legislation is both long and complex—even the tax experts appearing before the Committee concede that the Bill is complex and that problems will emerge as the reforms are put into practice;
- there is ongoing review that is proving constructive and productive;
- there is a general understanding that the legislation as it matures will undergo further refinement;
- business is satisfied with the extent and nature of the consultation (again this is not so with the GVSR) and is now urgently calling for certainty; and
- in some cases, notably with demergers, the urgency for the legislation to be enacted overrides the need for any changes that would delay the passage of this legislation.

7.9 In weighing the competing forces—the desire to ensure that the legislation is without flaws and the pressing need by business to have the legislation passed—the Committee is persuaded that the Bill should proceed without delay.

Recommendation

The Committee reports to the Senate that it has considered the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 and recommends that the Bill proceed without delay.

7.10 The Committee hopes that the passage of this legislation would not encourage the ATO and Treasury to relax their efforts to improve the legislation. The Committee is convinced that further review and refinements are necessary and urgent. In this regard the Committee seeks assurances from the Government that problems in the

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15 Anthony Stolarek, Ernst and Young, *Committee Hansard*, p. E8.

proposed legislation identified during this inquiry will be addressed as soon as possible.[16]

Recommendation

The Committee recommends that the Government give a clear undertaking that it will continue to monitor and review the operation of this legislation and, in particular, in consultation with the business sector address the problems that have been documented in this report.

SENATOR GEORGE BRANDIS
Chairman

16 The problems identified in this report are dealt with in paras. 3.17–3.22; 3.23–3.26; 5.10–5.21; 6.13–6.40 and Appendix 3.

Senate Economics Legislation Committee

New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

ADDITIONAL COMMENT BY LABOR SENATORS

The Senate referral asked the Committee to explore the detail of the operation, revenue costs and compliance costs of the major measures in the Bill.

The information provided in the Submissions, and in the public hearing, was very helpful to the Committee in this exploration. Labor Senators commend those involved in the inquiry process for their constructive input.

Notwithstanding the additional comments on matters of detail set out below, Labor Senators continue to support the business tax reform principles underlying the Bill.

Complexity

Many of those providing evidence to the Committee highlighted the high degree of complexity of these business tax measures.

A certain degree of complexity is inevitable when dealing with such complex taxation concepts and transactions. However, Labor Senators are concerned there seems to be a bias in favour of more and more complexity in tax legislation of this type.

We call upon the Government to put more effort into clearer, plain-English expositions of the tax principles in the legislation itself and the explanatory material prepared for the Parliament.

Labor Senators call upon this systemic issue to be explored further by the Government through a reference to the Board of Taxation in the first instance, or through an independent body.

Compliance costs

As noted in the main report, there was a great deal of concern in evidence to the Committee regarding the start-up compliance costs imposed by this new consolidations regime.

These compliance costs may impact particularly heavily on those small businesses that are affected by the measure.

There was mixed evidence regarding the extent of these costs, and how many small businesses would be affected. However, Labor Senators note that the indicative estimates suggest start up compliance costs in the small business sector could be in excess of half a billion dollars. This is a significant concern, and we call upon the Government to re-examine its transitional arrangements for small business.

Revenue costs

Labor Senators remain concerned about the cursory treatment given to the costings of such significant tax expenditures measures in this and similar business tax Bills considered recently by the Committee.

The Committee requested, and received, further detail on the costings for the consolidations measure when the first tranche was considered in June 2002.

However, a similar level of detail has not been forthcoming on the demergers measure.

The revenue cost of this measure is listed as 'unquantifiable' in the Explanatory Memorandum, due to the difficulty in estimating the extent of behavioural change induced by the measure.

Evidence provided to the Committee by the Treasury indicated that the 'costing would be quite small … the measure itself is trying to remove tax impediments that stop corporate restructures that would not have otherwise occurred'.

However, this does not address the amount of tax foregone on the corporate restructures if they do occur under this new regime. This may be considered a nominal cost, but Labor Senators consider that it would have helped the Committee to have a fuller picture of the impacts of the measure.

In particular, given that the measures go substantially beyond what was proposed in the Ralph review, Labor Senators consider that it would have been appropriate for the Committee to have been given some indication of the scale of these extra concessions.

SENATOR JACINTA COLLINS
Deputy Chair

Appendix 1

List of public submissions and additional information

Submission No 1: Corporate Tax Association

Submission No 2: The Institute of Chartered Accountants in Australia

Submission No 3: Freehills

Submission No 3A: Freehills(Supplementary)

Submission No 3B: Freehills(Supplementary)

Submission No 3C: Freehills(Supplementary)

Submission No 3D: Freehills(Supplementary)

Submission No 4: PriceWaterhouseCoopers

Submission No 5: CSR Limited

Submission No 6: WMC Limited

Submission No 7: Incitec Ltd

Submission No 8: Ernst & Young. Melbourne

Submission No 9: Council of Small Business Organisations of Australia Ltd.

Submission No 10: KPMG

Submission No 11: CPA Australia

Submission No 12: Jerrard & Stuk Lawyers

Submission No 13: Taxation Institute of Australia

Submission No 14: Tax Technology Pty Ltd

Submission No 15: Securities Institute of Australia

Submission No 16: Hall & Wilcox Lawyers

Submission No 17: Department of the Treasury

Additional Information: Securities Institute of Australia

The Rationale for Behavioural Responses in Tax Revenue Estimation
Technical Supplement - Methodology for Modelling the Revenue Impacts of Rollover Relief
The Revenue Impact of Capital Gains Tax Rollover Relief for Share-Swap Mergers and Demergers

Additional Information: Incitec Ltd
Correspondence to Committee from Incitec Managing Director, Mr George Witcombe

Additional Information: Australian Taxation Office
Response to question taken on notice during Committee hearing 14/10/2002

Additional Information: Department of the Treasury
Response to questions taken on notice during Committee hearing 14/10/2002

Appendix 2

Public hearing and witnesses

Monday, 14 October 2002 - Canberra

Australian Taxation Office
Davies, Mr Glenn, Acting Centre Manager, Office of the Chief Tax Counsel
Hawkins, Mr Murray, Acting Assistant Commissioner, Large Business and International
Holz, Mr David, Director, Office of the Chief Tax Counsel
Olesen, Mr Neil, Acting First Assistant Commissioner, Large Business and International

Corporate Tax Association of Australia Inc.
Drenth, Mr Frank, Executive Director
Timmers, Mr Miguel, Assistant Director

CPA Australia
Drum, Mr Paul Joseph, Senior Tax Counsel
Thring, Mr Gordon, Chairman, National Tax Practice Committee

CSR Ltd
Mcguigan, Mr Peter, Group Tax Manager

Department of the Treasury
Anderson, Mr John, Specialist, Business Income Division
Buckley, Mr Michael, Specialist Adviser
Lonsdale, Mr John, General Manager, Tax Analyst Division
McCullough, Mr Paul, General Manager, Individuals and Entities Tax Division
Regan, Mr Tony, Manager, Business Income Division
Sim, Ms Irene, Manager, Individuals and Entities Tax Division

Ernst and Young
Stolarek, Mr Anthony, Tax Partner, National Tax

Incitec Ltd
Collins, Mr Peter, Partner, International Tax and Transaction Services, PricewaterhouseCoopers, appearing on behalf of Incitec Ltd

Institute of Chartered Accountants in Australia
Mansell, Mr Ken, Senior Taxation Consultant

KPMG
Poulos, Mr Peter, Mergers and Acquisitions Tax Partner

Law Council of Australia
Morgan, Mr F. John, Taxation Committee Member

Office of the Chief Tax Counsel, Australian
Davies, Mr Glenn, Acting Centre Manager, Taxation Office

PriceWaterhouseCoopers
Plummer, Mr Wayne Stephen, Partner

WMC Ltd
Morley, Mr Donald Marshall, Executive Officer

Appendix 3

A list of matters raised in submissions on the provisions for the new consolidation regime.

Beneficial Ownership

1. Ernst and Young stated that corporate groups need a clear workable rule about the date on which an entity leaves or joins a group in a divestment or acquisition. In its opinion, using the traditional tax concept of beneficial ownership is unworkable with contracts having conditional or deferred settlement dates. Consolidation requires a refinement of these rules.[1]

2. The ICAA also drew attention to the perceived shortcomings in this area asking for clarity to allow corporate groups certainty about the date on which an entity leaves or joins a group in a divestment or acquisition. It maintained that the problem exists in relation to the traditional tax concept of using beneficial ownership, suggesting that it is unworkable with contracts having deferred settlement dates.[2]

The Same Business Test (SBT)

3. The SBT deals with company tax losses which fail the continuity of ownership test. Ernst and Young maintain that this area has needed refinement for some years. It submitted that the test as it stands 'does not deal adequately with companies and groups which have diversified businesses'. It asserted that the long-standing difficulties with the SBT 'make it necessary to modernize this rule, especially for consolidated groups'.[3]

4. The ICAA agreed with this assessment. It stated that upon entering into the Consolidation regime the same business test will apply to the entire consolidated group not just a single entity in the group. It maintained that 'this is far more onerous in relation to prior year losses as the case law states that to be carrying on the same business there must be no new business or transactions from when the previous year loss occurred'. It submitted:

> Therefore, if anywhere in the consolidated group, one of the legal entities in the group starts a new business or undertakes a new transaction, then the

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1 Submission no. 8, Appendix 1.

2 Submission no. 2, para 2.2.2.

3 Submission no. 8, Appendix 1.

entire group fails the same business test and assuming there has been a change of ownership, all previous year losses are lost.[4]

Tax Sharing Agreements (TSA)

5. Under the consolidation regime, only the head entity is responsible for the tax obligations. According to the ICAA most consolidated groups will enter into tax sharing arrangements so that each member of the consolidated group will pay to the head entity their 'share' of the entire consolidated groups tax bill. Ernst and Young stated simply that the TSA rules need clarification to ensure the scope for really clean exits in bona fide divestments, otherwise sales of companies will be commercially problematical. The ICAA agreed.[5]

Losses, capital injections and the available fraction

6. The CPA was especially concerned about the capital injection rules which it maintained would in some circumstances operate inappropriately and produce outcomes that appear to be inconsistent with the policy as articulated in the Explanatory Memorandum.[6]

7. According to Ernst and Young and the ICAA, at the moment capital injections made after 2000 into any company having tax losses (including share subscriptions into new companies) affect the utilisation of tax losses, because the capital injections erode a subsidiary company's tax loss 'available fraction'.[7] It suggested that the rules need some adjustment as they operate inappropriately in some conventional business situations. It stated:

> Whilst it is recognised that the rules operate as a strong integrity measure in the law, revenue protection measures must be commercially realistic. There is also an inappropriate outcome from the exclusion of synergistic goodwill from the value of every member of a group, which denies the group the opportunity to attain an available fraction of one.[8]

8. The CTA regarded the 'available fraction' method adopted in the legislation as a 'fair and balanced approach' to the treatment of entity losses on the formation of

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4 Submission no. 2, para 2.2.1

5 Submission no. 8, Appendix 1 and submission no. 2, para. 2.2.4.

6 The examples include certain intra-group transactions (debt/equity conversions, company roll-overs in consideration of share issues), public company rights issues and group restructures. Submission no. 11, Attachment, p. [4].

7 According to the *Revised Explanatory Memorandum*, p. 69: 'The "available fraction" method set out in Subdivision 707–C of the ITAA 1997 sets a limit on the utilisation of losses transferred to a consolidated group by reference to the contribution to group income expected to be made by the entity that made losses. The available fraction is basically the proportion the loss entity's market value bears to the value of the group at the time the entity joins the group.'

8 Submission no. 8, Appendix 1.

a consolidated group.[9] It believed that the impact of the Consolidated regime on the vast majority of unutilised tax losses could be either positive or negative, but that the overall amount involved would not likely be significant.[10]

Over-depreciation and dividends (S.705-50)

9. Ernst and Young suggested that these complex integrity measures require educational material and possible refinement of the law to assist compliance.[11] For instance, identifying and allocating profits giving rise to dividends paid years ago is problematical; tracing the dividends by widely held entities is a challenge, and determining individual market values for each individual asset is costly. Again, it asserted there is a need for revenue protection measures to be commercially realistic.[12]

10. The ICAA also argued that further educational material is required in this area and possible refinement of the provisions to assist compliance. It shared the view that the rules regarding identifying over-depreciated assets and the allocation of profits giving rise to dividends paid years ago are problematical. It stated further that 'the tracing of the dividends paid by widely held entities, which can be required, is impossible, and determination of individual market values for each individual asset is impractical.'[13]

Allocable cost amount (ACA) and uniform capital allowances (UCA)-Div 702

11. Ernst and Young maintained that the ACA and uniform capital allowances, which deal with mining rights, currently causes difficulty when subsidiaries are sold with mining rights.[14] The ICAA agrees with Ernst and Young that some refinement is needed in this area.[15]

Substituted accounting periods

12. The ICAA contended that some adjustments would be needed in relation to the interaction of substituted accounting period rules in relation to specific technical and compliance and transitional issues. According to ICA, they include foreign

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9 Submission no. 1, p. 3.

10 Submission no. 1, p. 3.

11 Submission no. 8, Appendix 1. The Explanatory Memorandum, p. 17 states that: 'the operation of section 705–50 is modified to prevent a duplicated reduction to a joined consolidated group's cost for its assets because of an unfranked dividend paid by a joining entity to a member of the joined group before joining time'.

12 Submission no. 8, Appendix 1.

13 Submission no. 2, para. 2.2.3.

14 Submission no. 8, Appendix 1. The Explanatory Memorandum deals with this matter on p. 39.

15 Submission no. 2, para. 2.2.7.

tax credits, tax losses, transitional elections, and the operation of various steps of the ACA calculation that is used for asset tax value setting.[16]

Continuity of ownership

13. The continuity of ownership test regulates the use of tax losses. The ICAA submitted that the test does not operate effectively for listed public companies or other widely held groups 'given that tracing to ultimate natural-person shareholders is almost impossible for widely held groups (given the use of nominee holdings, institutional investor funds, privacy laws which prohibit disclosure of shareholder identity in USA and many other countries)'.[17]

Profits 'accrued'

14. The ICAA asserted that the calculation of profits accrued, in the context of prior years, needs ATO guidance and the law remedied to facilitate what can be an extremely difficult compliance task.[18]

Linked assets and liabilities

15. Again the ICAA is looking for clarification. In this case, it wanted clarification on the treatment of inextricably linked assets and liabilities such as leases over assets, 'because the circumstance that permits treating them as a single asset under the existing law does not extend to consolidation'.[19]

Privatised assets subject to particular uniform capital allowance limitations

16. The ICAA submitted that guidance is needed to ensure a tax-neutral outcome where a consolidated group is looking to purchase shares in a group of companies that own infrastructure assets.[20]

Other matters

17. Mr John Morgan, Freehills, also expressed concern at a number of matters involving the consolidation regime. He cited in particular the treatment of losses notably where there is a part year pre-consolidation period which appears to be dealt with anomalously. He stated:

> The idea is that the group loss transfer provisions can operate up to a particular time but because loss transfers work for a period, some mechanism is required for periods that straddle this date.[21]

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16 Submission no. 2, para 2.2.5.

17 Submission no. 2, para. 2.2.6.

18 Submission no. 2, para. 2.2.7.

19 Submission no. 2, para. 2.2.7.

20 Submission no. 2, para. 2.2.7.

In addition, he suggested that clause 701–35, which deals with a CGT event for pre-formation roll-over after 16 May 2002, has the potential to create unintended or unfortunate consequences.[22] Mr Gerald Jaworski, Director, Tax Technology, also commented on the measures determining pre-CGT status. He maintained that 'any group with pre-CGT shareholdings will most likely lose the benefit of pre-CGT status if the group consolidates under the proposed tax consolidation rules'.[23]

21 John Morgan, Freehills, submission no. 3, p. 3.

22 Submission no. 3A, p. 2. See also *Committee Hansard*, p. E8. *Revised Explanatory Memorandum*, p. 36.

23 Submission no. 14, p. 1.

Appendix 4

Attachment A to CPA Australia Submission (No 11)

Attached are schedules showing estimates only of additional costs that may be incurred in terms of accounting fees for a very basic consolidated group to consolidate. The 'Consolidation Pathway' outlined in the ATO *Consolidation Reference Manual* has broadly been followed for consistency.

Familiarisation and training time has not been factored in. The figures noted below are estimates only and costs will vary from group to group.

We believe that range of $20,000 to $30,000 in professional advice to consolidate even the simplest group.

In addition to costs incurred in a corporate group going into consolidation, the following table also provides a broad comparison of likely costs after a group is consolidated.

	Existing System	**Consolidation**
Going into Consolidation	Not applicable.	Significant – see attached.
Ongoing Compliance	Continue to lodge a number of returns.	One return only is required but more work is likely to be required to collate information into a single return.
Record Retention	Current rules continue to apply.	Likely to be greater on an ongoing basis, and especially to avoid significant costs on exit.
Transactions – Within Group	Continue to be recognised for income tax purposes unless roll-over applies.	Less costs anticipated as no income tax implications. State taxes, such as stamp duties remain an issue.
Exit from a Consolidated Group	Current rules continue to apply.	Significantly more costs anticipated.

Consolidation Process - Cost to Clients

Assumed facts: Simple Corporate Group

- Parent company with two sister subsidiaries.
- Structure continues without change. No acquisitions or disposals anticipated.
- Active business carried on in subsidiaries.

1. Choose

	$
Can we consolidate?	-
Do we consolidate?	
• Initial client briefing	600
• Gathering of relevant data	1,000
- CGT Profile/cost bases	
- Franking Accounts	
- Estimate of Values	
- Tax loss profile	
• Pro's and cons High Level	1,000
• Recommendations (High Level)	
- Yes or No	
- Timing	
Initial Decision to Proceed	2,600
How do we consolidate?	
• Membership	
• Asset Value Methodology	
- Valuations ($3000 x 2)	6,000
- Reset Calculations	3,000
- Existing Cost Bases	1,000
- Recommendation	-
• Losses to be brought in	-
	10,000

2. Notify

• Completion of Forms	300

3. Implement

• Reporting System Changes	1,000
• Calculation of Starting Position – see	2,000
- See above - re Cost Bases	
- Franking Credits	
- FTC	
- Losses	
	3,000

4. Instalments

• Data Collection	-
• Calculation	

5. Determine Annual Liability

• New Tax Schedules	4,000
- Depreciation	
- Trading Stock	

- Loss Utilisation
- Other - Pre-CGT Factors

• Accounting Data Alignment	2,000
• Accounting/Tax differences - group basis	1,000
• New forms/changeover	1,000
• PAYG Reconciliations	1,000
	9,000

Finalisation of Subsidiaries' Tax Returns

• Closing down subsidiaries	500
Total	
	25,400
	=====

Appendix 5

Answers to questions on notice – Department of the Treasury

Topic: **Tax relief for demergers**

Hansard Page: **E41**

Senator Watson asked:

Do other jurisdictions require this 20 per cent?

Answer:

A principle adopted in designing the demerger measure is to focus on the head entity of a demerger group. As a general rule, the entity at the highest level in the group that is able to exert control over the group is the head entity. This approach is not generally a feature of demerger measures in overseas jurisdictions as they often focus on rules for specific transactions. This makes direct comparisons with Australia's proposed demergers legislation difficult. In addition, comparisons of a general kind are often difficult to make because taxation systems in overseas jurisdictions are very different from Australia's taxation system.

> The issue raised in submissions before the Committee relates to the requirement that the head entity of a demerger group cannot have any entities (companies and trusts) above it with more than a 20 per cent shareholding. This provision is an integrity measure directed at identifying an appropriate head entity of the demerger group rather than allowing taxpayers an open ended choice of the entity they like as the head entity of a demerger group. If such a choice were available, groups may be able to inappropriately access the demerger concessions for internal restructures that are dealt with by other measures (eg. the Consolidation regime).
>
> This may not be an issue for demerger groups containing more than one listed entity because they have greater flexibility in identifying an appropriate head entity and demerger group. In light of representations that have been made to the Committee, the merits of suggestions to provide greater flexibility to groups containing no listed entities (such as non-widely held groups) needs to be assessed to determine whether there is a justifiable case to amend the demergers legislation. This is best done following passage of the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, as suggested in the submissions.

Another issue in this context is the requirement for the head entity of a demerger group to own at least 20 per cent of a company or trust subject to the demerger in order to gain access to demerger tax relief. The policy intention of this minimum threshold is to ensure that demerger tax relief is available where there is the potential for efficiency gains by undertaking a demerger. A 20 per cent threshold was chosen because it represents the point where the head entity of a demerger group can exercise a degree of control over the subsidiary subject to the demerger. This threshold applies to both widely held and non-widely held entities and is generally accepted as an appropriate benchmark.

Topic: Tax relief for demergers

Hansard Page: E42

Senator Watson asked:

What is the Capital Gains Tax (CGT) status of a pre-1985 K6 event? Is the benefit lost or is it not?

Answer:
CGT event K6 ensures that a CGT liability arises where a pre-CGT interest in an entity is disposed of, and the proceeds reflect significant (at least 75 per cent) post-CGT value in the entity. CGT event K6 triggers a capital gain that reflects that part of the value of the interest that is attributable to the post-CGT assets of the entity.

Section 125-155 of the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 addresses concerns about the possibility of a demerger triggering a CGT K6 event for the demerging entity. The section ensures that the demerging entity disregards a capital gain or capital loss made from a CGT event A1, C2 or K6 happening to its ownership interest in a demerged entity under a demerger. This exclusion recognised that the demerger itself could trigger CGT event K6 on the disposal or cancellation of pre-CGT shares by the demerging entity. Consequently, the exclusion is a necessary part of ensuring that there are no direct taxing consequences for the demerging entity because of the demerger.

The issue raised in the submissions refers to the possibility of a CGT event K6 happening to the shareholder of a demerging entity, who has been able to obtain pre-CGT shares in the demerged entity by claiming demerger relief (because their original shares were also pre-CGT). Should the shareholder later sell those pre-CGT shares, CGT event K6 may then be triggered, if the assets of the demerged entity are predominantly post-CGT assets. This outcome is consistent with the policy intent of the provision.