Senate Economics Legislation Committee

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

Submission No. 1

Submittor: Corporate Tax Association
Mr Frank Drenth
Executive Director

Telephone: 03 9600 4127

Facsimile: 03 9600 4055

EMAIL: mtinners@corptax.com.au

Attachments? Attachment Included

CORPORATE TAX ASSOCIATION OF AUSTRALIA INC.

SUBMISSION TO SENATE ECONOMICS LEGISLATION COMMITTEE

NEW BUSINESS TAX SYSTEM (CONSOLIDATION, VALUE SHIFTING, DEMERGERS AND OTHER MEASURES) BILL 2002

The Corporate Tax Association, which represents the taxation interests of some 114 of the largest corporate groups in Australia, is pleased to make this submission to the Senate Economics Legislation Committee in respect of the above Bill. A list of the corporate groups making up the CTA's membership is attached as Appendix A.

The main thrust of this submission is that the various measures in the Bill will, in our view, broadly achieve their intended effect without impacting adversely on the revenue. There has been an ongoing and effective consultation process between government officials and external stakeholders, which has helped to identify and address problem areas. Further comments in relation to revenue impacts are discussed below, however we wish to emphasise at this initial stage that as an entire package of reform the Ralph proposals were to be revenue neutral. Consultation has progressed on that basis. Accordingly, any revenue impact of the Consolidation measures cannot be considered in isolation from the entire reform package.

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.

We note the reasons for referral of the Bill to the Senate Committee are:

> "*To explore the detail of the operation, revenue costs and compliance costs of the major measures in the Bill*".

This submission addresses separately each of the three main measures that are included in the Bill, with particular attention being given to the reasons for referral to this Committee.

CONSOLIDATION

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.

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.

The Consolidation measures offer a number of advantages to corporate groups. Once implemented, the system offers:

- reduced compliance costs in the medium to long term;
- streamlining of corporate group structures;
- the removal of the scope for double taxation in certain circumstances;
- the freeing up of franking credits within some wholly-owned groups;
- some limited scope for resetting of the tax base for certain depreciating assets, albeit the impact of which will arise over an extended time-frame; and
- improved flexibility in respect of certain commercial transactions.

While these advantages are all worthwhile, implementing Consolidation will involve a considerable up-front cost for the corporate community. Also, the extent of any benefits available will very much depend on the specific circumstances facing particular corporate groups. The benefits are not spread in nearly the same uniform way as, say, the recent reductions in the corporate tax rate, with the result that some groups now question whether the benefits in fact warrant the costs.

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.

Impact on revenue

It is apparent from the Hansard record that some Senators and Members have had concerns about the potential revenue impact of the package of Consolidation measures, and in fact this Committee questioned government officials on this matter when considering the first tranche of Consolidation measures in June of this year. The earlier Bill has since been enacted as the *New Business Tax System Consolidation Act No 1 (2002)* (Act No 68 of 2002). While the date of effect of that Act is 1 July 2002, Senators will recall that this law will not come into force until the second tranche (the Bill now before this Committee) has been considered and passed by the Parliament.

One of the questions that could reasonably be asked in relation to Consolidation is: how can it be that a measure which is said to improve the integrity of Australia's tax system produces a net cost to the revenue of more than $1 billion over a three-year period?

The CTA has always questioned the revenue costing of this measure, which is considered by government officials to result mainly from the improved usage of tax losses - refer *A Tax System*

Redesigned, at pp.719, 720. We do not accept that the official estimates are an accurate reflection of the likely impact of Consolidation on the utilisation of tax losses under the current state of the proposed law.

But even if that $1.165 billion estimate were correct, the Committee needs to remember that this figure was factored into the revenue neutral package of RBT measures, which was originally intended to be introduced as a single "big bang" package of changes on 1 July 2000. With hindsight, that implementation date has proved to be wildly optimistic.

We submit, 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 (which we strongly dispute), business 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.

We further note from the Committee's report in relation to the first Consolidation Bill[2] that the forward estimate of $1.165 billion is roughly similar to the estimates provided in Treasurer's press release dated 11 November 1999 (albeit with a one-year deferred start).

Losses

The treatment of entity losses on the formation of a consolidated group has proved to be a very difficult issue to resolve. Following extensive consultation, however, we consider that the "available fraction" approach now adopted in the legislation represents a fair and balanced approach to this issue.

By adopting the market value of the various loss entities that make up a consolidated group as a proxy for their respective abilities to generate taxable income, the proposed Consolidation regime broadly replicates the outcomes that would be achieved under the current system.

The "available fraction" approach is complemented by "value donor" rules, which are necessary to reflect the ability of individual group companies to transfer losses to each other under the previous rules during the period leading up to the commencement of Consolidation. Anti capital injection rules prevent groups from manipulating market values of particular subsidiaries, and/or improving the ability of the consolidated group as a whole to generate additional taxable income.

It may be possible that application of the "available fraction" concept could result in a faster rate in loss utilisation than might otherwise have been the case for some loss entities. However, there is higher probability of consolidated groups having grouped "available fractions" less than one. We consider that the impact of the Consolidation regime on the vast majority of unutilised tax losses could be either positive or negative, but the overall amount involved is not likely to be significant.

[2] Inquiry into the New Business Tax System (Consolidation) Bill (NO. 1) 2002 dated June 2002, at paragraph 3.7.

The only exception may be a very limited category of losses that are non-wholly owned losses incurred by entities that subsequently come to be wholly-owned. Losses of that kind would generally have been difficult to utilise under the new ownership because of various loss usage rules that are a feature of the current system. Under the proposed Consolidation rules, however, such losses would become deductible to the Head Company over a period of three years.

The difficulty for company groups that now wholly own such loss entities is that those entities become highly susceptible to a failure in the continuity of their ownership. Take, for example, a 60% owned "joint venture" company that incurs tax losses before the 60% owner moves to 100% ownership. Because the loss entity has experienced a 40% change in ownership, it would take very little further change at the shareholder level in the Head Company to indirectly push the loss company past the 50% "continuity of ownership" threshold level.

Once that level is passed, the losses become subject to the "same business" test, which can be highly problematical, particularly where the significant change in ownership has involved making more than just minor changes to the business conducted by the loss company (which is often the case). We understand the Australian Tax Office (ATO) enforces this aspect of the law quite rigorously, and we are aware of a number of cases where the efficacy of such losses has been successfully challenged on audit.

Accordingly, we do not consider that the concessional treatment of previously partly owned "continuity of ownership" test losses would lead to a significant impact on the revenue either, and the estimated net cost to the revenue of the Consolidation measures has, in our view, been significantly overstated.

Resetting the cost base of assets

One of the fundamental features of Consolidation is that within a wholly-owned group, the tax value of equity interests in various entities are "pushed down" to the various assets that are held at the entity level. The Allocable Cost Amount (ACA) comprises the cost base in the shares, plus and/or minus various specific adjustments that are necessary to properly reflect the economic interest held in the relevant entities, adjusted for previous and future tax events.

ACA pushdown occurs on the initial formation of a consolidated group (i.e. at any time during the transitional period starting 1 July 2002), as well as under the "ongoing" case, which is to say for corporate acquisitions and restructurings that occur in the longer term beyond 2004.

We submit that the "ongoing" case should not present any particular revenue concerns, since there would always be symmetry between vendor and purchaser. In other words, the ACA amount that the purchaser pushes down to the relevant assets will generally match the CGT consideration that the vendor receives for the shares and accounts for under its CGT calculation in respect of the disposal.

For consolidated groups that are formed during the transitional period, however, the circumstances are a little different because there is no vendor/purchaser symmetry. Indeed,

there is not even a transaction, and the rules have been designed to enable corporate groups to convert their existing multi-level equity interests into the cost bases of assets.

The cost setting rules for the transitional case are highly complex, and include the three major integrity measures that were announced by the government on 27 June and included in the *New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002* on 26 September 2002. Those measures include:

- the treatment of trading stock as a retained cost base asset (i.e. no uplift in cost base);

- converting what would otherwise be an uplift in certain depreciating assets as a result of the earlier resetting of pre-CGT equity interests within a group; and

- measures to prevent the "refreshing" of certain internally generated assets as depreciating assets, the cost of which has previously been deductible.

Combined with the over-depreciation adjustments that were already a feature of the proposed rules, the scope for uplifts in depreciating assets has been significantly curtailed. Where there have been actual acquisitions of equity interests, however, some limited scope for uplifts remains, which we see as being quite consistent with the underlying policy objectives of the Consolidation measures.

One major factor which will significantly mitigate any potential adverse impact on the revenue of any uplifts in depreciating assets is the rule that depreciating assets that actually benefit from an uplift on the ACA push down lose their entitlement to accelerated depreciation (which has been phased out on a "grand-fathered" basis from 21 September 1999). Combined with the Commissioner of Taxation's current project of revising the effective lives of depreciating assets, this factor will have the effect of deferring deductions of what might be a larger amount of depreciation over a much longer period of time. This will have a significant impact on cash flows and hence a positive effect on government revenue.

A number of large company groups that have carried out a detailed analysis of the proposed new rules have reported that, although they may experience an uplift in the nominal amount of depreciation they will be entitled to claim over the long term, they actually expect to end up paying more tax over the first three or four years of Consolidation because of the adverse timing impact caused by the loss of accelerated depreciation.

In the medium to long term, there is an additional factor that should provide a significant boost to government revenue. Under the current regime, a company which owns well-maintained and valuable depreciating assets which have been subject to tax depreciation can avoid what would otherwise be a significant recapture of depreciation deductions previously allowed by choosing to sell at the entity level rather than at the asset level.

Under the proposed Consolidation regime, however, the vendor company will be treated as if it has sold the relevant assets, resulting in significant amounts of depreciation recapture which could previously have been legitimately avoided.

We recognise that revenue estimates are a difficult issue for non-government Senators in particular, and in some respects business shares many of the same concerns, albeit from a different perspective. However, we are comfortable that the Consolidation regime in its proposed form will not represent a significant threat to the revenue in the short term. 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.

DEMERGERS

The CTA strongly supports the basis for introducing demerger relief for the kinds of reasons that were set out in *A Platform for Consultation* and *A Tax System Redesigned.*

> "*A corporate deconsolidation does not involve any change in ownership of assets and applying CGT to such transactions would raise the same cash flow concerns as for scrip-for-scrip transactions. There are strong equity grounds for not making a deconsolidation a taxing event and splitting the cost base over the same underlying assets*".[1]
>
> "*...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.*"[3]

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.

The revenue impact of these measures would, in our view, be negligible because many demerger proposals that are presently under serious contemplation would simply not go ahead but for these measures. To proceed with such a transaction under the present tax rules would be destroying shareholder wealth by incurring significant tax liabilities at the company level and in some cases at the shareholder level.

Concerns have been expressed to us that the proposed legislation goes beyond the RBT recommendations in three respects – tax deferral is provided at the entity level, pre-CGT status for shareholders is retained, and the proposal extends beyond widely-held entities. We will deal with each of these concerns in turn:

[1] *A Platform for Consultation, at p.298.*
[3] *A Tax System Redesigned, at p.619.*

- *Tax deferral at the entity level.*

  Under the current law a demerger is treated as an asset disposal by the demerging entity. Depending on the cost base and movements in market values, the CGT impact of such a disposal could be considerable, and unless CGT deferral were granted at the entity level, proceeding with the transaction would in many cases destroy shareholder value, and could not be justified. Without tax deferral applying at the entity level, demerger tax relief would have only a very limited impact.

- *Preserving the pre-CGT status for shareholders*

  On the basis that a demerger represents no more than the reorganisation of an entity's assets and operations that leaves members in the same economic position as before, it seems perfectly reasonable that a shareholder with an existing pre-CGT share should end up with two or more pre-CGT shares after a reorganisation. In this respect the demerger proposal should be seen as being very much like a share split, where the current law also preserves the pre-CGT status of the original share.

  We would add that the revenue impact of this departure from the RBT recommendations, if any, would not be significant because of the relatively low proportion of pre-CGT shares now held by individual investors (mainly self funded retirees – CGT having commenced in 1985).

- *Extending demerger relief beyond widely-held entities*

  It should be noted that the RBT recommendation in respect of scrip-for-scrip rollover relief was also to limit the scope of such relief to exchanges of membership interests where at least one of the entities involved was widely-held. In the event, the measure went further by extending scrip-for-scrip rollover relief more generally – a move which was supported in the Senate. In this respect we would submit that the proposed demerger rules are quite consistent with the already enacted scrip-for-scrip measures.

  We would add that the kind of economic efficiency gains achievable as a result of demerger rules apply equally to the SME part of the economy. We are aware of a number of diversified closely-held businesses that would be interested in restructuring their operations once this measure is passed. 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.

The proposed demerger measures do not go beyond providing CGT relief. During the constructive consultation period we suggested that, where feasible, demerger relief should apply to all income tax consequences including: (i) equity interests held on non-capital account; and (ii) shares acquired under employee share acquisition schemes, which are taxed under specific rules outside the CGT provisions. Whilst the RBT recommendations were not limited only to CGT

relief, we recognise that current provisions also do not provide relief in the two circumstances mentioned above (including, for example, the scrip-for-scrip relief).

GENERAL VALUE SHIFTING RULES

The General Value Shifting Rules (GVSR) were proposed by the RBT as a complementary integrity measure to the Consolidation regime. 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 has been designed to fill this gap.

We question the need for these measures in relation to publicly listed companies in particular. Corporate governance practices should generally prevent value shifting between associates. Nevertheless, business supports well-considered and balanced integrity measures designed to prevent systemic and planned avoidance activities or deferral opportunities within the tax system.

The consultation process in relation to these measures has on the whole been constructive and worthwhile. Although the legislation is quite lengthy and complex, we believe it does strike a practical balance between integrity and compliance concerns through a combination of thresholds and safe harbours.

We have raised with government officials the need to have some flexibility around what is currently a hard start date of 1 July 2002 for the GVSR measures. This has become necessary because of the government's decision to now have an appropriately flexible start date around Consolidation (which we support). Large companies should not be required to put in place onerous compliance rules around intra-group interest-free loans and service arrangements absent any disposals of membership interests in entities that might otherwise have had value shifted in or out of them.

PASSAGE OF THE BILL

We submit that this Bill should now be passed by the Senate without further delay, and without any conditions attached. This would also result in giving effect to the first tranche of Consolidation measures.

At the time the first tranche of Consolidation measures was being considered by this Committee this current Bill, comprising hundreds of pages of legislation and explanatory material, had only just been introduced into the House of Representatives. It would therefore have been very difficult in the short time then available for non-government Senators to give the Bill the sort of detailed consideration it no doubt warranted. The first two Bills are also linked, the first tranche encompassing mainly the "ongoing" Consolidation rules, while the second tranche (the Bill now before this Committee) includes the rules for the transitional formation case.

Senators will be aware that a third tranche of Consolidation measures, the *New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002*, was introduced into the House on

26 September 2002. That Bill includes a number of further measures, including the remaining cost setting rules, rules relating to trusts, part-year rules, non-operating head company rules, rules that apply when one consolidated group is acquired by another, further MEC rules, as well as measures that give effect to the further cost setting integrity measures announced by the government on 27 June 2002.

Business has supported the government's approach of a staged release of legislation because 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.

We suggest that between them the three Bills introduced so far cover more than 95% of the total legislative material required to give effect to the Consolidation proposals. As a package of measures, we would also suggest the legislation broadly reflects the government's policy intent, and does not pose any risk to the revenue. A subsequent Bill or Bills will be required to fill in the last few remaining gaps, notably rules relating to life companies and various consequential amendments.

We respectfully submit 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.

In respect of the demerger measures, shareholders need to be provided with information about how the law is expected to apply to them and companies contemplating such transactions would need to obtain Class Rulings from the ATO to give their shareholders the required level of certainty. Until the current Bill receives Royal Assent requests for rulings cannot be entertained by the ATO.

In respect of Consolidation, corporate groups contemplating acquisitions or disposals need to have a clear picture of exactly how the law will operate. We are aware of transactions that have been put on hold pending a resolution of the legislative position.

That concludes our formal submission in relation to the Bill. Thank you again for the opportunity to assist the Committee in its deliberations.

If required, we would be happy to appear before the Committee to answer any further questions we can and to provide a business perspective on the operation of the Bill that may not be otherwise available to the Committee in other more technically focused submissions.

Frank Drenth

(Executive Director)

1 October 2002

APPENDIX A

Corporate Tax Association
Corporate Membership

A.W. Baulderstone Holdings
Alcoa
AMP
ANZ Bank
AurionGold Limited
Australian Postal Corp
BHP Billiton
BOC Gases
Brambles
Cadbury Schweppes
CGNU Australia Holdings
Coles Myer
Crown Casino
David Jones
Energy Australia
ETSA Utilities
Foster's Group
George Weston Foods
Hanson Australia
Holden
ING
John Fairfax Holdings
Leighton Holdings
Lion-Nathan
McDonalds Australia
National Foods
Newmont Australia
Nufarm Ltd
Origin Energy
Pasminco
QBE Insurance
Santos
SingTel Optus Pty Limited
St George Bank
Tenix
Unilever
Vodafone
Westpac
Woolworths

ADI Limited
Allianz Australia
Anglo Coal
Apache Energy
Australand Holdings
AXA Australia
BHP Steel
Boral
British American Tobacco
Caltex
ChevronTexaco Australia
Commonwealth Bank
CSR
Deutsche Bank
Epic Energy
ExxonMobil
Futuris Corporation Ltd
Goodman Fielder
Henry Walker Group
HSBC Bank Australia
Insurance Australia Group
Kimberly-Clark
Lend Lease
Macquarie Bank
MIM
Nestle
News Limited
One Steel
P and O Australia
Philip Morris
Rio Tinto
Shell
Smorgon Steel Group
Tabcorp
Toyota
United Energy
Wesfarmers
WMC Resources Ltd
Zurich Financial Services

AGL
Amcor
Ansell
Asea Brown Boveri
Australian Meat Holdings
BankWest
BNP Paribas
BP
BT Financial Group
Carter Holt Harvey
Coca-Cola Amatil
Credit Suisse First Boston
DaimlerChrysler
EDS Australia
ERG Limited
Ford Australia
General Electric
Hagemeyer Asia Pacific
HIH Insurance Ltd
Iluka Resources Limited
Japan Australia LNG
Kodak
Linfox
Mayne Group
National Australia Bank
Newcrest
Norske Skog
Orica
PaperlinX
Qantas
Roc Oil Company
Sigma
Southcorp Holdings
Telstra
Transfield
Village Roadshow
Westfield Limited
Woodside Petroleum