Senate Economics Legislation Committee

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

Submission No. 2

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Attachments? No Attachments

4 October 2002

The Secretary
Senate Economics Committee
Suite SG.64
Parliament House
Canberra ACT 2600

To whom it may concern

Re: SENATE ECONOMICS COMMITTEE – submissions in relation to the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002*

Please find enclosed a second submission in relation to the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002* as requested in your letter dated 20 September 2002. We have previously sent a submission and wish to replace it with this submission due to some minor changes.

Due to the short timeframe that has been offered for the preparation of the submission, we have only prepared a high level analysis. Should the committee wish to discuss any of the matters raised in the submission please do not hesitate to contact me on 02 9290 5623 or Ken Mansell on 02 9290 5625.

We understand that the enclosed submission can only be made public after the decision of the committee. However we request permission to use the following clause (subject to minor editorial changes) in our weekly tax bulletin:

> "ICAA REQUESTS CONSOLIDATION EXENTION FOR SMALL BUSINESS
> As a part of their submission to the Senate Economics Committee in relation the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002*, the ICAA has requested a further year extension for small business in relation to the transitional period for entering into the Consolidations regime. This would mean that small business groups (with turnovers of less than $5million) would have until 1 July 2004 before they would either have to enter into the Consolidations regime or lose the current grouping concessions in the current Act, like the group transfer of losses.
>
> The full submission can only be made public after the decision of the Senate Economics Committee. Following the decision the submission will be available on the ICAA's tax portal at http://www.icaa.org.au/tech/index.cfm?menu=163&id=A105244242."

We publish the tax bulletin on every Monday and would appreciate a response to whether approval is or is not granted by either 12pm on Monday 7 October 2002 or 12pm on Monday 14 October 2002. Would you please contact Ken Mansell on 02 9290 5625 regarding this matter.

Yours sincerely

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SENATE ECONOMICS COMMITTEE

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

Submission by The Institute of Chartered Accountants in Australia

Senate Economics Committee

Submission by The Institute of Chartered Accountants in Australia

1 GENERAL COMMENTS:

1.1 Introduction

The Institute of Chartered Accountants in Australia ("ICAA") welcomes the opportunity to provide input to the Senate Economics Committee on the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002.*

The ICAA, as the leading professional accounting organisation in Australia, represents some 31,000 members in public practice, commerce, academia, government and the investment community. Its members are advisers to businesses at all levels, from small and medium sized businesses to the largest global corporations operating in Australia.

We have had active representation on all the consultation groups covering all three of the areas of taxation reform covered by this Bill. Further we have discussed the broad concepts of the Bill with our members.

We note that it is not possible to prepare an in-depth submission in the time frame given by the Senate Economics Committee. The request was received by the ICAA on 25 September 2002 and the submission date is 4 October 2002, a mere eight working days. Therefore this submission only addresses high-level principles in the Bill.

1.2 The ICAA's In-Principal Support for the Bill

The ICAA supports the three general concepts that this Bill implements. We believe that all three general concepts are positive steps in relation to the current tax reform process and will provide real benefits to business efficiency in Australia.

- Group consolidations will allow for effective tax restructuring for Australian businesses and reduce compliance burdens once the initial set up is completed.
- Demergers will allow there to be no taxing event where there is, in effect, no change in the beneficial ownership of assets.
- A general value-shifting regime is required to complement the consolidations regime to cover entities that are not covered by the consolidations provisions.

However we believe the following issues need to be addressed:

2 CONOLIDATIONS

2.1 Introductory Comments

Whilst the ICAA agrees with the Consolidations provisions included in the Bill, we believe that amendments should be made to the consolidation section of the Bill based on the issues raised below.

2.1.1 The Importance of Certainty

Our experience is that very few of our small and medium enterprise members have begun to address the effect that the Consolidation provisions found in this Bill (and the previous Consolidations Bill) will have on the their business. This is even though the Bill, once passed, will actually take effect from 1 July 2002. Primarily this is a result of the uncertainty that has arisen in relation to how the consolidations regime will operate. The mere fact that this Bill is before the Senate Economics Committee is an indication of the uncertainty that exists throughout the business community as to the actual form of Consolidations that will exist after the introduction of a Consolidations regime.

It is important that the actions of the Senate in relation to the Bill do not continue to cause uncertainty about the commencement of this measure, which has been broadly and publicly exposed in principle, with various exposure drafts and draft explanatory memoranda delivering on the regime as recommended by the Ralph Review of Business Taxation.

Businesses that are currently overloaded from a tax perspective due to the increased burdens of the New Tax System that have been introduced in the last two years, are not willing to undertake the massive compliance task that is required to prepare for entry into the consolidations regime without knowing for certain what the regime will be and exactly what the rules are.

Even with this Bill before the Senate, there is still a further Bill before the House of Representatives and the Assistant Treasurer has indicated that the final legislation will not be available until December 2002. With such a level of uncertainty many business and their tax practitioners have not even begun the process required to enter into consolidations.

2.1.2 Consolidation Is Not Optional

Although it is theoretically possible for group to not enter into the Consolidations regime by the year ended 1 July 2003, is not a practical option for any group of companies. With the removal of the intercorporate dividend rebate and the loss transfer provisions, all group companies will practically have to ensure that they are fully prepared to enter into consolidations from the date that these provisions are removed (currently 1 July 2003).

2.1.3 Agents Overwhelmed

In the implementation of the New Tax System, the ATO misjudged the tax compliance obligation they had created for the business community and most of that workload was passed to tax practitioners. For the last two years they have struggled to

meet unrealistic compliance deadlines, exacerbated by a myriad of systems problems that the ATO was too slow to acknowledge and fix. There has also been poor support to practitioners by the ATO, via their call centres and in the provision of access to client transactional information.

Our members' most common complaint is that they currently cannot keep up with this increased workload. They are spending all their time merely meeting compliance deadlines, not even contemplating tax planning requirements, like entry into Consolidations.

For small and medium enterprises these tax practitioners are the conduits through which the ATO releases information regarding the changes in the tax system. Currently these conduits are blocked with the additional burdens the New Tax System has created.

2.1.4 The Task to Prepare is Massive

It must be noted that the process for preparing to enter into the Consolidation regime is a massive undertaking. 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. The ATO has always admitted that the compliance task that this regime will bring, in relation to initially entering into Consolidations, will be large. 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 changed 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 set tax 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. We believe it would be negligent of a tax practitioner to not have assessed the potential benefits that may arise in revaluing every asset but to have just elected to stick with the current tax values.

This highlights the need for an ongoing refinement of the rules to allow efficient compliance. For example the calculation of the adjustment in relation to over-depreciated assets requires a calculation to be performed on an asset-by-asset basis in relation to its market value and existing tax values. This task alone will require significant cost and time for corporate groups and their tax agents.

2.1.5 The Importance of Education

Although the ATO has undertaken a series of training session up to this point in time, it has hardly been enough given the nature of the changes that are about to occur. This has been especially true in relation to the small and medium enterprise sector. For example, the ATO, when speaking to our Continuing Professional Education Unit recently, indicated that they believed that tax practitioners would be unlikely to look at Consolidations until well into next year (they were question the early timing of our training series). As such, it appears that the ATO will be scaling up their education

program with only months left before every group will need to be prepared to operate in a consolidation regime.

Further we understand that the ATO's education program is being held up by the speed at which the legislation is being passed. The primary source of information for practitioners, the Consolidations Reference Manual, does not included the provisions in the third Consolidations Bill and we have been told not to expect this document to be updated until November 2002, subject to the Bill being passed.

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.

2.1.6 Recommendations to the Senate Economics Committee

Based on the above, the ICAA recommends to the Senate Economics Committee that:

- In the interest of certainty and planning, and to allow the task of preparing for the start of the Consolidation regime, that the Bill is passed as soon as possible (as should be the third Consolidations Bill, *New Business Tax System (Consolidation and Other Measures) Bill (No. 1)*); and
- 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 undertake the processes required (see below for further details).

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 Consolidations 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.

We acknowledge that the initial granting of an additional transitional year to allow entities to enter into consolidations has been provided, however we believe that the same concerns that prompted this granting of this year for transitional entry still apply. There is still uncertainty as to the nature of the final legislation (we do not accept that a Bill provides an appropriate level of uncertainty), entry is not practically option for corporate groups, tax practitioners are currently overwhelmed by other burdens placed on them by other elements of the New Tax System, the task is an overwhelming one and the education programs offer by the ATO to date have been inadequate (primarily due to the above concerns).

2.2 Other Technical Issues

While the ICAA offers in-principle support for the Consolidations provisions of the Bill there are a series of technical issues that still need to be addressed. However these items have already been identified to the ATO in the various consolidation practitioner forums and the ATO have indicated that they will be addressing the

identified problems. We applaud the ATO's process of consultation throughout the development of the Bill and as a result do not believe that any of these issues should stop the committee from recommending the Bill be passed.

For completeness we include these issues. It should be noted that some of these issues do not relate specifically to the Bill in question, but rather the combined effect of the first three Consolidation Bills.

We provide this list not to suggest any inaction by the government, but rather to indicate to the Senate that it is important to have a very efficient process, with speedy resolution of the law, to deliver what is a major modernisation of the law relating to to the taxation of corporate groups.

2.2.1 Same Business Test

Prior year losses can be utilised by an entity where there is a continuity of ownership or the same business is being carried on. Upon having entered into the Consolidation regime the same business test will now apply to the entire consolidated group not just a single entity in the group. 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.

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

The legislation needs to be amended to isolate the same business test to the legal entity or the same business test conditions need to be amended.

2.2.2 Beneficial Ownership

Clarity is needed to give corporate groups certainty about the date on which an entity leaves or joins a group in a divestment or acquisition. The problem exists in relation to the traditional tax concept of using beneficial ownership being unworkable with contracts having deferred settlement dates. These discussions in relation to the Consolidation regime provide the opportunity, and perhaps the necessity, to explore modernization of the traditional tax rules of beneficial ownership.

2.2.3 Over-depreciation and dividends

Although we agree with the equity of the rules regarding over-depreciated assets and dividend, we believe that further educational material is required and possible refinement of the law to assist compliance. The rules regarding identifying over-depreciated assets and the allocation of profits giving rise to dividends paid years ago is problematical. Further 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.

2.2.4 Tax Sharing Agreements.

As under the consolidations legislation, only the head entity is responsible for the tax obligations. Therefore 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.

The law regarding tax sharing arrangements needs clarification to ensure the scope for clean exits in bona fide divestments, otherwise sales of companies will be commercially problematical.

2.2.5 Substituted Accounting Periods

Clarification and some adjustments will be needed in relation to the interaction of substituted accounting period rules with the Consolidation regime in relation to specific technical and compliance and transitional issues. These include foreign tax credits, tax losses, transitional elections, and the operation of various steps of the ACA calculation that is used for asset tax value setting.

For example, due to the extension of the grouping provisions for entities with substituted accounting periods, they have access to the intercorporate dividend rebate until the end of their substituted accounting period, not 30 June 2003. However, calculation of the ACA under the transitional provisions only allows undistributed, unfrankable profits that accrued to the group before 30 June 2003 to be taken into account. This places a compliance cost on entities with a substituted accounting periods, by requiring them to actually pay dividends prior to consolidating in order to not be disadvantaged.

2.2.6 Continuity of Ownership

The continuity of ownership test which regulates use of tax losses 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).

2.2.7 Other Issues

There are other issues of a minor nature that have been raised. These include:

- ***Losses, capital injections and the Available Fraction.*** Currently capital injections made after 2000 (including fresh share issues into new companies) cause erosion of an entities ability to use losses by reducing the Available Fraction used in the loss availability calculation. The rules need some adjustment as they operate harshly in conventional business situations.

- ***Profits "accrued".*** The calculation of these, in the context of prior years, needs ATO guidance and the law remedied to facilitate what can be an extremely difficult compliance task.

- ***ACA and uniform capital allowances***. There are currently some difficulties when subsidiaries are sold with mining rights in relation to the operation of the uniform capital allowances. These need to be addressed.

- ***Linked assets and liabilities***. Clarification is needed in relation to 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.

- ***Privatised assets subject to particular uniform capital allowance limitations.*** 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.

2.2.3 Recommendations to the Senate Economics Committee

Based on the above, the ICAA recommends to the Senate Economics Committee that:

➢ Confirms 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.

3 DEMERGERS

3.1 ICAA's concerns

The main concern that we have discussed above regarding the Consolidation section of this Bill, extend to the Demergers section of the Bill.

These provisions, providing a capital gains tax rollover and a dividend exemption in certain corporate demergers, were proposed by the Ralph Review and announced almost a year ago. Most importantly, the business community has started to undertake restructures based on the rules that are in this Bill, under the assumption that, as there were no major issues raised by the non-government parties, these provisions would pass unheeded.

However, with the slow passage of this Bill, business has again been left is a state of uncertainty. In good faith these businesses have prepared themselves for the retrospective application of this Bill (once passed the provisions will apply from 1 July 2002), and now, as a result of this committee's discussion, are left uncertain as to how to manage the future operations of their business.

There has been a detailed consultation process with industry practitioners and the major issues that were identified through this process have been rectified. For example in its original form the legislation only applied to listed corporations but due to practitioner lobbying this has already been amended so that private companies can now take advantage of this legislation.

3.1.1 Recommendations to the Senate Economics Committee

Based on the above, the ICAA recommends to the Senate Economics Committee that:

- In the interest of certainty and business planning, that the Bill is passed as soon as possible.

4 GENERAL VALUE SHIFTING

As discussed above the ICAA supports the general concepts of the General Value Shifting Regime introduced in this Bill. However, unlike the above two sections of the Bill, this package did not undergo the same level of practitioner consultation as it was presented to practitioners in a final form. Therefore we make the following technical comments.

4.1 ICAA's concerns

In summary we have the following concerns:

- The general value shifting measures in this Bill are drafted in a way that is overly complicated. 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.

- Much of the complication arises from specifically legislating to deal with situations which in practice are exceptions to usual conduct. Many of these situations would likely fall within the ambit of the general anti avoidance provisions of the Income Tax Assessment Act. For example, the proposed Division 723 (eg the scenarios which Division 723 is designed to address could have been addressed by extensions to existing market value substitution and arm's length dealing rules).

- In this context, it should be remembered that these value shifting provisions will hit hardest the small to medium enterprise sector (SME). SME corporate groups are not expected to enter into the Consolidate regime to the same extent as large corporate groups. Consolidation effectively renders much of the value shifting provisions irrelevant, given that intra-group transactions are ignored under the single entity rule applicable to consolidated groups. Therefore these overly complex provisions are targeted at the SME.

- The identification of situations where a common ownership nexus exists, as is required to be shown under Division 727 will not be easy for practitioners. Structures much more complex than that shown in Example 11.5 of the Explanatory Memorandum can arise in practice. A broader "controller and collusion to avoid tax" test should have been prescribed to cover such cases, rather than draft the specific tests for determining ownership through tiers of entities.

- A further concern is that, despite the level of detail that is required to determine whether the provisions apply, calculated adjustments required to be made to the costs bases of particular equity and loan interests are to be reduced to the amount that is "reasonable" having regard to the objects of the value shifting provisions. Whilst clearly the "reasonableness" test is appropriate, the question that needs to be raised is why the need for calculating specific adjustments which ultimately are reduced to an amount that is reasonable?

Unless the reasonableness test can be applied at the outset to avoid the mechanical calculation of adjustments to be made, there will be many situations where a value shifting transaction will require adjustments to be calculated in respect of interests that, upon their realisation, would have had no impact to the revenue. In other words there will be no inappropriate loss arising from the value shift.

This situation arises because an interest (eg a share a company) may be an indirect interest (ie via an interposed company) in both the gaining and losing company involved in a value shift with the provisions seemingly requiring the market value of the interest to calculated twice (the first time ignoring the effect of the transaction on the gaining company, and the second time ignoring the effect of the transaction on the losing entity) with a subsequent decrease in cost base in respect of the first valuation and then increase in cost base in respect of the second valuation. The law then states that "the reduction in adjustable value under this Division will usually be offset by an uplift under this Division". It is unclear why this provision could not have been simply drafted to state that, where there is no affect on the market value of the indirect interest because of the value shift, the interest is not to be considered. This would mean that only the direct interest in the losing and gaining entity would be subject to the value shifting provisions rather than every "affected interest" held by an "affected owner" via its indirect interest in the losing and gaining entity.

4.1.1 Recommendations to the Senate Economics Committee

Based on the above, the ICAA recommends to the Senate Economics Committee that:

- 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.

5 SUMMARY

All of the three elements of the Bill have undergone some level of public consultation and has received in principle support for all interested parties. The ICAA believe that they all are positive steps in the current process of business tax reform.

Therefore the ICAA recommend that, for the sake of certainty and to allow for planning by our members, the Bill be passed immediately. To assist with this concern, and the others raised above, we recommend that a further extension of the transitional entry period for small and medium enterprises in relation to the consolidation regime be allowed for.

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