Senate Economics Legislation Committee

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

Submission No. 3

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Attachments? No Attachments

Dermody, Kathleen (SEN)

From: John Morgan [John.Morgan@freehills.com]
Sent: Thursday, 3 October 2002 6:12 PM
To: Economics, Committee (SEN)
Subject: Consolidations: Design problems with "non-membership periods" for which there are losses (particularly with transferring those losses within the wholly owned group under subdivision 170-A immediately before consolidating) - Submission to the Senate Econom

Dr. Kathleen Dermody
Committee Secretary
Senate - Economics Committee

Inquiry into the NBTS (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 - The "Second Consolidation Bill"

I am responding to your 25 September 2002 letter inviting submissions on the above Bill. Thank-you for the opportunity to do so.

You will see from the attached extract of an email I sent a colleague, that in my view we need a further provision to be inserted to remedy an anomalous result under the consolidation provisions.

Strictly the fault is with the First Consolidation Act (the May Act) and it may be too late for the new provision to be inserted in the Second Consolidation Bill (though it may be inserted by subsequent Bills). Nonetheless, I am hoping that this is still within your terms of reference, as the Senate moved amendments to the First Consolidation Act, so it did not commence until the Second Consolidation Bill received Royal Assent. The purpose of this was, I understood, to allow the Senate to review the effect of the consolidation provisions (as a whole) that would be enacted by these two bills if the Senate were to pass the second bill.

As you can see, I hope that the same submission makes it directly to the relevant Treasury or Tax Office staff, but I can't be sure that it will. Further, I thought it might be of some assistance to the Senate to have an example of the type of problems that are emerging gradually as we try to apply these provisions in real life. They may appear to be "fine print" type problems, but often the policy and revenue effect can be quite serious.

I have others examples which I might forward to you in due course.

The detail set out below is horribly technical. Whilst this is revealing in itself about the complexity of this legislation, it would be much better that I set out the submission in something close to English here, and treat the subsequent detail as technical support for what I say and something of a technical guide to the draftsman in preparing remedial legislation if the thrust of what I submit is accepted.

My submission therefore is,
(a) That the amendments to subdivision 170-A of the Income Tax Assessment Act 1997 effected by the First Consolidation Act (Schedule 3, Part 3, Division 2) be supplemented by inserting another provision (say new section 170-75, with an appropriate heading) to do for subdivision 170-A, what recently inserted s707-405 does for Division 707 (which is about the way losses a subsidiary member brings to a consolidated group are transferred to the Head Company of that group). That work it must do is to deem the loss calculated for a "non-membership period" under recently inserted s701-30(3) to be a "tax loss" for an "income year" being that part year period described as a "non-membership period".
(b) Without s707-405, s701-30(3)&(7) would have been quite ineffective to allow a part year loss which a subsidiary member might bring to a consolidated group to ever be transferred to the Head Company.
(c) For similar reasons, if subdivision 170-A does not get an equivalent provision, part year losses prior to consolidation will not be eligible to be transferred elsewhere in the same wholly owned group even though the period for transfer of the loss is prior to the cut-off date for such transfers (and may predate even the period of parallel operation of that form of transfer with the availability of the consolidation regime).
(d) There is no indication that it was intended to so arbitrarily deny (pre-consolidation) group loss transfers for part periods - particularly as

it is plainly allowed for whole year losses that precede consolidation (eg. where a group waits until the first day of the next income year to elect to consolidate). There is no reason to suppose that the part year period should be any different to a full year loss - particularly where part years are catered for extensively and this very problem has been solved in one place but not in another.
(e) Because the consolidation regime has effectively commenced without there being law (or complete law), transactions have been entered into based on what could reasonably be expected, and it could prejudice those transactions and those who entered into them, to leave an unexpected defect (ie. an anomalous or counter-intuitive problem) unremedied.

I certainly don't mean to undermine support for the consolidation regime by this submission. My aim is 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 fixing the further defects that will emerge over the first few years of its operation.

I am a tax partner with Freehills, and am happy to say that this submission is made on behalf this "organisation". I am also a member of the Law Council of Australia and Law Institute of Victoria's tax committees (Chair of the latter). I will send this submission to them in case they want to support the submission, but I cannot necessarily say that they will.

I have no objection to the submission being made public.

Kind regards,

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----- Forwarded by John Morgan/Melbourne/FHP/AU on 02/10/2002 23:12 -----

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02/10/2002 23:11
Ext : 1474

To:
cc:
Subject: Consolidations: Design problems with "non-membership periods" for which there are losses (particularly with transferring those losses within the wholly owned group under subdivision 170-A immediately before consolidating)

X ...
Partner - Y
Member - Consolidations Design Team

Dear X,

First, let me thank you for listening to the issue and then having the presence of mind to suggest the expeditious solution of asking the Treasury guys specialising in the treatment of losses under the consolidation regime whether we'd overlooked something.

I've now checked the provisions which they suggested solve the problem, but in my view only one of them does solve the problem and hence it only solves half the problem (leaving the problem with group loss transfer for a part year period immediately before consolidation unsolved). Accordingly I'd be appreciative if you could raise this conclusion with these Treasury people (say by simply sending them this email and asking them to give me a call).

Before going on to assess whether these provisions solve the problem or

not, it would help if I articulated the problem.

The problem is that when a head company consolidates part way through an income year (lets assume common accounting periods for both the head company and all subsidiary members), there is a part year pre-consolidation period (called a "non-membership period") which appears to be dealt with anomalously. Non-membership periods are dealt with in s701-30 ITAA97, and in particular subsection (3). It appears to substantive work, but infact it doesn't. It only invites taxpayers to calculate their taxable income or tax loss for that part year period as if that period were an income year but it does not deem that part of the year to be an income year. Nor does it deem the loss to be a "tax loss" for an "income year". Indeed, the remaining subsections (4)-(7) make it clear that all sub-section (3) invites a taxpayer to do is a computation. The result of that computation for tax purposes is dealt with in those subsection. For instance, subsection (5) satisfactorily enough says allows aggregation of any subsection (3) taxable income amounts as the taxable income of the company for the income year. Less satisfactorily though, the equivalent provision for losses in subsection (7), dictates that all a company can count as a "tax loss" for its "income year" is one single subsection (3) part year loss (if there is more than one) and then it can only be counted if the part year period ends on the end of the income year. In other words, the company can only count its loss for the last period in the year when it found itself unconsolidated, and then only if the company ended the year unconsolidated.

This was justified in the EM (for the first Bill, para 2.86) as being appropriate because any prior periods of consolidation should not leave the company with carry forward losses - the scheme of the consolidation regime being that losses a subsidiary brings into the group are either transferred to the Head Company (if they pass the tests) or fall away never to be used (s707-105(2)). A little further thought however, reveals that this is not an adequate response. It does not justify subsection 701-30(7) ignoring entirely losses for non-membership period that end before year end. If a group consolidates mid year, this will leave the first part of the year as a "non-membership period" and any losses for these periods will be lost for ever, unable to transfered in the group before consolidation or transferred to the Head Company on consolidation, unless some section deems the subsection 701-30(3) loss for the part year period to be a "tax loss" for an "income year". This is because both of these transfer provisions require this as a starting point (s170-10(1) and s707-115(1)(b)). This is where s701-30, and in particular subsection (7) fall down as they are not prepared to accord a loss for a period that finishes earlier than year end with this status.

So if not s701-30(7), then are there any other provisions that do this work? This is where we come to the Treasury suggestions and our assessment which is set out below.

They are correct in saying that s707-405 (ITAA97) does deem a loss for a part year "non-membership period" before year end to be a "tax loss" for an "income year" being that shorter period. This is only for the purposes of Division 707 however, which effectively says that the loss can make its way into being considered for transfer to the Head Company of a consolidated group (and it will be so transferred if it passes the tests in subdivision 707-A).

They are not correct in suggesting that item 39(9) of the First Consolidation Bill (the May Act) does the same work for group loss transfer under subdivision 170-A. Superficially it might look like it does. It applies not only to the operative provisions of item 39, but also to sub-division 170-A. And for these purposes it goes on to deem the part year "non-membership period" to be a "final year". But this is not what is needed. It does not deam this part year period to be an "income year" (only a "final year" which is not the same). It does not do anything to deem the s701-30(3) loss to be a "tax loss" (for any year). And when you read into item 39 (which is not easy), you see that it is aimed at something quite different anyway. It is aimed at closing down the group loss transfer provisions in an orderly way when consolidation leaves a non-membership period straddling the cut-off date for group loss transfer. The idea is that the group loss transfer provisions can operate up to a particular time (the apportionment time), but because loss transfers work for a period, some mechanism is required for periods that staddle this date. Certainly group loss transfer is wholly disallowed from the first full year after the apportionment date (item 37(1)(a) and 38(1)(a)) but arrangements are made for apportionment for the year prior to that (the so called "final year"). This is in

item 39, which goes on (in sub-item (9)) to treat a "non-membership period" as if it were the "final year" for these purposes. This effectively means that the company must delay consolidation until after the apportionment date, so that there is part of the year when the company is not consolidated (ie. a "non-membership period") that staddles the apportionment date and therefore warrants the apportionment treatment which item 39 dispenses. None of this comes close to deeming the s701-30(3) loss for a non-membership period early in the year to be a "tax loss" for an "income year" for the purposes of subdivision 170-A. This, and nothing less than this, is what is required to allow group loss transfer (see s170-10(1)(a) as noted above). What is needed is the equivalent of s707-405, that will do for group loss transfers under subdivision 170-A, the same work that it does for the transfer of losses to a Head Company under the consolidation provisions in Division 707. That work of course (to remind ourselves) is to deem the s701-30(3) loss amount for a non-membership period to be a "tax loss" for an "income year" being that part year "non-membership period".

It would be good if Treasury confirmed (a) that they agreed and (b) that this was unintended and (c) that they will arrange to get it fixed.

Assuming they do, it might be tempting for them to insert the provision as new sub-item 39(10) of the First Consolidation Act (the May Act), but this is just an application provision that will never make it into the substantive Assessment Act and for that reason will be easily lost from sight in years to come. A provision of this importance (effectively amending either s701-30 or subdivision 170-A) warrants, in my view, a section in the Assessment Act which will leave it prominent for people to see - just as has been done with s707-405.

I might take the liberty of forwarding a copy of this email to the Senate Economics Committee (along with details of other consolidations problems I have found and mentioned to you) as they are taking submission on the consolidations provisions (amongst other things) until this Friday 4th October 2002.

Thanks Richard.
Cheers,

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