Senate Economics Legislation Committee

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

Submission No. 3A

Submittor: Freehills
Mr John Morgan
Partner
GPO Box 4227
SYDNEY NSW 2001

Telephone: 03 9288 1474

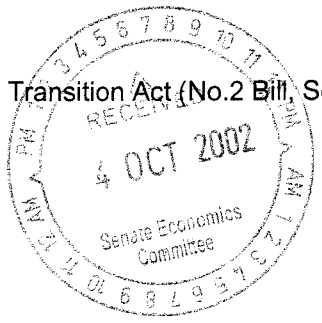
Facsimile: 03 9288 1567

EMAIL: John.Morgan@freehills.com

Attachments? No Attachments

Dermody, Kathleen (SEN)

From: John Morgan [John.Morgan@freehills.com]
Sent: Thursday, 3 October 2002 6:47 PM
To: Economics, Committee (SEN)
Cc: carol@lawcouncil.asn.au; plowenst@liv.asn.au
Subject: Suggestions in relation to proposed Section 701-35 of the Transition Act (No.2 Bill, Sched 7, item 2) - Senate Economics submission



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 what follows that I have already suggested (to the ATO) that we need significant surgery on the above provision. This should fall squarely within your terms of reference as the provision is part of the Second Consolidation Bill. In the overall scheme of things this one is in the "must fix" category - in my view.

What follows is technical, but I think it can stand on its own better than the equivalent part of my first submission so I will let the extract of my letter to the ATO be the submission.

It is sufficient if I say that this provision could work in ways clearly not intended. Also it was apparently introduced into the Bill without the normal consultation process (because of its anti-avoidance nature). Unfortunately this shows.

This provision is to have retrospective effect back to 16 May (well prior to its 27 June introduction date). Transactions have already occurred which it affects. In these circumstances enormous care must be used to only act in a measured way and in line with what could not have been reasonably expected.

I confirm again that this is not intended 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, but I should probably say that I make this submission in my own capacity. 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.

John Morgan
Partner
Freehills

Direct 61 3 9288 1474
Telephone 61 3 9288 1234
Facsimile 61 3 9288 1567
Mobile 0438 637 638
http://www.freehills.com

----- Forwarded by John Morgan/Melbourne/FHP/AU on 03/10/2002 18:13 -----

John Morgan To:
cc:
23/07/2002 17:16 Subject: Suggestions in relation to proposed
Ext : 1474 Section 701-35 of the Transition Act (No.2 Bill, Sched 7, item 2)

X
ATO - Consolidations,

Dear X,

I have spotted some difficulties with one of the proposed Consolidations provisions which I think (particularly after discussing it with Y) are not what the Government intends. Y said I might try addressing these comments to you.

The provision is in the New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 ("No. (2) Bill") which was introduced to the Lower house on 27 June 2002 and proceeded no further when Parliament rose the same day at the conclusion of the Winter sittings.

Proposed Section 701-35 of the Transition Act (No.2 Bill, Sched 7, item 2)

This provision could well be creating many unintended or unfortunate consequences (ie. be looking like a loose cannon) and no doubt you are getting many submissions about them.

The basic intention (??)
My read of what was intended with this provision is that it was not intended to alter the "envelope" of what companies and assets are in the group. Rather it assumes that the rollover asset stays wholly within the group that ultimately elects to consolidate and that the rolled over asset will end up a deemed Head Company asset (whether it was rolled over to the transferee or stayed with the transferor). On this basis, I think the provision then assumes that it is reasonable to assume that it shouldn't matter if we ignore the rollover transaction, for the purposes of ensuring that the Head Company's tax cost is set by reference to the pre 16 May 2002 position, without any advantage sought by parties since that date.

Suggestion 1
If this is the case, then perhaps the lead sentence in the provision should be amended to read:
"701-35 If:
(a) after 16 May 2002 and before the transitional group came into existence, a CGT event happened wholly within that group in relation to an asset for which there was:
(i) a rollover under Subdivision 126-B ..."

Suggestion 2
A second issue could benefit from clarification in my view also. The test as to whether s701-35 is triggered or not depends on whether the Head Company's cost base on any of its (deemed or actual) assets differ from what they would have been if "the rollover had not occurred". I am not sure if this means the rollover transaction had not occurred or merely that the parties had not chosen rollover tax treatment (for a transaction that we assume has occurred). I suspect the more sensible result (and probably what is intended) is the first interpretation - namely that the cost base effect is tested against the hypothetical of the entire rollover transaction having not occurred. The trouble is that this is not an easy construction to reach looking just at the form of drafting used. The existing provision draws a distinction between a "rollover" and the "CGT event" which suggests that the CGT event is the transaction and the "rollover" is merely the particular CGT treatment that can be elected (and this is probably consistent with the meaning of "rollover" in Divisions 124 and 126 of the 97 Act). Also not much can be made of any potential distinction between the use of the terms "rollover" and "rollover relief". Initially I thought a "rollover" might be the transaction and the "rollover relief" might be the tax effect, but in s701-35(a) both terms seem to be references to different rollover provisions ("rollover" to CGT provisions and "rollover relief" to the depreciating asset provisions).

If I am correct about which is the more sensible construction, can I suggest the drafting of paragraph (b) could possibly be changed as follows:
701-35 If:
(a) ...
(b) the cost base or reduced cost base of that asset or any other asset that:

(i) became an asset of the head company at the time when the transitional group came into existence because [the single entity rule operates]; or
(ii) was otherwise an asset of the head company at that time;
differs at that time from what would have been if the rollover transaction had not occurred ..."

An example of the problem
Having made these two observations, can I illustrate a potential problem by returning to my concern that s701-35 could have a wild and unhelpful effect by changing the companies which are taken to form the consolidatable group and the assets which are deemed to be owned by the Head Company after it elects to consolidate the consolidatable group.

Take for example a foreign company which has two (multiple entry point) Australian sister subsidiaries. It may transfer one subsidiary underneath the other (by way of rollover) to get ready for consolidation (either not knowing that MEC relief was available or preferring a normal consolidated group) and do so by way of Subdivision 126-B rollover as the wholly owned can include non-residents for these purposes. The non-resident transferor however cannot be part of the Consolidated Group because it is non-resident. This sets up the potential for the share transfer to be treated as if it didn't happen (if s701-35(b) is also triggered) which would mean that all of the provisions in Part 3-90 (ie. all the consolidation provisions in the 97 Act) would apply as if this share transfer had not taken place. This would mean that Head Company would have to approach the Consolidation provisions in Part 3-90 as if it had no subsidiary at all and none of the subsidiaries assets (under the single entity rule). There is nothing in the EM to give any indication that the effect of this retrospective provision would behave like this. Also it is inconsistent with the structure of s701-35(b) as currently drafted in that it implicitly assumes that the provision does not alter the assets which the Head Company owns under the single entity rule (it would be odd otherwise to ask if the rollover affects the cost base of an asset if the effect was to deny that the Head Company even had the asset).

The same thing could happen where both the transferor and transferee were Australian residents. For example, let me change the multiple entry point scenario above so that both of the Australian subsidiaries are themselves holding companies, each holding 100% of an Australian resident operating company. The foreign company might have decided that in moving to an ordinary consolidated group (not an MEC group) it didn't need both holding companies and would arrange for one of the Australian holding companies transfer its operating company to the other Australian holding company (and that it would liquidate the redundant Australian holding company). Again the transaction by which one of the subsidiaries was added to the consolidatable group could be taken to have "not happened" under s701-35 by virtue of the share transfer being done by way of subdivision 126-B rollover - if s701-35(b) were also triggered.

Suggestions 3&4
There is another potential loose end in the current drafting in that the proposed deeming effect is that the "CGT event" is to be treated as if did not happen. I presume that it is not only the CGT event that does not happen (eg. the transfer of the rolled over asset) but also the remainder of the transaction that is also to be treated as having not happened (eg. the giving of consideration).

Finally, I think there is another problem in the last line and a half of the proposed provision to do with the scope of the deeming which it effects. If the proposed provision is triggered, it is the whole of Part 3-90 of the 97 Act (ie. the whole of the substantive consolidation provisions) that must be applied as if the relevant CGT event or transaction is treated as having not happened. It seems to me that the deeming should only be for the purposes of applying the tax cost setting rules in Division 705 of the 97 Act for Head Company Core Purposes. There may be many unexpected problems with deeming as broad as this, but the one that I can foresee is with the workings of things like the exit history rule which will be unworkable if the history gets separated from real ownership of the assets. For instance if a business was transferred from Subsidiary A to subsidiary B after 16 May 2002, it could be subsidiary B that actually owns the assets, but the whole of Part 3-90, including the exit history rule, will operate as if is subsidiary A that still owns the assets and will inherit history for assets it doesn't own.

If these suggestions are correct, could I suggest that the wording of the

last line and a half of the provision could be amended to read as follows:
701-35 If:
(a) ...; and
(b) ...;
then Division 705 (strikethrough: Part 3-90) of the Income Tax Assessment Act 1997 applies for head company core purposes as if the rollover transaction (strikethrough: CGT event) had not happened."

Conclusion
I hope that this is of at least some assistance in getting these laws into better shape. They are to have retrospective effect on transactions entered into between 16 May and when their form is finally settled. I would have thought great care should be taken to not enact anything which could not be reasonably anticipated from the announcement which heralded the retrospective measure.

I would appreciate receiving any comments you feel able to make at this stage and in due course by return email, phone (03-9288 1474) or any convenient means.

Cheers,
John Morgan.
Partner Freehills Melbourne

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