Senate Economics Legislation Committee

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

Submission No. 3B

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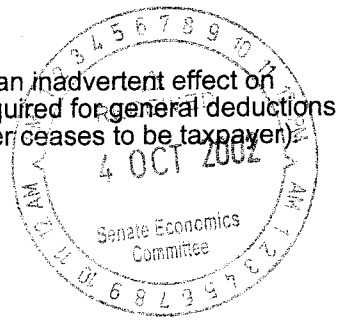
Attachments? No Attachments

Dermody, Kathleen (SEN)

From: John Morgan [John.Morgan@freehills.com]
Sent: Thursday, 3 October 2002 7:16 PM
To: Economics, Committee (SEN)
Cc: carol@lawcouncil.asn.au; plowenst@liv.asn.au
Subject: Consolidation Anomaly (??) - Single Entity Rule may have an inadvertent effect on Subsidiary Members in establishing the "income nexus" required for general deductions claimed before consolidation (because a subsidiary member ceases to be taxpayer) - Sen



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.

I have attached a note to a member of the Consolidations design team by way of my submission. In summary, the concern is that the fact that subsidiary members cease to be taxpayers under the consolidation regime under the single entity rule. The issue is that general deductions depend on being able to demonstrate a link or nexus between the outgoing incurred and the derivation of assessable income. Sometimes the income to which the outgoing is linked is in the future and thus could be received after consolidation when that income will no longer be assessable to the subsidiary member. So, for instance, the subsidiary member might have trouble claiming the deductions (say on interest incurred on a loan) in the period before consolidation and before receiving any income that is linked to the interest outlay. This is not a concern about the on-going deductibility of such interest in the Head Company's hands (where the income will be assessable). I is a concern that the switch into being a non-taxpayer could have some unexpected effects on the normal operation of the tax law in pre-consolidation periods.

As I've said below, there may well be counter arguments to the concerns I've expressed, but it would be much more efficient and comforting to put an end to these unnecessary concerns by an appropriate deeming provision. This has been done for other issues (see for example s707-400 - in the First Consolidation Act).

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.

Kind regards,

John Morgan
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Freehills

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----- Forwarded by John Morgan/Melbourne/FHP/AU on 03/10/2002 18:56 -----

John Morgan To:
cc:
27/09/2002 17:40 Subject: Consolidation Anomaly (??) - to take
Ext : 1474 back to the design team ...

Dear X
Member of the Consolidations Design Team,

I've come across what I think is a potential anomaly with the effect of the consolidation election on pre-consolidation periods. I'll explain what I mean, and you may have some comments or think it worth taking forward to the statutory design team.

The circumstance I have encountered is where a company within a group borrowed to buy shares in another company. Ignoring the possibility that the borrower (and the purchased company) might become members of a consolidated group shortly, there would be no reason why the interest would not be deductible. There is nothing unusual about the dividends that could be expected to flow from the shares purchased and there is no reason why the dividends would not be assessable (meaning that the first limb of the inclusive test for general deductions under s8-1 would be made out). It would not matter that in the first income year in which the interest outgoings were incurred, there was no dividend received from these shares as it is sufficient if there is the prospect of assessable income in future years.

The problem I'm concerned about though, arises if the borrower then becomes a member of a consolidated group at the end of that first year (ie. at a time when it still has received no dividends) - say because there is a Head Company of a consolidatable group which elects consolidated treatment for the group and the borrower is a member of that group. From the time of consolidation on, the borrower will cease to be a taxpayer and the dividends which it (still) expects to receive will no longer be assessable to it.

There seems to me to be a significant technical risk that this precludes the borrower deducting the interest in the pre-consolidation period as the borrower will never receive dividends that are assessable (and if it is known that consolidation is likely at the time of borrowing the money, this could infect the deductibility).

I could think up arguments against this, but none that seem water-tight.

Equally, this seems a daft result that is in no way justified in principle. The consolidation election after all does not in substance exempt any of the group's income - it shifts where it will be assessed and eliminates double counting.

Has this sort of problem been raised before to your knowledge? Are there sound answers that I haven't thought about? Should we be pushing for some statutory remedy?

Thanks for your thoughts,

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