Senate Economics Legislation Committee

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

Submission No. 8

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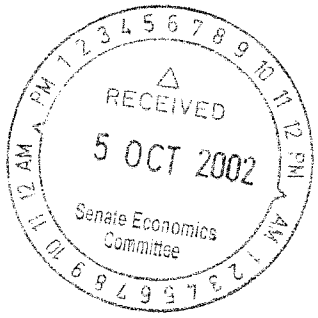

4 October 2002

Dr Kathleen Dermody
Committee Secretary
Australian Senate Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Dr Dermody

Senate Economics Legislation Committee Inquiry into the New Business System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002 (the Bill)

Thank you for your letter of 20 September concerning the reference of the above Bill to the Senate Economics Legislation committee. Our submission is brief, to expedite the desire of the Committee to report back on 18 October 2002.

Overview

Ernst & Young welcomes the opportunity to make a submission, having contributed significant time and experience in consultation forums developing the measures.

Our involvement, over the period since the initial development of the proposals in the Ralph Review of Business Taxation (RBT), has included the commitment of various National tax practice leaders to the process of analysing the proposals, considering the impact on clients and delivering training seminars. They are continuing to discuss the emerging issues with Treasury and Australian Taxation Office (ATO) executives across the range of consultation forums established to improve the legislative design. Many other partners and managers of the firm have complemented this process in discussions with clients to bring real issues to the table.

1 Senate Must Resolve Uncertainty About The Measures As Soon As Possible

It is vital for business that the measures should apply from 1 July 2002 as currently proposed, and that certainty be provided to the business community.

There is now uncertainty in the business community following the Senate action in relation to these measures. This is causing tension for business with various transactions and compliance processes being deferred pending the Senate's passage of the measures.

The policies behind the tax consolidation and the demerger measures are not new or unknown. The consolidation measures, in particular, have been exposed to the public in various ways over an extended period of time.

Since the RBT first recommended the measures we have seen an Exposure Draft of December 2000, a second Exposure Draft of February 2002, an Australian Taxation Office Reference Guide issued publicly in early 2002, followed by Bills introduced in May 2002, June 2002 and September 2002.

2 Tax Consolidation Measures

Ernst & Young applauds the government for the introduction of the law, which has 2 strands:

a) Intra-group transactions will be disregarded for tax purposes by treating them as if they arise within one company.

This will generate major integrity advantages and long-term revenue enhancements for the Government. This will occur because tax planning involving intra-group capital gains tax rollovers, intra-group dividends and value shifts will no longer be available within tax consolidated groups.

At the same time this treatment will enhance business efficiency by streamlining intra-group reorganisations without tax costs.

b) The measures allow the true economic cost of a company acquisition to be pushed down into the underlying assets. This is a major enhancement to the competitiveness of the Australian tax system that will boost the competitiveness of Australian business. It will significantly reduce the "black holes" arising from part of the purchased price of shares in a company being ineligible for capital allowances or write-off.

This feature is an important element of the package, and should not be further eroded by any additional integrity measures or compliance complexity. This may reduce any incentive for groups to voluntarily adopt consolidation, resulting in a reduced effectiveness of the integrity objective mentioned above.

2.1 Substantial Completion Of The Rules

With the recent tabling of the third tranche of the tax consolidation rules, the detail is now substantially complete. Taxpayer groups can now understand the dynamics of the regime in relation to the formation of consolidation groups and the acquisition of new subsidiaries.

Ernst & Young reiterate that consultation on the measures has been very effective in ensuring that the concerns of both the revenue and taxpayers have been taken into account.

Taxpayers are now in a position to deal with law due to its extent of development. This is an entirely different situation to previous practices of Press Release announcements. These were generally operational from a particular date and with no delivery of the law for 8-15 months after the operative date, resulting in high risks due to unknown implications.

Ernst & Young emphasise and support the staged entry dates into tax consolidation. This means that company groups can resolve to finalise tax consolidation entry

decisions at any time within the 2003 year and still retain the transitional concessions and grouping.

This staged entry allows both:

a) time for business and government to resolve the practical issues and achieve an administrable and effective law in time for the close of the 2003 financial year; and

b) taxpayers to be satisfied with the progress of the law before commencing their major compliance tasks in the lead-up to their income tax returns for the 2003 financial year. Those taxpayers who would prefer more guidance and resolution of the second order issues need not enter tax consolidation immediately.

There are various detailed mechanical measures which need to be resolved, and there is an opportunity for refinement of the rules (see Appendix 1 for our summary of some of the more significant issues remaining to be resolved). However it is reiterated that consultation to date on the measures has been very effective in ensuring that the concerns of both the revenue and taxpayers are taken into account. The remaining issues, it is expected, will be subject to similar ongoing consultation.

Under this approach corporate groups can make informed decisions regarding their entry into the tax consolidation regime in a timely fashion.

2.2 Complexity

The tax consolidation rules are complex. However the need to integrate these rules with the existing provisions across the whole of tax law was bound to involve complexity to provide an effective consolidation system. This is a significant task. Complexity should not be used as a justification for deferring or abandoning the tax consolidation regime.

There are a number of existing measures that are directed at simplifying the operation of the consolidation rules. It is important that these rules are not abandoned and that further developments for simplification be encouraged. For example, Ernst & Young supports the transitional rule for taxpayers entering consolidation before 1 July 2004 where they will have the option of setting asset tax values in relation to the assets held by subsidiary members by reference to the existing values of the assets. This will help reduce complexity for those taxpayers who will not need to calculate and allocate Allocable Cost Amounts (ACA) into the underlying assets of a subsidiary.

2.3 Compliance Costs

There is a balance to be struck between protection of the revenue and compliance efficiency for taxpayers.

Ernst & Young consider that in some respects the compliance tasks around the ACA pushdown method are still too costly and problematical. Work continues with the ATO to ensure that guidance material is available. It is clear that early practical experience of applying the rules might create refinements to streamline compliance.

To the great credit of the Government and ATO, consultation is continuing to ensure the balance is correct.

Ernst & Young are not troubled by, and applaud, the ongoing improvement of the compliance aspects of the consolidation rules. A great benefit of the consultation process has been the ability to identify issues proactively and resolve them – rather than a belated identification of issues after income tax returns and year-end financial statements are prepared for the 2003 financial year.

In this regard, it is expected that the ATO will take into account the extent to which the complexity impacts on smaller businesses in assessing remedies and penalties for "non-compliance".

2.4 Guidance Material And Reliance Which Can Be Placed On It

Ernst & Young note the ATO's commitment to updating the "Tax Consolidation Reference Manual" which is intended to largely supplant the Explanatory Memorandum. If this is the case, then the Manual will assume great significance (with taxpayers relying on it for protection from penalties) and it should therefore be developed as a joint project with business and the professions.

It is important that the Reference Manual should be given a formal status as a Public Ruling, beyond that of a mere publication of the ATO, so that it can be relied upon by taxpayers.

2.5 Small Business

We support the Institute of Chartered Accountants' recommendation that small business be granted a further transitional year to 30 June 2004 to access existing group concessions. Small business groups and their advisers do not have the resources to analyse the rules fully at this stage and will benefit from the experience which larger groups, as early adopters, will have.

It is noted that there are a number of provisions which may cause substantial compliance costs to be incurred by small business. Whilst concerned about the impact of those requirements on small business, we consider that ongoing refinement of the rules should address the compliance cost issues. The Government is to be congratulated in taking the concerns of business in this regard into account in a number of areas to date.

3 Demergers

The demerger measures in the Bill are critically urgent. Delay is causing road-blocks in the mergers and acquisitions arena – a vital component of Australia's competitiveness in international markets.

There are a number of matters of detail, which need to be addressed, but we are confident that ongoing consultation should resolve these issues. We attach at Appendix 2 a listing of the more significant outstanding issues.

3.1 Senate Must Not Delay The 1 July 2002 Commencement Of This Measure

We think this measure should not under any circumstances be sidelined or deferred or made contingent on the third consolidation Bill.

The delay of this feature of the law is, in our view, creating the potential for real economic costs for Australia. It is causing major business transactions to be held up, and is delaying desirable restructures of Australian companies – via a mechanism highlighted three years ago in the RBT.

If the Senate was to delay the coming into effect of the consolidation measures of the Bill, even for a few weeks pending linkage to the September consolidation Bill, the Senate should carve out the demerger provisions and give them immediate entry into law.

3.2 Support For The Development Of Demerger Rules Since Ralph RBT

This submission now addresses three features of the demerger law which were not apparent in the RBT original recommendation and which arose from the consultative and policy development process.

3.2 1 Shareholder Continuity Of Pre-Capital-Gains-Tax Membership Interests

Ernest & Young support the law providing a continuity for shareholders of their pre-Capital Gains Tax (pre-CGT) membership interests.

There is already a Capital Gains Tax (CGT) concession available for share splits under Section 124-240 of the CGT law within the Tax Act which has the effect of preserving pre-CGT status for pre-CGT shares after a split. It would be inappropriate and inequitable to have the demerger (which applies in relation to demergers that are effectively analogous to share splits) deny the pre-CGT advantages to investors.

Demergers are easily distinguished from scrip takeover rules (which have no inheritance of pre-CGT status). In a scrip takeover the holder of the previous target receives new shares in the acquirer, which has many other activities in it other than the target's activities.

3.3 Demerger Concession For Non-Widely Held Entities

The RBT originally proposed limiting both scrip takeover rules and the demerger rules to widely held entities.

The scrip takeover concession was broadened beyond widely held entities in the New Business Tax System (Capital Gains Tax) Act 1999, which appropriately received bipartisan support, and which we support. The increased efficiency which can emerge from scrip takeovers and demergers applies just as much to non-widely held entities as to widely held entities. As well, any limitation to widely held entities would raise massive boundary issues (it disadvantages a company where a widely held entity has only a partial interest or a consortium company comprising various super funds and institutions not being widely held entities).

The expansion beyond widely held entities is supported by a strong array of integrity measures in the demerger rules. These surround the CGT concession, and the dividend concession, with the capacity of the ATO to declare certain unacceptable demergers under Section 45B to constitute taxable dividends.

3.4 CGT Rollover Concession For The Demerging Group

The RBT was silent in relation to the CGT rollover concession for the demerging group, whereby no gain is recognised on a spinout under a demerger. It is suggested that the overall RBT recommendation on demergers was a big-picture outline of the future concession for further development.

We support the approach taken in the Bill, that there should be no CGT event for the demerging company on the demerger. If there was a CGT event, then the demerger law would not operate any more efficiently than the pre-existing tax law, which effectively limits demergers to two types of assets in companies:

i) assets which were pre-CGT in nature (and could thus be demerged without attracting CGT); and
ii) assets which were post-CGT but had not appreciated significantly since the post CGT status was achieved.

Both of these categories represent an increasingly small percentage of assets, and so the whole demerger concession would effectively be frustrated.

The United Kingdom demerger concession provides a similar exemption/rollover from CGT for the demerger company. This was brought to the attention of the Australian policy makers when this law was being developed.

4 General Value Shifting Regime (GVSR)

The need for and concepts around the General Value Shifting rules are understood and logical. The Explanatory Memorandum sets these out in an understandable fashion. However, the form of the legislation is difficult to follow and would merit from refinement.

In many cases there will be difficulty in determining from the Bill whether any of the exceptions are applicable and, if not, how to work out the amount taxable or the cost base adjustment. **Ernst & Young recommend that the rules should be scheduled for review at an early date with substantial streamlining being the object of the review.**

A rigorous application of the GVSR is considered to be unwarranted in cases where groups of companies enter into the Consolidation regime during its transitional introductory period. That is, where corporate groups enter consolidation by the end of the 2003 financial year, there appears little merit in their needing to devise the tax compliance systems (and incur the compliance costs) required by the GVSR for a mere one-year operation.

Ernst & Young recommend a statutory refinement to allow a reduced-scope GVSR in these circumstances to enable compliance costs to be managed and to achieve efficiency.

Contacts

We shall be pleased to discuss any of the above comments. Please call either Tony Stolarek on 03 8650 7654 or John Gonsalves on 03 9288-8699.

Yours sincerely

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Partner – National Tax

Appendix 1 Some Tax Consolidation Issues To Be Resolved

These issues are presented to indicate to the Senate Committee to indicate how the consultative process is delivering workable law. They also demonstrate that tax consolidation involves consequential adjustments to many areas of the tax law which, under the consultative model, are receiving attention.

a) **Beneficial Ownership**. Corporate groups need a clear workable rule about the date on which an entity leaves or joins a group in a divestment or acquisition. Using the traditional tax concept of beneficial ownership is unworkable with contracts having conditional or deferred settlement dates. Consolidation requires a refinement of these rules.

b) The **Same Business Test** (SBT), which deals with company tax losses which fail the Continuity of Ownership test, has needed refinement for some years. As it stands it does not deal adequately with companies and groups which have diversified businesses. The long-standing difficulties with the SBT make it necessary to modernize this rule, especially for consolidated groups.

c) **Tax Sharing Agreements (TSA)**. The TSA rules needs clarification to ensure the scope for really clean exits in bona fide divestments, otherwise sales of companies will be commercially problematical.

d) **Losses, capital injections and the Available Fraction**. Currently any capital injections since 2000 into any company having tax losses (including share subscriptions into new companies) affect the utilisation of tax losses, because the capital injections erode a subsidiary company's tax loss Available Fraction. The rules need some adjustment as they operate inappropriately in some conventional business situations. Whilst it is recognised that the rules operate as a strong integrity measure in the law, revenue protection measures must be commercially realistic. There is also an inappropriate outcome from the exclusion of synergistic goodwill from the value of every member of a group, which denies the group the opportunity to attain an available fraction of one.

e) **Over-depreciation and dividends** (S.705-50). These complex integrity measures require educational material and possible refinement of the law to assist compliance. For instance, identification and allocation of profits giving rise to dividends paid years ago is problematical; tracing of the dividends by widely held entities is a challenge, and determination of individual market values for each individual asset is costly. Again there is a need for revenue protection measures to be commercially realistic.

f) **ACA and Uniform Capital Allowances (UCA)** – Div 702 (which deals with mining rights) currently causes a difficulty when subsidiaries are sold with mining rights. Some refinement is needed.

It is reiterated that the consultative process is addressing these issues

Appendix 2 – Demerger issues to be resolved

These issues are presented to indicate to the Senate Committee to indicate various issues which have been raised under the consultative process, and which we trust will result in additional consequential amendments and technical corrections. Many of these issues are only appreciated when the law is first used in real-life commercial transactions, as occurs with all major policy initiatives.

(a) The definition of **"widely held"** does not include wholly owned subsidiaries of widely held entities. It is considered that it is intended that such companies (subject to integrity concerns) should be included. This issue is now endemic to the Act and a review of its application across a range of fact situations is long overdue.

(b) The identification of the Head Entity and the Demerger Group is limited by the inappropriate application of a **20% 'interest** in the Head Entity' rule, which means that any company which is not widely held, and which has more than 20% of its equity held by another company, cannot engage in a demerger. This rule performs little if any useful function and Ernst & Young would support its refinement or removal.

(c) Guidelines for further relief from the operation of the dividend anti-avoidance rules **(S. 45B)** are urgently needed. The ATO is understood to have been working on guidance material for many months but this is urgently needed now to ensure efficiency of the ATO and commercial processes.

(d) ATO guidance as to how **Part 1VA** may or may not apply to particular demerger structures is needed to provide the capital markets with some certainty for planned demergers.

(e) Recent amendments deem a "demerger dividend" to be unfrankable but at the same time there are no mechanisms for the dividend to create a cost base in relation to the resulting shares. It is suggested that if an election is made to treat the dividend as taxable, it should be frankable.

Also, the CGT law or demerger law needs to be adjusted to provide for cost bases to arise for CGT purposes where no rollover is available. In other words, if a transaction results in taxpayers being taxable on taxable income, the resulting share equity interest should be granted a cost base.

(f) Participants in employee share acquisition schemes (ESAS) encompassed by Division 13A are not afforded CGT treatment and cannot access scrip for scrip or demerger relief. In essence, where employee shareholders hold ESAS shares and their employer undertakes a demerger or is taken over in a scrip takeover, the employees are taxable on gains arising from demerger or takeover of their ESAS shares as ordinary income, with no access to rollovers which are available to non-ESAS investors.

This is essentially a result of the **mis-alignment** between CGT rules (of which scrip for scrip and demergers are a part) and the ESAS rules in Division 13A.