CORPORATE TAX ASSOCIATION OF AUSTRALIA INC.

SUBMISSION TO SENATE ECONOMICS LEGISLATION COMMITTEE

TAXATION LAWS AMENDMENT BILL (NO. 7) 2003

The Corporate Tax Association of Australia, which represents the taxation interests of some 115 of the largest corporate groups in Australia, is pleased to make this brief submission to the Senate Economics Legislation Committee in respect of the above Bill. A listing of the corporate groups comprising the CTA membership is attached as Appendix A.

The Bill is an omnibus bill proposing various amendments to the taxation laws, however this submission is contained to making comments with respect to the following specific proposals (in order in which they appear in the Bill):

- Schedule 5 - Foreign losses and consolidation;
- Schedule 6 – Interaction of goods and services tax and consolidation; and
- Schedule 10 - Income tax and foreign hybrids.

Schedule 5 – Foreign Losses and Consolidation

It has been clear since the release of the Exposure Draft consolidation provisions in February 2002 that the consolidation treatment of carry forward tax losses relating to foreign source income would require further legislative attention.

Without provisions of the kind proposed in Schedule 5 of the Bill, Australian corporate groups that have embarked on foreign activities directly via an Australian subsidiary and have incurred start-up losses are likely to be significantly disadvantaged by the introduction to the consolidation regime. Giving groups the option of leaving affected entities out of their consolidated group for up to three years represents an appropriate way of dealing with most of the immediate problems created under the current rules.

Available Fraction Mechanism

In considering this issue, it is important to have an understanding of the way in which losses are utilised in a consolidated group. Consolidation creates a kind of virtual tax world where the ultimate Australian holding company, known as the head company, is treated the sole tax representative of the entire group. For tax purposes, the group is treated as a single divisionalised entity, where the actions and history of its subsidiary members are taken to be those of the head company.

Subject to entry rules, any losses that previously belonged to subsidiary loss making companies are transferred to the head company on the formation of a consolidated group. Before consolidation, those losses could be carried forward by the subsidiaries and/or transferred to other wholly owned subsidiaries.

The consolidation rules track each separate loss, known as a loss bundle, and set rules for the utilisation of the various loss bundles by the head company. As a rough way of achieving the same rate of loss utilisation that would have applied to the subsidiaries separately, the concept of available fractions has been developed. The available fraction is the proportion that the market value of the subsidiary that brought in the loss bears to the market value of the entire consolidated group. The available fraction is applied to the net assessable income of the consolidated group in a particular year to determine how much of the loss bundle can be recouped in that year. In other words, assessable income could arise from anywhere in the consolidated group, and relative market value has been adopted as a proxy for the loss making subsidiary to generate its own assessable income, thereby roughly replicating the rate of loss utilisation pre-consolidation.

Problems with foreign losses

This generally satisfactory result that the available fraction mechanism achieves in respect of losses unfortunately does not apply to foreign losses, the difficulty being that in most groups foreign branch income is usually only derived by just one or two subsidiaries. This significantly detracts from the usefulness of the available fraction as a proxy for loss utilisation, and the clear policy objective of broadly replicating what would have happened before consolidation is not achieved.

Say a company has incurred foreign losses of $1m in developing a future source of foreign income. Those losses are quarantined so that they are only claimable against the future foreign income of the same class. Prior to consolidation, and on the subsequent receipt of foreign income of $1m, the foreign losses would then have been applied as an immediate offset.

Say the same company is part of a larger consolidated group, and its market value represents 1 per cent of the market value of the entire group. The loss bundle representing the $1m foreign loss accordingly has an available fraction of 1 per cent. Absent the Schedule 5 amendments, the consolidation regime would apply so that on the post-consolidation derivation of the $1m foreign income, only $10,000 of the foreign loss could be utilised. This would require the Australian head company to pay tax on a non-existent gain of $990,000, leaving the future recovery of the unutilised foreign loss of $990,000 highly doubtful.

Retrospective impact on projects

Australian companies investing offshore through a branch structure before the consolidation regime was developed would have done so with the expectation of being able to recoup their start-up losses before being required to pay Australian taxes. Unless this measure is passed,

the existing loss recoupment rules under consolidation have the potential to retrospectively render some foreign projects uneconomic. We believe that such an outcome would clearly be contrary to the stated policy objectives of the treatment of losses under the consolidation regime.

Revenue considerations

As to the question of revenue costings, we broadly concur with the financial impact statement included in the Explanatory Material to the Bill - i.e. since these measures essentially allow entities with foreign losses to maintain their existing tax treatment for a transitional period, there should be no significant revenue impact against the benchmark of the forward estimates. We note also that that are restrictions to which entities may be excluded from the consolidated group under Schedule 5, and the exclusion option is only available for up three years. Indeed, they may even be revenue positive given that other consolidation transitional benefits will not be available to excluded companies, nor will they be eligible for loss transfer, asset roll-over, or the thin capitalisation grouping concessions.

For the reasons stated above, the CTA strongly supports the amendments proposed under Schedule 5. We would be happy to answer further questions if required.

Schedule 6 – Interaction of Goods and Services Tax and Consolidation

Schedule 6 to the Bill proposes amendments to the provisions of *A New Tax System (Goods and Services) Tax Act 1999* ("the GST Act") to remove any doubt that a "thing" which is supplied either as a consequence of the statutory operation of the income tax consolidation provisions or as a result of contractual arrangements entered into because of those provisions will not be a taxable supply, as defined in section 195-1 of that Act.

The CTA supports the proposed amendments and notes that they are expected to reduce compliance costs and to have nil financial impact (refer to page 6 of the Explanatory Memorandum accompanying the Bill). Moreover, the amendments will ensure similar GST treatment under the consolidation regime as would be the case in a pre-consolidation environment. If not for the amendments, GST may have been an impediment to some entities that wish to enter the consolidation regime.

The definitions of the terms "supply", "consideration" and "acquisition" in the GST Act are extremely broad and could, in the absence of the proposed amendments, be interpreted to include the sorts of "things" supplied or acquired either as a direct result of the operation of the consolidation provisions or as a result of the arrangements that are entered into because of consolidation. Examples of such "things" are set out in paragraph 5.3 of the Explanatory Memorandum.

Paragraph 5.14 of the EM notes "*These amendments should not be taken to imply that all transfers that occur as a result of the statutory operation of the consolidation regime would be taxable supplies apart from the operation of the new provision. Rather, they ensure that if such transfers could be taxable supplies, no GST consequences will result*". Accordingly, the amendments merely avoid any doubt that such "things" could be taxable supplies for GST purposes. We further note the amendments are "*intended to be broad*" (paragraph 5.15 of the EM) because "*the consolidation provisions will operate in a variety of ways*".

It is appropriate that the amendments apply with effect to tax periods starting or that started on or after 1 July 2002, being the commencement of the consolidation regime.

Finally in relation to this schedule, we note that further amendments are required to ensure certain income tax and GST interactions maintain the existing outcomes in a pre-consolidation environment. For example, we are concerned that under the "single entity" rule in the consolidation regime a consolidated group could be denied an income tax deduction for non-creditable GST arising on an intra-group acquisition. In a pre-consolidation environment the recipient member would be entitled to an income tax deduction for the non-creditable GST amount provided the acquisition is made in the course of carrying on its own business or in gaining or producing its assessable income.

Schedule 10 – Income Tax and Foreign Hybrids

Schedule 10 proposes amendments to the *Income Tax Assessment Act, 1936* and the *Income Tax Assessment Act, 1997* in respect to certain foreign hybrid[2] entities to ensure they are treated as partnerships for all purposes of the income tax laws. In the absence of the proposed amendments, such an entity may be treated as a Foreign Investment Fund ("FIF") for the purposes of Part XI or a Controlled Foreign Company ("CFC") that is a resident of no particular unlisted country for the purposes of Part X of the 1936 Act.

In summary, the amendments would ensure that a foreign hybrid is treated as a partnership under Division 5 of Part III of the 1936 Act and not as a company as set out in Division 5A of Part III. Because a hybrid entity would no longer be treated as a company it would not be either a FIF or a CFC under the relevant provisions.

If enacted, the amendments would fulfil the Governments announcement of 8 April 2003[3].

The CTA supports the proposed amendments and notes that they will provide greater certainty and remove unintended consequences for taxpayers that could result from the potential current treatment of investments in affected hybrids. The proposed measures are expected to have minimal financial impact (page 9 and paragraphs 9.169 and 9.176 of the Explanatory Memorandum); generally reduce compliance costs (although there may be some minor

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[2] Refer to paragraph 9.2 of the Explanatory Memorandum accompanying the Bill.
[3] Refer the Assistant Treasurer's press release C26/03.

additional compliance costs in some cases in relation to the capital gains tax consequences of being taken to own a proportionate interest in the assets of the hybrid entity); and increase certainty in compliance.

The amendments would protect the revenue by the inclusion of targeted loss-limitation rules as set out in paragraphs 9.51 to 9.79, inclusive, of the Explanatory Memorandum.

Moreover, the proposed amendments would generally align the Australian tax treatment with that of the relevant foreign jurisdictions and with the way foreign hybrids are regarded for commercial purposes.

In our view, if not for the proposed amendments, the potential current taxing provisions would result in inappropriate and unintended outcomes compared with the policy intention underlying the relevant CFC and FIF provisions. For example, at the time the CFC provisions were introduced into the Parliament the policy underpinning Part X was described in the second reading speech in the following terms:

> *"[to] attribute to Australian residents, with some exceptions, certain income derived by a non-resident company that is controlled by Australian residents, unless the company is* ***subject to a tax system comparable to Australia's*** *and is predominantly engaged in active business."* (emphasis added).

It should be noted that under the tax laws of the United Kingdom and the United States of America, both of which have comparable tax systems to Australia's, the income of a foreign hybrid would be subject to tax in the respective jurisdiction, albeit the applicable tax would be paid or payable by the relevant partner/investor and not by the hybrid entity per se.

On 12 December 2001 the Commissioner of Taxation published a preliminary, though considered, view that a foreign hybrid entity would be considered a resident of no particular unlisted country for the purposes of Part X of the 1936 Act.[4] A potential and, in our view, inappropriate and unintended result of that conclusion would be the income of such an entity that is beneficially attributable to an Australian resident company taxpayer would indeed be attributable to tax in Australia, notwithstanding the income would be also subject to comparable taxation in the foreign jurisdiction. This would occur because the active income test could not be used (refer paragraph 9.5 of the Explanatory Memorandum). In addition, the income tax paid in that jurisdiction would not be recognised for the purposes of Part X because that tax would be paid by the partner/investor and not the deemed CFC itself (refer to paragraph 9.10 of the EM).

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[4] Draft income tax determination TD 2001/D14: *Which country is for the purposes of Part X of the Income Tax Assessment Act 1936 (the Act) the country of residence of a UK Limited Partnership (LP), a US LP, a UK Limited Liability Partnership (LLP) and a US LLP being a nonresident corporate limited partnership within Division 5A of Part III of the Act?*

In other words, the active income of an entity formed under the laws of one of two of Australia's largest trading partners and subject to tax in the applicable country could otherwise be subject to less favourable tax treatment in Australia than non-active income derived in a less comparable tax jurisdiction, or even a tax haven. We are advised that the income of such investments could, in certain circumstances, be subjected to total effective tax rates of as much as 60 per cent to 71 per cent under the interpretation of the current provisions set out in the draft determination.

It is generally acknowledged that limited liability companies and limited partnerships formed in accordance with the laws of the US and the UK are not used as vehicles or structures to shelter or defer non-active income from Australian taxation by Australian resident entities.

In general terms the amendments would apply from the start of an Australian resident entity's 2003/04 income year, although an affected taxpayer would have a choice to apply the rules to its 2002/03 income year. In addition, to the extent an Australian entity has treated a foreign hybrid as a resident of no particular unlisted country under Part X it would have a irrevocable choice to amending prior assessments on that basis, but will not be compelled to do so (proposed section 830-15(3) of the transitional provisions).

We would like to acknowledge the Government's constructive consultative processes, through the department of the Treasury, and with the Australian Taxation Office, that have contributed greatly to the proposed amendments. The CTA together with other taxpayers' representatives, as well as a number of potentially affected corporate groups, actively participated in the consultative process.

Yours faithfully,

(Frank Drenth)
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20 August 2003

APPENDIX

A.W. Baulderstone Holdings
ADI Limited
Australian Gas Light Company
Alcoa of Australia
Allianz Australia Limited
Amcor Limited
AMP
Anglo Coal Australia Pty Limited
Ansell Limited
ANZ Banking Group Limited
Apache Energy Limited
Australand Holdings Limited
Australia Post
Australian Meat Holdings Pty Limited
Austrim Nylex Limited
AXA Australia
BankWest Limited
BHP-Billiton Limited
BHP Steel Limited
BNP Paribas
BOC Gases
Boral Limited
BP Australia
Brambles Industries Limited
British American Tobacco Australia
Cadbury Schweppes
Caltex Australia Limited
Carter Holt Harvey
ChevronTexaco Australia Pty Ltd
Coca-Cola Amatil Limited
Coles Myer Limited
Commonwealth Bank Limited
Computershare Limited
ConocoPhillips Australia Pty Ltd
Crane Group Limited
Credit Suisse First Boston
Crown Limited
CSR Limited
DaimlerChrysler Australia/Pacific P/L
Deutsche Bank
Duke Energy International
EDS (Australia)
Energy Australia Limited
Epic Energy Limited
ERG Limited
ETSA Utilities
ExxonMobil Australia Pty Ltd
Ford Australia
Foster's Group Limited
Futuris Corporation Limited
GE Capital Finance
George Weston Foods
Goodman Fielder Limited
Hagemeyer Asia Pacific Pty Ltd
Hanson Australia Pty Limited
Holden
HSBC Bank Australia
Iluka Resources Limited
Insurance Australia Group (IAG)
Japan Australia
John Fairfax Holdings Limited
Kimberly-Clark Australia
Kodak
Leighton Holdings Limited
Lend Lease Corporation
Linfox Pty Ltd
Lion Nathan Limited
Macquarie Bank Limited
Mayne Group Limited
McDonald's Australia
National Australia Bank Limited
National Foods
Nestle Australia
Newcrest Mining Limited
Newmont Australia Limited
News Limited
Norske-Skog
Nufarm Limited
ONESTEEL Limited
Orica Limited
Origin Energy Limited
P&O Australia
PaperlinX Limited
Pasminco Limited
Philip Morris Limited
Placer Dome Asia Pacific
Qantas Airways Limited
QBE Insurance Group Limited
Rio Tinto Limited
Roc Oil Company Limited
Santos Limited
Shell Australia
Sigma Company Limited
SingTel Optus Pty Limited
Smorgon Steel Group Limited
Southcorp Limited
St George Bank Limited
Suncorp Group Limited
Tabcorp Holdings Limited
Telstra Corporation Limited
Tenix
Toyota Motor Corporation Australia
Transfield
Unilever Australia
United Energy Limited
Village Roadshow Limited
Vodafone
Wesfarmers Limited
Westfield Holdings Limited
Westpac Banking Corporation Limited
WMC Resources Limited
Woodside Petroleum Limited
Woolworths Limited
Xstrata Queensland Limited
Zurich Financial Services Australia Ltd