Consolidation integrity measures: a second look at proposed law

14 September 2017

In brief

On 11 September 2017, Treasury released exposure draft law that seeks to give effect to various integrity measures associated with the tax consolidation rules that were announced in prior years' Federal Budgets. In summary, the measures in this latest exposure draft deal with the tax cost setting rules when an entity joins and/or leaves a tax consolidated or multiple entry consolidated (MEC) group and operate to:

- Prevent a double benefit from arising in relation to certain deductible liabilities when an entity joins the group (the 'deductible liabilities' measure).
- Ensure that deferred tax liabilities are disregarded on entry or exit.
- Remove anomalies that arise when an entity holding securitised assets joins or leaves the group (the 'securitised assets' measure).
- Prevent unintended benefits from arising when a foreign resident ceases to hold membership interests in a joining entity in certain circumstances (the 'anti-churn' measure).
- Clarify the outcomes that arise when an entity holding an intra-group financial arrangement leaves the group (the 'TOFA' measure).
- Clarify the treatment of intra-group liabilities when an entity leaves the group (the 'value-shifting' measure).

Unfortunately, all but one of the measures continue to have retrospective effect - in some cases, as early as 14 May 2013.

In detail

The measures currently proposed by the exposure draft are largely aimed at addressing integrity issues or anomalous outcomes which were previously identified by the Board of Taxation as a result of the tax cost setting process that applies when an entity joins a consolidated or MEC group as a subsidiary member or ceases to be a subsidiary member.

For some of the measures included in this draft law, this is a revised version from a previous exposure draft released in April 2015, and reflects some issues that were raised during that prior consultation.

References in this item to consolidated groups include MEC groups.

Deductible liabilities

The deductible liabilities measure in this latest exposure draft follows the Government's revised proposal announced in last year's Federal Budget and seeks to eliminate the 'double benefits' that can arise from certain deductible liabilities held by an entity joining a consolidated group.

By way of reminder, the Government's original proposal in the 2013-14 Budget to recognise an assessable amount corresponding to the deductible liabilities of a joining entity was replaced in the 2016-17 Federal Budget with a less controversial proposal to simply exclude deductible liabilities from the allocable cost amount (ACA) of the joining entity.

Specifically, under the current exposure draft law, for a subsidiary member joining the group under an arrangement that commences on or after 1 July 2016, to the extent that an accounting liability would result in a deduction to the joined group, it is excluded from step 2 of the ACA calculation. The effect of excluding such liabilities from the ACA is that the assets of the acquired entity will have a lower tax cost base which may have the outcome of reduced future tax depreciation deductions. However, the joined group will still be entitled to tax deductions in the future from the discharge of the relevant liability.

There is an exception for certain insurance liabilities, liabilities arising under retirement village residence or service contracts, or those which are subject to the taxation of financial arrangements (TOFA) rules in Division 230 of the *Income tax Assessment Act 1997*.

Typical deductible liabilities that are subject to this new rule include provision for employee leave entitlements, or an out-of-the money derivative or foreign currency liability that is not subject to the Division 230 rules.

The exclusion from the ACA for deductible liabilities applies regardless of whether the entity is joining the group as a result of an acquisition (staged or otherwise) or on formation. This means there is no need to identify the 'owned' or 'acquired' component of the joining entity's deductible liabilities at the time of joining. It is worth noting that there is an adjustment made to Step 3 of the ACA calculation to ensure that any excluded deductible liability is also not taken into account when working out the undistributed taxed profits of the joining entity that accrued to the group before the joining time.

Anti-churn

In brief, the anti-churn measure seeks to ensure that non-residents are not able to reset the tax cost of assets of Australian entities in which they have held a majority economic ownership for longer than 12 months by transferring the entity to a consolidated or MEC group owned by the non-resident in circumstances where the non-resident transferor does not realise a taxable Australian capital gain (or loss) in respect of the transfer transaction.

The latest exposure draft is slightly different to the version previously released in April 2015, in that it also ensures that the rules apply to prevent tax cost setting of assets of the wholly-owned subsidiaries of the transferred entity which is joining the group.

Although the new rules might have been motivated by ensuring that there is no ability for the tax costs of the joining entity to be uplifted as a result of the entry ACA process, the rules also mean that there is no downward resetting of tax costs. That is, when the provision applies, the tax costs of the joining entity's assets will be retained.

The rules do not apply in cases where the membership interests in the joining entity is taxable Australian property, that is, where the capital gain or loss made by the non-resident is not disregarded.

Unfortunately, in spite of the considerable length of time that has elapsed since this measure was first announced, there has been no change to the proposed start date, which remains 14 May 2013.

Deferred tax liabilities

The exposure draft law provides that deferred tax liabilities (DTLs) are to be disregarded in the entry ACA calculation when an entity joins a consolidated group under an arrangement that commences on or after

the day that the amending legislation is introduced into Parliament. Presumably, this may occur before the end of this calendar year.

Once enacted, this change will reduce the complexity involved in the joining ACA process. In particular, there will no longer be the requirement to undertake the iterative process in dealing with the effect that the tax cost setting of assets of the joining entity has on the DTL recognised by the joined group. Furthermore, the exclusion of DTLs from the tax cost setting calculations aligns the treatment with deferred tax assets which are already excluded from the ACA process on entry and exit.

A similar rule will apply to also exclude DTLs from the exit ACA calculation when an entity leaves a consolidated group under an arrangement that commences on or after the day that the amending legislation is introduced into Parliament. However, this will only apply to the extent that the DTL was previously disregarded when the leaving entity joined the group under the amendments to be made. Accordingly, not only will existing groups have to monitor the time at which a subsidiary member joins the group (and specifically whether DTLs were disregarded by these amendments), but also potentially deal with the adverse consequences which can arise from DTLs on exit of those entities that are already subsidiary members of an existing group.

Securitised assets

The securitised assets measure will modify the entry and exit tax cost setting rules to remove anomalies that arise when an entity that has securitised assets joins or leaves a tax consolidated group by ensuring that the corresponding accounting liability arising from the transfer or equitable assignment of the securitised assets is disregarded.

While securitisation arrangements are common in the financial industry, such arrangements can also be entered into as a means of financing by entities that are not authorised deposit taking institutions (ADIs) or financial entities. In this respect, subject to transitional rules, there are two different application dates depending on whether a member of the group is an ADI or a finance entity or otherwise (refer to table below).

Value shifting

The so called 'value shifting' measure is intended to remove anomalies that arise when an entity leaves a consolidated group with an asset that corresponds to a liability it is owed by a member of the group which it left. The amendments will achieve this by aligning the tax cost of the asset that the leaving entity takes with it with the amount taken into account at Step 3 of the exit ACA calculation.

Under the current provisions, an asset held by the leaving entity that is a liability owed to it by the old group is taken into account at Step 3 of the exit ACA calculation. Generally, the Step 3 amount is the market value of the asset, however in certain circumstances it is reduced to the cost base of the asset. The tax cost setting amount of this asset is set at the market value of the asset for the leaving entity.

The draft Explanatory Memorandum to these measures notes that the current provisions "do not appropriately identify all of the circumstances in which the step 3 amount should be less than the market value of the corresponding asset; and in some cases, the tax cost setting amount for the corresponding asset should be less than the market value of that asset."

Accordingly, the proposed amendments, which will broadly apply when an entity exits a group under an arrangement that commenced on or after 7.30pm (AEST) 14 May 2013, will:

- Set the tax cost setting amount of the leaving entity's asset at market value (where the asset corresponds to a debt owed to the leaving entity by the old group), or an amount that reflects the cost of the asset (in some cases this will be nil).
- Modify the ACA exit calculation so that the Step 3 amount will be equal to the tax cost setting amount for the asset of the leaving entity (i.e. the amount noted above).

This measure also interacts with the TOFA measure (discussed below) where the relevant arrangement between the leaving entity and the consolidated group is a TOFA financial arrangement. It does this by

aligning the tax cost setting amount of the asset in the hands of the leaving entity with the reset 'cost' of the TOFA liability in the hands of the consolidated group. The impact of this for the consolidated group is discussed further below.

TOFA measure

The amendments proposed by the draft legislation relating to financial arrangements (the TOFA measure) are intended to clarify the operation of the TOFA provisions in Division 230 of the *Income tax Assessment Act 1997* when an asset or liability emerges from a consolidated group because a subsidiary member leaves the group.

There has been some ongoing uncertainty as to how TOFA applies where, for example, an intra-group loan between two members of the group is recognised when one of the members leaves the group. In the case where the loan originated within the group, it has been argued that because the loan has no 'cost' (the initial drawdown being ignored for tax purposes because of the single entity rule), the lender could be assessed on the return of the principal of the loan, and the borrower could claim a deduction for the repayment of that principal after one of the entities exists the group.

The proposed amendments (in conjunction with the value shifting measures discussed above), address this issue in two ways. Firstly, they set the cost of financial arrangement liabilities on exit for both the head company and the leaving member. Secondly, they ensure that Division 230 operates appropriately to recognise the tax cost of financial arrangement assets and liabilities on the go forward basis (post-exit). Broadly, in respect of a financial arrangement that is a debt, these amendments will:

- Deem the borrower to have received, as consideration for assuming that liability, a financial benefit equal to the liability's market value at the leaving time, so that any deduction obtained under the TOFA regime will reflect the borrower's economic loss, and
- Ensure that the lender (the entity that holds the asset) takes into account the asset's tax cost setting amount (worked out taking into account the proposed amendments relating to value shifting discussed above) in working out the TOFA gain or loss from the asset, so that the entity is assessed on their economic gain (if any).

Where the financial arrangement is not debt, and the financial arrangement is a liability of the head company, the tax cost may be set at nil or a lower amount depending on the circumstances.

From when will these measures apply?

As noted above, all but one of these measures is intended to have retrospective effect. Summarised below are the proposed application dates of the measures (in chronological order for ease of reference).

Measure	Proposed application date
TOFA	Broadly applies from the commencement of the TOFA regime (in most cases, income years commencing on or after 1 July 2010), subject to a transitional rule.
Anti-churn	Broadly applies in relation to an entity that becomes a subsidiary member of a consolidated or MEC group under an arrangement that commences on or after 7.30pm (AEST) 14 May 2013.
Value shifting	Broadly applies in relation to an entity that exits a consolidated or MEC group under an arrangement that commenced on or after 7.30pm (AEST) 14 May 2013.
Securitised assets	For ADIs or financial entities, this broadly applies in relation to an entity that becomes or ceases to be a subsidiary member of a consolidated or MEC group under an arrangement that commences after 7.30pm (AEST) 13 May 2014. However, transitional rules might apply to allow the measures to apply in relation to arrangements that commence before that time.

	For all other entities, this measure broadly applies in relation to an entity that becomes or ceases to be a subsidiary member of a consolidated or MEC group under an arrangement that commences after 7.30pm (AEST) 3 May 2016.
Deductible liabilities	Broadly applies in relation to an entity that becomes a subsidiary member of a consolidated or MEC group under an arrangement that commences on or after 1 July 2016.
Deferred tax liabilities	The specific application date is unknown, however the measure will broadly apply in relation to an entity that joins or leaves a consolidated or MEC group under an arrangement that commences on or after the start of the day on which the amending law is introduced into the House of Representatives.

Some of the above measures relate to the time at which an arrangement commences, rather than the actual date at which an entity becomes or ceases to be a subsidiary member of a group. The proposed law clarifies that an arrangement will commence when the decision to enter into the arrangement is made, unless the arrangement relates to a takeover bid or it is determined by a court order.

The takeaway

There is an opportunity to provide comments to Treasury on the current exposure draft law by 6 October 2017. Presumably this will be the last chance before Government seeks to finalise the measures and include in a Bill to be introduced into Parliament, presumably before the end of this calendar year.

The proposed amendments should be taken into consideration for any upcoming acquisitions and disposals of entities in a tax consolidated group. In particular, any groups contemplating an acquisition in the short term will need to factor in the uncertain start time for the exclusion of deferred tax liabilities from an entry ACA calculation. In addition, given the retrospective nature of the other measures, consolidated groups should revisit any joining or leaving transactions to determine whether any amendments might be required to relevant income tax returns or tax cost setting calculations once the relevant law is ultimately enacted.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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