Start date is fast approaching for important tax consolidation changes

1 June 2016

In brief

It has been more than three years in the making, but the operative date is fast approaching for important tax consolidation changes that will affect every Australian Mergers and Acquisitions (M&A) transaction. And we now have proposals that are likely to have bi-partisan political support, as well as broad acceptance amongst the corporate taxpayer community.

The proposals will apply to remove both 'deductible liabilities' and deferred tax liabilities from calculations that reset the tax cost of assets of an entity that joins a tax consolidated group. They should therefore be taken into account in any current planning for M&A transactions involving corporate groups.

In detail

'Deductible liabilities'

The 2016-17 Federal Budget announced much welcomed "changes to the changes" in relation to the treatment of 'deductible liabilities' (for example, provision for employee leave entitlements) of an entity that joins a tax consolidated group. For three years, taxpayers have been grappling with previous versions of the proposals, which the Government kept announcing would have a retrospective effect back to 14 May 2013. The previous version went far beyond the stated objectives and would have been the cause of significant distortions in the approach to M&A transactions.

Thankfully, Treasury and the Government took on board reasonable submissions and modified the proposals and deferred the start date to 1 July 2016. While now more clearly targeted at the potential 'double benefit' that can be realised from 'deductible liabilities', the revised proposals will still need to be carefully taken into account when planning for M&A transactions.

The Government has announced that the revised proposals will be less complex and will focus on removing deductible liabilities from calculations to reset the tax cost of assets of an entity that joins a tax consolidated group. As currently enacted, the law removes 30% of deductible liabilities from joining calculations. The proposed amendment will now remove 100%.

This will result in a lower tax cost of assets, some of which will mean lower future tax deductions (such as trading stock, work in progress, and depreciation on plant and equipment), and others which will mean a lower Capital Gains Tax (CGT) tax base for any future disposals (such as land and buildings, and goodwill). The changes are likely to impact some industries more than others (as discussed below).

Legislation is expected to be treated as a priority after the Federal election, but unlikely to be released prior to the 1 July 2016 start date. We will await the legislation to clarify some of the details of the changes, including the extent of any specific exclusions (which, in the previous version, applied for certain liabilities of insurance companies and retirement village operators).

Start date for deductible liability changes

The Government announced that the start date for these changes will be deferred until 1 July 2016. It is expected that the changes will apply for 'arrangements that commence' on or after 1 July 2016, consistent with the application measures that would have applied under the previous rules.

It is also expected that the revised measures will include the previous rules around when an arrangement commences, as follows:

Arrangement type	Time of commencement of the arrangement
On-market takeover bid	The day on which the bid is announced
Off-market takeover bid	The day on which the bidder's statement is lodged with the ASIC
Scheme of arrangement	The day on which a company applies to the court for the scheme meeting
Other arrangement	The day on which a decision to enter into the arrangement was made

Deferred tax liabilities

The 2016-17 Federal Budget also announced that deferred tax liabilities will be excluded from calculations when entities join or leave a tax consolidated group.

The treatment of deferred tax liabilities under the tax consolidation rules has been the cause of much complexity and uncertainty, principally due to the requirement to deal with the restatement of these liabilities by the joined group and due to the range of outcomes possible under the relevant accounting rules.

The proposal will remove this complexity and uncertainty. However, it also has the potential to give rise to significantly different tax outcomes for M&A transactions. In particular, when an entity joins a tax consolidated group, the calculations required to reset the tax cost of the assets of that joining entity will not be increased by deferred tax liabilities, as has been the case under the rules in place for the last fourteen years.

With similar impact to the removal of 'deductible liabilities', this change will result in lower tax costs of assets and, in many circumstances, lower future tax deductions for the tax consolidated group.

Start date for deferred tax liability changes

The changes relating to deferred tax liabilities will apply to transactions commencing after the date the amending legislation is introduced into Parliament. The same rules should apply as discussed above to determine when a transaction commences. It is expected that these changes will be a priority for the Government to introduce soon after Parliament resumes after the Federal election.

Different industries likely to be affected differently

The removal of both deductible liabilities and deferred tax liabilities from the calculations to reset the tax cost of assets of a joining entity will have a cumulative adverse effect in lowering the reset tax cost of assets and in lowering corresponding future tax deductions. The extent of the adverse effects will differ based on the make-up of assets and liabilities of joining entities, and are therefore likely to vary between different industries.

Service industries are typically characterised by high employee costs (including high levels of future deductible employee leave liabilities); by low levels of tangible assets (such as tax depreciable plant and equipment); and, where successful, high levels of (non-tax depreciable) intangible assets.

The protection of future deductions for employee leave payments is a welcome outcome for joining entities in these industries, compared to the previous proposals. Furthermore, the reduction of cost amounts to allocate across assets will typically have limited adverse implications.

Some joining entities, such as 'start-up' companies or companies in declining markets, may not yet have generated significant intangible asset values but may have high levels of receivables . The exclusion of employee liabilities and deferred tax liabilities from tax consolidation joining calculations may result in a total cost to allocate which is so low that is does not even exceed the level of retained cost base assets, such as cash and receivables. To this extent, the joining transaction can give rise to an up-front taxable gain.

A joining company in a capital intensive industry with a balance sheet consisting predominantly of tax depreciable plant and equipment will be more likely to see a reduction in the tax cost of that plant and equipment (and therefore future tax depreciation deductions) as a consequence of the exclusion of employee liabilities and deferred tax liabilities from the tax consolidation joining calculations.

The takeaway

Application of the 'deductible liability' tax consolidation changes is only a few weeks away; with the changes to deferred tax liabilities to follow soon after Parliament resumes post the Federal election.

The cumulative effect of these changes can be significant and should already be being taken into account by corporate groups that are looking at M&A transactions.

Let's talk

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

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