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DOCTORAL THESIS

# Legal Policies Affecting the Initial Tax Consolidation Decision.

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# Legal policies affecting the initial tax consolidation decision.

**by**

**Thomas Schostok**

A dissertation submitted to the Bond University Faculty of Law
in partial fulfilment of the requirements for
the Degree of
Doctor of Legal Science

**May 2004**

**Gold Coast**

**Australia**

## CERTIFICATE

This dissertation is submitted to Bond University in partial fulfilment of the requirements for the Degree of Doctor of Legal Science.

This dissertation represents my own work and contains no material which has been previously submitted for a degree or diploma at this University or any other institution, except where due acknowledgement is made.

Signature: ______________________ Date: 1st of May 2004

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Thomas Schostok

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## ABSTRACT

In the course of 2002 and 2003, the Australian Government introduced a fundamental change to the taxation of corporate groups. The new tax consolidation legislation allows wholly-owned groups to be regarded as one homogenous entity for income tax purposes from 1st of July 2002. After making an irrevocable decision to implement the elective consolidation provisions, a group, consisting of a head company and at least one other wholly-owned entity (company, trust or partnership), lodges a single income tax return and pays a single set of PAYG instalments over the period of consolidation.

The assessment of the policies, principles and rules governing the implementation and operation of the consolidation regime reveals far-reaching implications for the accessibility of tax attributes and changes to the tax cost / adjusted values of capital / depreciating assets. Tax accounting systems and corporate governance guidelines established by groups are also affected.

Groups deciding against the implementation of the consolidation rules, on the other hand, face the removal of previous grouping concessions, such as loss transfer provisions, CGT asset roll-overs and inter-corporate dividend rebates. Furthermore, a number of modified anti-avoidance and integrity measures affect intra-group transactions undertaken outside the consolidation regime.

This thesis identifies and analyses the areas of taxation, accounting and corporate governance which are relevant for the initial consolidation decision. The following analysis is structured with primary regard to legal concepts stipulated by the consolidation legislation. However, frequent references to policies underlying the relevant provisions, for instance the wholly-owned approach, allow a deeper understanding of the consolidation core rules and the effects arising for groups deciding to implement them.

Finally, this thesis also provides a comparative perspective through the discussion of consolidation policies and rules delivered by German tax legislation, accounting regulations and corporations law.

Law and materials are stated to 1st of January 2004.

Gold Coast, May 2004

Thomas Schostok
Bond University, Faculty of Law

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Taxation Administration Act 1953

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# FOREIGN LEGISLATION

## Germany

Aktiengesetz (Joint Stock Company Act)

Einkommenssteuergesetz (Income Tax Act)

Gewerbesteuergesetz (Trade Tax Act)

Handelsgesetzbuch (Code of Commercial Law)

Körperschaftssteuergesetz (Corporation Income Tax Act)

Steuersenkungsgesetz (Tax Reduction Act)

## United States of America

Internal Revenue Code 1986

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## LIST OF ABBREVIATIONS

**AASB** ..................... Australian Accounting Standard Board

**ACA**........................ Allocable Cost Amount

**ATO**........................ Australian Taxation Office

**CGT**........................ Capital Gains Tax

**DVS** ........................ Direct Value Shift

**ICAA**....................... Institute of Chartered Accountants in Australia

**EM** .......................... Explanatory Memorandum

**ESAS**...................... Employee Share Acquisition Scheme

**FTC** ........................ Foreign Tax Credit

**GST** ........................ Goods and Services Tax

**ITAA** ....................... Income Tax Assessment Act

**ITTP**........................ Income Tax (Transitional Provisions) Act

**IVS**.......................... Indirect Value Shift

**MEC** ....................... Multiple Entry Consolidated

**SAP** ........................ Substituted Accounting Period

**SME**........................ Small and Medium Enterprise

**TSA** ........................ Tax Sharing Agreement

## Part A: Introduction

Until the year 2002, Australian taxation legislation did not stipulate any rules providing corporate groups with an option to consolidate their income tax statements. The corporate income tax balances of wholly-owned groups were determined on the basis of individual tax returns lodged by single member entities. The business taxation system merely employed grouped concessions for wholly-owned companies in relation to loss transfers, *Capital Gains Tax* (CGT) asset roll-overs, foreign tax credits, thin capitalisation and inter-corporate dividend rebates. These numerous grouping regulations, which were included in the relevant general provisions of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] and the *Income Tax Assessment Act 1936* (ITAA 1936), lacked the coherence and consistency that can be delivered by a framework of homogeneous consolidation principles. Tax evasion[2] as well as the double taxation of corporate income[3] were the inherent detrimental side effects of this approach to the taxation of wholly-owned group entities. Moreover, the notion of corporate groups being constituted by a number of individually taxable members contrasted to the practice employed by Australia's western industrialised

[1] Section and Division references in this paper are to the *Income Tax Assessment Act 1997* unless stated otherwise.
[2] For example, loss duplication through value shifting.
[3] Taxation of gains when they occur and subsequent taxation at the disposal of equity.
See Chapter 1 (Paragraph 1.9) Explanatory Memorandum (EM), *New Business Tax System (Consolidation) Act (No.1) 2002*.

counterparts, where elective consolidation rules were already in place.[4]

A reform paper released by the Federal Government in August 1998 recognised the need for a fundamental change in the approach to the taxation of business entities, and in particular to the taxation of corporate groups in Australia.[5] The two major areas of reform announced within this document were:

- a general shift from direct taxation to indirect taxation, resulting in the introduction of the *Goods and Services Tax* (GST) in the year 2000, and
- a comprehensive business tax reform, including the introduction of a consolidation regime.[6]

The first comprehensive draft of consolidation rules was issued on the 8th December 2000. The exposure draft *New Business Tax System (Consolidation) Bill 2000,*[7] which already defined detailed conditions

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[4] See Chapter 6 Internal Revenue Code (United States of America).
See Paragraph 14 *Corporation Income Tax Act* (Germany).
Admittedly, the Australian, "asset based", consolidation system differs in a number of instances from the tax consolidation rules employed by foreign jurisdictions.
See Chris Kinsella, 'Asset rules' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 35.
[5]The Commonwealth Treasury, *Tax Reform, not a new tax, a new tax system*, Australian Government Publishing Service (AGPS), 1998.
[6] For a broad overview of the concepts underlying the new approach to business taxation in Australia, see: Michael Kobetsky, 'Tax Reform in Australia - The New Tax System' (2000) 1 *Bulletin for International Fiscal Documentation* 67, 73-77.
[7] Based on the recommendations of the so-called "Ralph Report".
J T Ralph, *Review of Business Taxation: A Tax System Redesigned*, Review of Business Taxation (1999) Chapter 15.

for the treatment of assets, losses and franking accounts at the time of the establishment and subsequent operation of consolidated corporate groups, was planned to come into force on 1st July 2001. However, as intense discussions about the final design of the consolidation regime continued, the date of final commencement of the new rules was postponed. A fresh attempt to introduce a tax consolidation system was made with the release of the second exposure draft *New Business Tax System (Consolidation) Bill 2002* on 7th February 2002. The adjusted consolidation rules and the proposed mechanism for their implementation again triggered a number of critical comments and submissions on the subject matter.[8] After further consultations, the first tranche of the consolidation legislation, the *New Business Tax System (Consolidation) Act (No.1) 2002*,[9] was finally issued on 16th May 2002. With the subsequent release of the second tranche of consolidation rules, the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002*[10] dating from 27th June 2002, the essential shape of the new consolidation regime was determined prior to its commencement on 1st July 2002. However, the legislative platform for tax consolidation has since been further extended and adjusted. The third legislative instalment, the

[8] The total number of official submissions issued in response to the February 2002 Exposure Draft was 34.
See Chapter 14 (Paragraph 14.30) EM, *New Business Tax System (Consolidation) Act (No.1) 2002*.
[9] Subsequent references to the *New Business Tax System (Consolidation) Act (No.1) 2002* will be made as to *Consolidations Act (No.1)*.
[10] Subsequent references to the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002* will be made as to *Consolidation, Value Shifting and Demergers Act*.

*New Business Tax System (Consolidation and Other Measures) Act (No.1) 2002*,[11] received Royal Assent on 2nd December 2002 and had effect from 1 July 2002. The fourth, and last, tranche of consolidation legislation, the *New Business Tax System (Consolidation and Other Measures) Bill (No.2) 2002*,[12] was finally enacted on 6th March 2003.

The newly established tax consolidation regime was designed to replace the existing grouping provisions which became redundant on 30th June 2003,[13] the end of the transitional period determined by the *Income Tax (Transitional Provisions) Act 1997 (ITTP 1997)*.[14] In this way, the legislator created a completely new statutory framework for the taxation of wholly-owned group entities. Due to that change, Australian corporate groups can currently choose between one of two options.

On one hand, a group can opt against full consolidation, which results in ordinary individual tax treatment of each group member without any regard for existing inter-company relationships. On the other hand, assuming that the group members fulfil the statutory eligibility conditions,[15] a head company can undertake the necessary steps

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[11] Subsequent references to the *New Business Tax System (Consolidation and Other Measures) Act (No.1) 2002* will be made as to *Consolidation and Other Measures Act (No.1)*.

[12] Subsequent references to the *New Business Tax System (Consolidation and Other Measures) Bill (No.2) 2002* will be made as to *Consolidation and Other Measures Act (No.2)*.

[13] With the exception of entities with a substituted accounting period (SAP).

[14] This measure followed recommendations made within Paragraph 15.1 of the Ralph Report.

[15] The general eligibility requirements for Australian resident groups are stated within Division 703. The conditions for the establishment of foreign-owned groups are stipulated by Subdivision 719-B.

towards consolidation,[16] which provides the group with the status of a single entity for income taxation purposes.

The outcome of a decision for or against consolidation cannot save any wholly-owned group in Australia from facing costs related to the introduction of the new consolidation system. Staying outside the consolidation rules implies the inevitable loss of the concessional grouping provisions. Applying the elective consolidation rules, however, imposes considerable costs for the initial implementation and subsequent compliance with the complex consolidation framework.

The potential extent of the efforts that are necessary to establish and maintain conditions for the operation of a group under the tax consolidation system are presumably heavily dependent on individual characteristics as the legal identity, size and structure of the eligible group members. Groups which are obliged to consolidate their financial statements according to provisions set by the *Corporations Act* (subsection 295 (2)(d)) in connection with Australian Accounting Standard Board (AASB) Standards[17] should be prepared to cope well with this challenge. Also entities consolidating on an optional basis under the Australian Securities & Investments Commission (ASIC) Class Order 98/1418 in connection with Cross Group Guarantees may

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[16] Among them a notice by the head company to the Commissioner (section 703-50 in connection with section 703-5).
[17] See AASB 1024 ‘Consolidated Accounts’.

already have employed the reporting instruments and structural adaptations related to general consolidation requirements. Nevertheless, the realisation of the novel and complex tax consolidation system certainly requires more than the adjustment of existing tools used for preparation of financial reports.[18]

In the case of small and medium enterprises (SMEs), the removal of the current grouping rules presents the most challenging impact. Entities preparing non-consolidated reports or exempted from the obligation to provide any financial statements because of their legal form and size,[19] have to reconstruct their accounting and reporting systems fundamentally in order to access the benefits of tax consolidation. Such considerable changes to their existing accounting practices provide consolidated SME groups with a range of new reporting tools, potentially fostering the ability to further optimise the operation of their business activities.[20]

[18] In this context it is important to consider the interrelation between the accounting policies employed in the preparation and completion of financial statements and the framework of the new tax consolidation tools. The simultaneous consolidation under the accounting regulations and the taxation legislation may provide synergy gains, but also imposes double obligations, primarily due to the different eligibility criteria.

[19] See subsection 285 (1) and section 292 *Corporations Act 2001* (small proprietary companies are only obliged to keep financial records but not to prepare financial statements).

[20] The consolidation measures have the potential to provide a stronger transparency and comparability of the tax related financial figures generated by the group members. The corporate income and the resulting income tax liability of all group entities must be calculated with regards to the head company. In other words, the business results of single group members co-determine the aggregated income of the group. This fact may contribute to a growing orientation on revenue aims set for an entire consolidated group and not for its single members. Less profitable entities can have a detrimental effect on the results generated by the entire group. From this it follows that restructuring and outsourcing may eventuate as side effects of the consolidation efforts. This can be particularly true for SMEs whose (financial) accounts were not consolidated prior to the tax consolidation measures.

It remains questionable, however, to what extent SME-groups are capable of actually implementing the new consolidation system. The financial and organisational challenges may limit the accessibility of the new rules for entities operating with a minimum range of accounting and administrative capacities. A number of transitional concessions are aimed at easing the burden of the initial consolidation measures. This fact implies, however, that the conditions for consolidation may be considered in a very different light when the transitional rules cease to apply. Moreover, not only the implementation of the complex rules but also the ongoing compliance with the consolidation system and the adjustments arising at de-consolidation of single group members impose costs which should be carefully considered in the decision-making process.

Without any regard to the size or legal form of the entities under consideration, the removal of tax barriers to group restructuring provides the potential for an increased flexibility for constant planning and realisation of the most effective allocation of resources among the consolidating group members.[21] Any changes to the operation of

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[21] Under the consolidation regime, shares may be bought back into a group company without giving rise to any CGT event. The liquidation of group members will also remain neutral for CGT purposes. Furthermore, assets can be moved between group entities without having to consider any statutory roll-over rules. However, the consolidation provisions do not remove the existing state taxes. Managing stamp duty costs on internal asset transfers remains a challenge under the current legislation. Furthermore, GST obligations remain relevant in the case of intra-group transactions where consolidating entities do not establish a GST group. See Mark Northeast, 'Should your group consolidate?' (2002) 35 (6) *Australian CPA* 74, 74.
The potential effect on the Australian economy can be significant, as there should be between 11,300 and 33,472 head companies and up to 101,870 subsidiaries eligible to be members of a consolidated group.
Chapter 14 (Paragraph 14.13) EM, *Consolidations Act (No.1)*.

wholly-owned entities, which may be directly triggered by the new approach to group taxation, should nevertheless be undertaken in view of the existing provisions in the scope of the financial accounting and corporate governance.

In the current legal environment, corporate groups are forced to comply with regulations orientated on diverging legal concepts. The main distinction can be made between

- the *single enterprise approach* (tax consolidation and accounting); and
- the *single entity approach* (corporations law and corporate governance).[22]

From this it follows that any initiatives undertaken in connection with the new tax consolidation rules need to be consistent with the broader legislative context. Undertaking an assessment of the major implications arising from the implementation of the consolidation legislation therefore requires a careful understanding of the diverse legal and economic factors to which corporate groups are exposed.

[22] The terminology used in this context may be confusing, since the consolidation legislation employs the term 'single entity rule' for the single enterprise approach. In the field of corporate governance, the term 'single entity approach' gives an opposite definition of intra-group relationships. In order to avoid confusion in the use the terms for the contrasting concepts within this thesis, these terms will be used as follows:

- single entity **rule** in relation to the area of tax-consolidation; and
- single entity **approach** in relation to the corporations law / corporate governance principles.

Admittedly, the consolidation provisions are complex and, as the following discussions indicate, often still need further clarification. A comprehensive analysis of the legal conditions determining the operation of wholly-owned groups subsequent to the introduction of the tax consolidation regime is, nevertheless, feasible and necessary, since major legislative activities have been completed.

## 1. Thesis objectives

The primary aim of this thesis and its underlying research is to identify the fundamental policies shaping the current tax consolidation regime and to examine those in the context of principles and rules affecting the group's initial tax consolidation decision.

The following analysis is based on the understanding that the consolidation policies are represented by legal principles which, again, are enforced through an array of rules codified in the consolidation legislation. The structure and contents of this thesis take both the conceptual framework and the statutory provisions into consideration. Consequently, the main focus within this thesis is devoted to the diverging conditions (principles and rules) for the operation of groups deciding for or against consolidation (core policy issue underlying the legislation).

As already indicated, tax consolidation policies have extensive effects stretching far beyond the immediate context of the taxation legislation. The interrelations between the identified consolidation policies and the policies embodied by the accounting and corporate governance regulations thus form a significant area of interest considered within this thesis.

Admittedly, the leading policies which are identifiable under the Australian consolidation legislation are not the only conceivable way of managing the consolidation agenda. A comparative analysis into an alternative foreign approach to the area of tax consolidation therefore takes a central position in the examination of the consolidation policies.

Resulting from the general aims formulated above, the following three specific objectives are pursued within this thesis:

**Objective A** (*Part B* of the thesis)

To identify and analyse the policies underlying tax consolidation and to explore in detail the principles and rules shaping:

- the eligibility criteria (*Chapter I*),
- mandatory rules for groups staying outside consolidation (*Chapter II*), and
- elective rules for groups choosing to consolidate (*Chapter III*).

**Objective B** (*Part C* of the thesis)

To identify and assess policies underlying the following legal areas interacting with tax consolidation:

- accounting (*Chapter I*), and
- corporate governance (*Chapter II*).

**Objective C** (*Part D* of the thesis)

To gain a comparative perspective for the assessment of consolidation policies through an analysis of the German approach to:

- consolidation policies and principles (*Chapter I*),
- accounting policies interacting with tax consolidation (*Chapter II*), and
- corporate governance policies interacting with tax consolidation (*Chapter III*).

Referring to the objectives stated above, this thesis analyses the structure and practicability of the framework of key policies, principles and rules governing the implementation of the consolidation regime. The findings made with regard to the tax legislation are set in relation to other legal sources strongly interacting with the consolidation regime. Finally, the Australian consolidation model is put into perspective through the analysis of the German consolidation system which employs a slightly different approach to the formation and operation of groups.

The three main thesis objectives are further introduced in the following sections.

## 1.1. Objective A (*Part B*)

The thesis starts with the analysis of the eligibility rules (*Part B Chapter I*) since, as later discussions illustrate, the policies shaping the relevant provisions constitute a conceptual platform for the framework of the main consolidation policies; for instance the single entity rule determining the consolidation of assets and losses.

Regardless of the novelty of the policies introduced by the consolidation legislation, the eligibility criteria for the application of the elective provisions are based on principles resembling those which governed the removed grouping rules. Accordingly, a consolidated group can only be assembled by a head company and its wholly-owned subsidiaries.

The elective provisions stipulating the way in which consolidated groups can be formed and operated are shaped with direct regard to the wholly-owned approach. Admittedly, the full integration of the group's assets and losses in the accounts of the head company would not be conceivable in the absence of this criterion.

However, consolidation can also be achieved without the integration of all tax attributes and the transition of a group into one homogenous taxable entity. German tax legislation shows an alternative approach (economic group approach) to consolidation eligibility criteria and formation of groups.

Besides the conservation of the restrictive wholly-owned approach, the consolidation eligibility rules widened the range of entities gaining access to group treatment. Wholly-owned trusts and partnerships and, where a number of stipulated conditions can be met, foreign-owned entities are eligible for membership in groups.

At the same time, the consolidation regime rests on a policy of sharp distinction between the treatment of groups electing to apply the consolidation provisions (*Part B Chapter III*) and those which are ineligible for or opt against the implementation of the elective rules (*Part B Chapter II*).

A decision against tax consolidation must be made in view of regulations imposing considerable burdens on the operation of wholly-owned groups. Considering the scope of the anti-avoidance and integrity measures as well as the tax costs arising from the operation of group members as individual entities which have no access to any grouping concessions, remaining outside the consolidation regime can become far more expensive than the implementation of the complex elective provisions.

On the other hand, the degree of integration of groups choosing to consolidate goes notably beyond the concept underlying the previous group regulations. The elements of this policy can be analysed best considering the principles for the treatment of group liabilities, assets, losses and franking accounts on consolidation.

Since a consolidated group is regarded as one homogeneous subject to taxation, the individual income tax liability of the group members ceases to exist and is replaced by group liability. With the implementation of the consolidation regime, the exposure to tax liabilities is shifted away from the single group members and becomes the sole responsibility of the relevant head company. However, even though the subsidiary members are not directly liable, they must be aware of the risk of becoming responsible for the group's outstanding income tax amounts in cases where the head company fails to meet its obligations.

The extent of income tax liabilities arising for consolidated groups is limited through the principle of disregarding intra-group transactions for the purpose of income taxation. This treatment is achieved on the basis of the elimination of membership interests and resetting of the tax cost of assets owned by joining group entities. Admittedly, the process of aligning the asset values with the joining time cost of membership interests constitutes one of the most complex and elaborate tasks which arise in the context of tax consolidation. Some

groups should recognise, however, that this procedure imposes not only considerable efforts but can also provide a welcome opportunity for an uplifting of the assets' tax cost to the maximum of their joining time market values. Where such benefits are not apparent or are considered to be insufficient, a transitional concession allows the retaining of the current tax cost.

The homogenous status of consolidated groups is further strengthened through the application of rules governing the use of losses. Since the head company is the only income taxable group member, tax losses fulfilling the stipulated criteria can be transferred into its accounts at the time of consolidation. Losses that are not, or cannot be transferred at this time are lost for the group and for the joining entities.

On the other hand, the use of losses in the hands of the head company is limited to certain annual rates which are meant to reflect the income generating capacity of the loss transferring group members. However, during the transitional period, concessional loss rules improve access to losses transferred at the time of the formation of a group.

The analysis of asset and loss consolidation rules includes an insight into selected areas of critical impact which, intentionally or seemingly unintentionally, arise from the implementation of the principles stipulated by the legislation. Such implications are mainly potential

changes in tax values of assets and restrictions to the accessibility of losses at the time of consolidation and during the following membership period. These particular issues require closer analysis, since the areas concerned have a direct influence on the tax assessment of corporate groups implementing the elective elements of the legislation and therefore play a decisive role in shaping the perception of the practicability of the consolidation regime and its policies.

Finally, the rules governing the consolidation of franking accounts and foreign tax credits must also be considered in the context of the integration of all available tax attributes in the accounts of the head company. Their application enables consolidating entities to shelter the group's income from double taxation.

However, consolidation cannot be considered as an opportunity to avoid the application of the exempt entity and former exempt entity provisions. The pooling of franking credits at the time of consolidation is subjected to adjusted rules preventing head companies from utilising certain franking credits which were accrued by exempt entities and former exempt entities prior to joining time.

### 1.2. Objective B (*Part C*)

The analysis of the tax accounting and corporate governance policies interacting with the policies and principles imposed by the tax consolidation framework constitutes the second area of core policy issues tackled within this thesis. The considerable differences between the financial accounting and tax accounting practices for consolidated groups (*Part C Chapter I*) and the difficulties to effectively reconcile the realisation of group interests with the interests of individual group members (*Part C Chapter II*) are the focal points of this part of the thesis. As the following analysis shows, these inconsistencies are the imminent result of diverging approaches to the group's identity and composition which are simultaneously enforced by relevant legal sources.

### 1.3. Objective C (*Part D*)

The last part of this thesis is devoted to an alternative approach to tax consolidation policies. In contrast to the Australian consolidation regime, German consolidation principles are primarily based on the economic group approach. Under this approach, consolidated groups can be assembled by wholly-owned and controlled entities. Such an open definition of eligibility conditions has far reaching implications for the process of formation and operation of consolidated groups.

Remarkably, the German consolidation provisions are based on principles showing a considerable degree of consistency with the rules stipulated by the accounting and corporate governance regulations. This fact makes a closer consideration of the policies determining the German consolidation system particularly relevant.

## 2. Scope of the thesis

The analysis of some of the issues discussed within this thesis is limited to findings which, in the opinion of the author, are the most relevant for the understanding of main policy issues. For example, this means that the discussion of asset and loss provisions necessarily concentrates on the events for which the relevant core consolidation provisions are designed. These are the events of an entity joining an existing consolidated group (asset rules) and the initial formation of a group (loss rules). On the other hand, due to the inherently limited scope of this thesis, some important questions cannot be analysed or are dealt with to a limited degree only, as in the case of issues concerning the de-consolidation of group members.

## Part B: Consolidation framework

The legislative changes introduced to the treatment of wholly-owned groups constitute a 'stick and carrot' approach.[23] On one hand, there is the potential for considerable economic benefits attributable to the implementation of tax consolidation rules.[24] These benefits result primarily from a changed income taxation status of eligible group entities for the duration of their group membership. On the other hand, corporate groups choosing to stay outside the scope of the consolidation regime suffer an almost complete loss of the advantages derived from the concessional grouping treatment, whose major elements were withdrawn for corporate taxpayers from 1 July 2003. Furthermore, a range of supplementary provisions, such as the adjusted value shifting rules and the anti-loss duplication provisions,[25] impose rigid anti-avoidance and integrity measures further affecting the operation of corporate groups that do not consolidate. In other words, to a large extent, the major policy underlying the new group legislation is to make the consolidation "attractive" by virtually penalising those who are reluctant to implement the new elective tax consolidation rules.

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[23] See Johanna Lowry, 'Confusion says…' (October 2002) *CA Charter* 44, 44.
[24] The government expects the overall benefits to be AUD 1 billion over the forward estimate period (this period is being not further specified by the ATO).
See General outline and financial impact, EM, *Consolidations Act (No.1)*.
[25] See Part 3-95 ITAA 1997 / Schedule 15 *Consolidation, Value Shifting and Demergers Act.*

Admittedly, the concessions and choices available during the transitional period, until 1st of July 2004, in particular the utilisation of carry forward tax losses and the option to retain current assets costs, provide considerable incentives for an immediate choice in favour of tax consolidation.

Leaving the application of transitional provisions aside, consolidating entities face issues directly affecting the tax value of assets, the transfer and utilisation of losses, exposure to income tax liabilities as well as considerable changes into income tax accounting regulations. A detailed assessment of these questions is not only vital for the long term decision in favour or against consolidation, it also influences the determination of the optimal time for initial consolidation (when to consolidate) and the individual use of the rules stipulated within the scope of the choices provided (how to consolidate).

However, such considerations are not accessible for non-consolidatable group members. These entities have no other choice than to accept their single entity status resulting from the removal of grouping concessions or, where it is feasible, to undertake necessary adjustments in order to comply with the eligibility conditions which are defined by consolidation legislation.

The decision to start this part of the thesis with the analysis of the eligibility criteria (*Chapter I*) is lead by the intention to follow the approach presumably applied in the practice of corporate groups, where the initial question in relation to the consolidation regime should be, whether and to what extent the group members can choose to apply the elective rules. Moreover, as further discussions show, the policies shaping the eligibility criteria, primarily the wholly-owned criterion, correlate with other consolidation concepts, such as the integration of the group's assets in the hands of the head company (the asset rules) and the subsequent use of tax losses within consolidated groups.

Importantly, to a large extent, the eligibility conditions constitute a conceptual platform on which the principles governing the formation and operation of consolidated groups are established (e.g. the single entity rule). Where relevant, these connections to the eligibility criteria are shown in the following chapters.

Prior to the discussion of the policies and rules determining group treatment under the elective consolidation rules (*Chapter III*), the major conditions characterising the status of groups staying outside the consolidation regime are analysed (*Chapter II*). In this way, the impact of the two contrasting policies pursued by the current group legislation, the policy of separating non-consolidated group entities and integrating consolidated groups, is considered.

## *Chapter I: Eligibility criteria and formation*

The initial question a potential consolidatable group must ask is whether it is in fact eligible to consolidate. In correspondence to the principles already governing the previous grouping concessions, tax consolidation is limited to wholly-owned subsidiaries and their head companies (subsections 703-10(1) and 703-15(2)). Both categories of group members must be Australian residents[26] and are together referred to as "consolidatable group". Moreover, Australian subsidiaries wholly-owned by foreign head entities are also eligible for the application of the elective consolidation provisions and can form "multiple entry consolidated (MEC) groups" (Division 719). In general, the eligibility criteria for both of the consolidating group types are based on the following considerations:

- legal form;
- ownership;
- income tax treatment; and
- residence.

This chapter focuses on the principles determining the composition of groups eligible for consolidation and takes the factors named above under close consideration.

[26] For the statutory definition of the term "Australian resident" see section 995-1 ITAA 1997 and subsection 6(1) ITAA 1936.

The consolidation regime makes the group treatment available to a broader spectrum of entities than was the case under the former grouping provisions. However, the condition for the subsidiary members to be wholly-owned is also at the centre of the eligibility policy pursued under the consolidation legislation.

As it is discussed in later stages of this thesis, retaining this policy means to ignore vital economic ratios in regard to controlled group entities that are already widely recognised under existing accounting regulations. In order to provide a basis for further considerations and comparisons, *section 1* explores the eligibility conditions applicable for Australian owned (consolidatable) groups. The major characteristics defining the structure and status of foreign owned (MEC) groups are analysed in the subsequent section (*section 2*).

The introduction of the novel MEC group provisions constitutes a remarkable change in the definition of groups under the Australian tax law and should have a significant influence on the question how to consolidate. As the following discussions illustrate, some head companies may qualify to choose between:

- the formation of a consolidated group, including all eligible wholly-owned subsidiaries, and
- the participation in the establishment of a MEC group, having the option to choose between the status of a provisional head entity or a subsidiary member.

Nevertheless, even though a number of eligibility conditions may be universally applicable for both group categories, there are also significant differences shaping the specific criteria for the formation and operation of the relevant domestic and foreign-owned groups.

The insight into the eligibility conditions concludes with an analysis of group business structures which do not qualify for consolidation (*section 3*). With the exclusion of groups headed by trusts and partnerships, the consolidation regime ensures that the consolidated group income must be taxed at the general company tax rate. This exclusion, however, does not prevent companies subordinated to trusts or partnerships from the formation of consolidated sub-groups which meet the mandatory eligibility requirements. The implications arising in the context of such consolidation decisions constitute the last critical eligibility policy issue outlined in this chapter.

## 1. Consolidatable groups

Since a consolidatable group cannot consist of a head entity alone, subsection 703-10(2), the consolidation can only be pursued where at least one head company and one subsidiary constitute the group.[27] In order to form a consolidatable group, both types of entities have to meet the specific eligibility conditions imposed by the consolidation legislation.

Importantly, the criteria governing the eligibility of subsidiary members (*section 1.2.*) and head companies (*section 1.1*.) must be considered in close connection to policies and principles underlying the complex process of formation and subsequent operation of consolidated groups. To a large extent, consolidation principles stipulating the treatment of group liabilities, assets and tax attributes such as accrued losses and franking credits correlate directly with the eligibility conditions which are analysed within the following sections.

[27] An already consolidated group, however, can consist of a head entity alone.

## 1.1. Head entity

The table within subsection 703-15(2) states a number of inclusion and exclusion criteria determining the identity of consolidatable head entities. The binding legal form for head entities is incorporation as an Australian resident, but not a prescribed dual resident, company.[28]

Such a company must have at least some of its income taxed at the general company tax rate.[29] At the same time, it must not be a subsidiary member of a consolidated or a consolidatable group.

Moreover, subsection 703-20(2) specifies categories of entities that, although fulfilling the above conditions, cannot become a head company of a tax consolidated group. These are:

- exempt entities;
- certain credit unions;
- pooled development funds (PDFs);
- film licensed investment companies.

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[28] See section 995-1.
However, the initial New Business Tax System (Entity Taxation) Bill 2000 determined a much broader definition of eligible head entities. Within this legislation draft, common Australian corporate tax entities (CACTE), such as companies, corporate unit trusts, public trading trusts and trusts covered by non-fixed rules, were eligible to become the head entity of a tax consolidated group. This approach has since been abandoned, as the legislation did not adopt the proposals made within the Ralph Report aiming at a consistent taxation of entities (companies, trusts and limited partnerships). The diverging treatment of trust distributions and company dividends makes the definition of uniform consolidation rules for both entity types not practicable.
See also Richard Hendriks, 'Partnership & trust' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 1-3.

[29] This requirement is crucial, as the tax treatment of the head company of a tax consolidated group determines the taxation of the tax income of the entire consolidated group.

## 1.2. Subsidiary

According to subsection 703-15(2), to be eligible for membership in a tax consolidated group,[30] a 100% subsidiary of the head company must have the legal form of either a

- *company*, an Australian resident (but not a prescribed dual resident);
- *trust,* a resident trust estate or a resident unit trust; or
- *partnership*.[31]

Accessibility to tax consolidation is further limited by specific eligibility criteria applicable to group members operating as companies or trusts (*section 1.2.1.*). Of central importance for the concepts underlying the consolidation regime is the wholly-owned criterion which is analysed within *section 1.2.2*.

[30] If consolidation occurs, all members of the consolidatable group become members of the newly formed consolidated group.
See subsection 703-50(1) stating that the choice a head company is making, is a choice for the consolidation of the consolidatable group.
[31] Subsection 703-15(2).

### 1.2.1. Specific eligibility criteria

Subsection 703-15(2)(b) stipulates that non-profit companies cannot become members of a consolidated group. Furthermore, at least some of the income of a joining company must be taxable at the general company tax rate. Trusts that are complying and non-complying superannuation entities, and trusts that are non-complying approved deposit funds (ADFs) are not eligible for tax consolidation (subsection 703-20(2)).

Categories of companies which are excluded from the head company status (subsection 703-20(2)) also do not qualify for the position of a subsidiary member within a consolidated group. The exclusion of these entities from participation in tax consolidation is due to the specific way their income is treated for income tax purposes.[32] The tax treatment of these entities is directly related to their particular identity and the type of business activities that are typically carried out. This correlation between the type of entities and their income taxation would be eliminated through the application of consolidation provisions, transforming all eligible group members into one subject, taxable at the general company rate.

[32] See subsection 703-20(2).

### 1.2.2. Wholly-owned criterion

The wholly-owned requirement for subsidiaries is fulfilled if all the membership (equity) interests in an entity (section 960-135) are beneficially owned by:

- the head company; or
- one or more wholly-owned subsidiaries of the holding company; or
- the holding company and one or more of its wholly-owned subsidiaries.[33]

Consistent with these rules, an Australian resident trust has the status of a wholly-owned subsidiary if there are no trust members other than the head company and / or its 100% subsidiaries.

According to the consolidation provisions, the 100% ownership requirement may also be met, even though the group companies do not hold a 100% stake in a company's shares. Section 703-35 determines under which circumstances minor shareholdings, not exceeding 1% of all ordinary shares issued by the subsidiary and

[33] Subsection 703-30(1).
The term membership interests is defined by section 960-135, which effectively restricts such interests to equity interests.
See Ray Conwell, 'Exiting a group' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 1.
For a discussion of the term "beneficial ownership" in the context of tax-consolidation, see Jim Killaly, 'Specific ATO aspects' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 8 ff.
Remarkably, section 703-30 does not refer to cases where a third party would be in position to affect rights in relation to a subsidiary (see section 975-150 ITAA 1997 and section 160AFE ITAA 1936).

owned beneficially for *employees*, can be disregarded in relation to the wholly-owned requirement.[34]

Section 703-45 determines the conditions under which the requirement for an entity to be wholly owned is fulfilled, where an entity that is not wholly-owned is interposed between the group member and its holding company. That is the case where an interposed entity holds interests in a subsidiary only as a nominee of either the head company or a subsidiary member / members of the group and carries the legal but not the beneficial ownership (subsection 703-45(2)).[35] The second category of interposed entities having no impact on the status of group companies as wholly-owned subsidiaries constitute non-member foreign-resident entities under the conditions defined by subsection 703-45(3), for companies, and subsection 703-45(4), for trusts and partnerships.

Finally, following the general rule of ITAA 1997, *debt interests*, as defined by Subdivision 974-B, cannot constitute membership interests.[36] Interests of this nature, primarily finance shares, are

[34] This is a major difference from the previous 100% grouping rules and ensures consistency with the employee share scheme concessions designed to encourage wide employee share ownership.
[35] Consequently, the head company or other wholly-owned group member / members must have obtained full beneficial ownership in the entity. In a practical sense, the interposed entity may be a trust or partnership. The head company and / or other consolidatable group members should be the sole beneficiary / beneficiaries of such a trust which holds interests in the particular entity. In other cases, the head company and at least one of its consolidatable subsidiaries may have formed a partnership which holds the legal ownership in the interests of the potentially consolidatable group entity. Moreover, section 703-40 explicitly stipulates that entities held through a non-fixed trust as the interposed entity may be considered as wholly-owned subsidiaries of the group.
[36] Subsection 960-130(3).

disregarded in determining whether the wholly-owned requirement is met, since no control over the issuing entity can be established through ownership of the debt.[37]

The wholly-owned requirement in the tax consolidation system forms an approach to the definition and operation of wholly-owned groups that is not fully compatible with the wider definition of group entities used for the corporations law and accounting standards.[38] There is an evident lack of consistency that potentially limits the benefits available under tax consolidation. This, however, will be discussed further in later chapters of this thesis.

[37] The disregarding of the debt interests happens consistent with the framework of the debt and equity rules.
[38] Both legal sources employ the concept of controlled entity.

## 2. MEC groups

Division 719 stipulates the conditions under which foreign-owned groups with multiple entry points of investment into Australia, that are embodied by a number of wholly-owned Australian subsidiaries, have the opportunity to implement tax consolidation.

The eligibility of foreign-owned groups to the application of consolidation provisions preserves the relative equality in the tax treatment of these entities and their Australian owned counterparts. As the previous grouping provisions, which were applicable for wholly-owned subsidiaries with no regard to the residency of the ultimate holding company, are removed, both categories of groups have the opportunity to adopt the new consolidation system. Moreover, the new rules also allow for the group treatment of foreign-owned companies which were not eligible for any grouping concessions under the previously applicable group taxation.[39]

The rules assisting the formation and operation of MEC groups constitute far more than only a supplement to the general consolidation framework. The core provisions are modified in a number of cases, particularly in relation to cost setting rules, loss transfer and utilisation, and value shifting and loss integrity measures, in order to take account the legal and economic characteristics typical

[39] These are wholly owned subsidiaries of foreign resident head entities, themselves holding no Australian resident subsidiaries.

for MEC groups. A deeper analysis of these provisions and the underlying policies would constitute an independent field of research and cannot be provided in the scope of this thesis.

At the same time, it appears not to be reasonable or practicable to draw a categorical distinction between the area of MEC groups and that of the Australian owned consolidatable entities when analysing the decision to consolidate. Both consolidation areas are of mutual influence and significance. Therefore, the following paragraphs provide a general overview over the rules stipulating the eligibility criteria for potential MEC group members, the joining rules, as well as the broader conditions under which such entities may consolidate. The fields of interaction with the general consolidation principles are of particular interest in this context. As the following discussion demonstrates, the current legislation provides a remarkable degree of flexibility regarding the accessibility to and the formation of MEC groups.

## 2.1. Tier-1 companies

A MEC group can be formed by at least two companies that are eligible to be members in such a group (section 719-15) and whose shares are held by a non-resident head entity, the *top company*.[40] Section 719-1 defines such companies, the first-tier subsidiaries of the top company, as *tier-1 companies*. In order to be eligible for membership in a MEC group, a tier-1 company has to satisfy the following conditions (subsection 719-20(1)):

- all or some of its income is taxed at the general company tax rate;
- it is not covered by an exclusion criterion derived from section 703-20;
- it is an Australian resident but not a prescribed dual resident;
- it is a wholly-owned subsidiary of the top company.[41]

Corresponding to the rules governing consolidatable Australian groups, the wholly-owned requirement can be met, although an entity is interposed between the top company and its tier-1 company.

[40] According to subsection 719-20(1), the top company must be
- a foreign resident; and
- not be a wholly-owned subsidiary of another company.

[41] Subsection 719-20 contains a further condition stipulating that an eligible tier-1 company is not a wholly-owned subsidiary of a company that is an Australian resident (other than a company that is a prescribed dual resident or an Australian resident that does not have its income taxed at the general company tax rate). This condition, however, is regularly met through the existence of an eligible top company that must be a foreign resident.

However, the interposed entity must not be:

- a foreign resident;
- a prescribed dual resident;
- a non-resident trust, unit trust, public trading trust or corporate unit trust;
- an entity covered by an exclusion criterion derived from section 703-20;
- an Australian resident company, where no part of its income is taxed at the general company tax rate;
- a non-profit wholly-owned subsidiary of another tier-1 company.[42]

Furthermore, an interposed entity can be disregarded if it holds the membership interests as a nominee of another tier-1 company/ companies or an entity that is a wholly-owned subsidiary of a tier-1 company of the top company (subsection 719-15(3)(b)). Consequently, in the context of the wholly-owned requirement, the beneficial ownership prevails over the legal ownership. This principle is equally applicable for the consolidation of Australian owned (section 703-45) and foreign-owned corporate groups.

[42] See subsection 719-15(3)(a).

## 2.2. Provisional head company

When a MEC group is formed, the eligible tier-1 companies deciding to consolidate nominate jointly among themselves one *qualified* tier-1 company to become the group's provisional head company (subsection 719-60(1)). An eligible tier-1 company is qualified to become the provisional head company if no interests in this company are beneficially owned by another member of the MEC group (subsection 719-65(1)).[43]

Where the MEC group is in existence throughout an income year and a company was the provisional head company at the end of this year, the provisional head company is regarded as the group's head company for the entire income year (subsection 719-75(1)). This means that in the event of a change in the identity of the provisional head company (subsection 719-60(3)) the succeeding tier-1 company will be held to be the group's provisional head company for the period for which the income statement is issued.

For groups coming into existence during an income year, subsection 719-75(2) stipulates that the company operating as the provisional head company at the end of the income year will be regarded as the group's head company for the period of the year since the choice for consolidation became relevant.

[43] This requirement excludes all eligible tier-1 companies from obtaining the head company status whose interests are held by an interposed entity.

## 2.3. MEC subsidiaries

According to section 719-1 and subsection 719-25(2), all qualified tier-1 companies, with the exception of the provisional head company, making the irrevocable choice (subsection 719-50(2)) to form a MEC group, or joining an existing one, become its subsidiary members. Furthermore, entities subordinated to joining tier-1 companies become members of a MEC group under the conditions determined by section 719-10. These conditions mirror the requirements for the membership in a consolidated group (section 703-15), providing wholly-owned companies, trusts and partnerships with the status of potential MEC group subsidiary members.

Consequently, a MEC group may comprise one or more consolidatable groups with all their members, including the head company, which at the same time is an eligible tier-1 company, and all consolidatable wholly-owned subsidiaries also fulfilling the requirements for the membership in a MEC group.[44] In conclusion, under the present consolidation rules, a consolidatable head company / tier-1 company willing to consolidate the group's income statements has the choice between the full consolidation of all its subsidiaries under the general consolidation provisions or as members of a MEC group.

[44] The fact that an Australian resident head company is wholly-owned by a foreign resident holding entity does not affect its eligibility for consolidation; the head company cannot be a subsidiary member of a consolidated or consolidatable group, a membership in a potential MEC group has no influence.

## 2.4. Potential MEC group

A number of eligible tier-1 companies and all their wholly-owned subsidiaries fulfilling the requirements for membership in a MEC group (subsection 719-10(1)(b)) constitute a *potential MEC group*. Such a group may be assembled by at least two tier-1 companies operating as single entities or in connection with wholly-owned Australian resident subsidiaries. The latter category of potential MEC group members may also be equally eligible for tax consolidation under the general rules stated in Division 703.[45]

At the same time, already consolidated group entities whose head company is also an eligible tier-1 company may potentially convert their status into a MEC group membership. This happens in the event that one or more foreign-owned group entities become eligible tier-1 subsidiaries of the top company subsequent to the consolidation time of the domestic group headed by a tier-1 company, *special conversion event*. Members of such potential MEC groups intending to form a MEC group have to notify their election to the Commissioner of Taxation (Commissioner) within an appropriate period (section 719-40).[46] Under these conditions, the head company of the consolidated group is considered as a potential MEC group.[47]

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[45] See Figure 1 on page 40.
[46] On the other hand, the conversion of a MEC group into a consolidated group can also take place (Sec. 703-55).
[47] According to subsection 719-10(1), a potential MEC group may be derived from a single company.

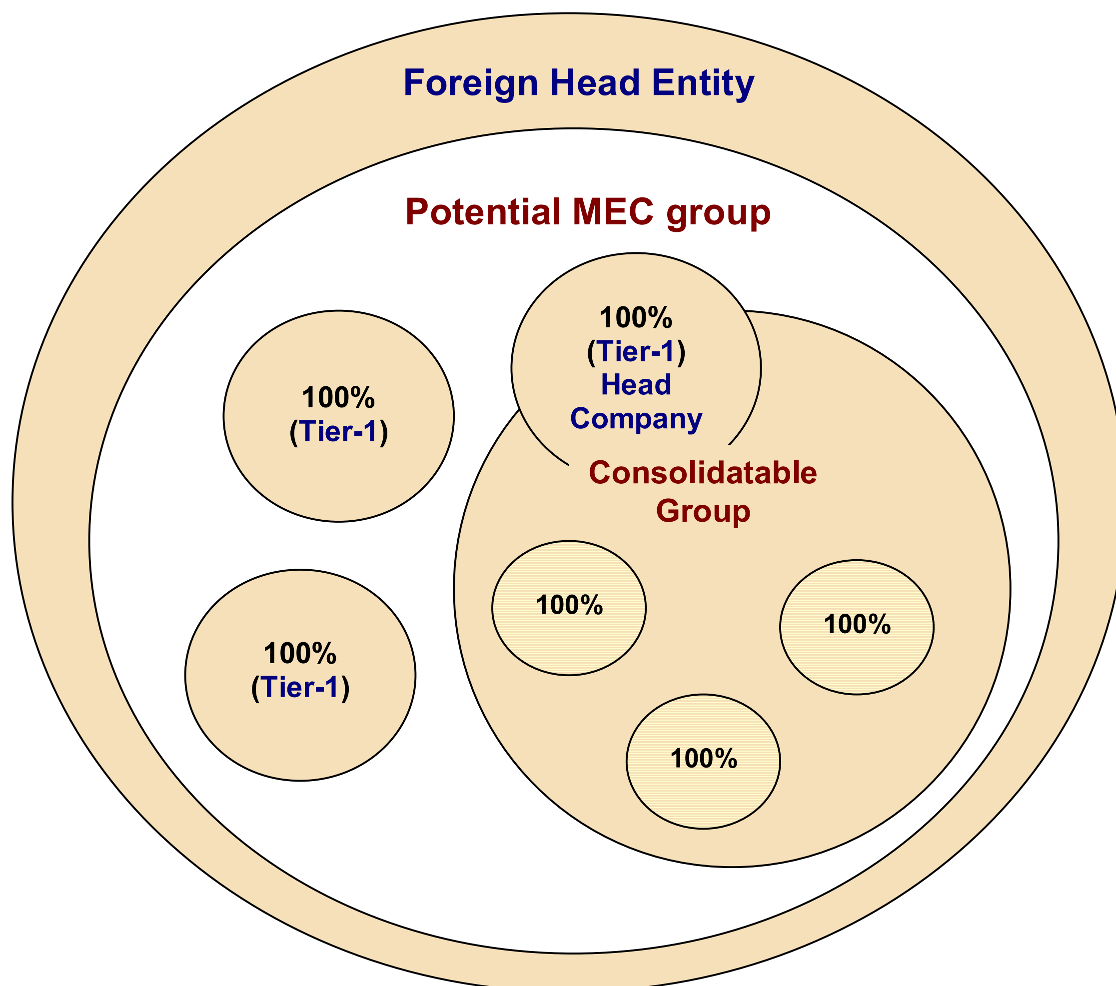


**Figure 1** Potential MEC group including a consolidatable group

Finally, it is important to remember that the composition of a MEC group does not necessarily have to reflect the structure of the potential MEC group prior to consolidation. As each eligible tier-1 company makes its individual decision whether to participate in the creation of a MEC group, respectively to join an existing group or to retain its current (non-consolidated) status, the actual MEC group may be formed by only a sub-group of its eligible members. Whereas the members of a consolidatable group have only the choice between a consolidation of all eligible group members, or their tax treatment as

individually taxable entities, a potential MEC group can be divided into consolidating and non-consolidating entities. The shape of a consolidated MEC group is therefore determined by the considerations made by its first tier members, the eligible tier-1 subsidiaries of the foreign top company.

## 2.5. MEC group membership of consolidatable companies

In view of the choices provided by the legislation, 'prior to a decision as to the form in which tax consolidation might be adopted, [eligible] entities would normally address the effects of tax consolidation […] in relation to their own tax-consolidatable group rather than a potential MEC group'.[48] Presumably, the implementation of consolidation rules, whether through the formation of a consolidated group or participation in the establishment of or joining a MEC group, will be pursued only by head entities / tier-1 companies recognising evident benefits available for themselves and their eligible subsidiaries under the consolidation system. Only where such positive assessment is made can an eligible tier-1 company determine whether a consolidation process including the remaining potential MEC group members appears to be more advantageous than the formation of a smaller but more homogeneous consolidated group.

The major factor determining such a decision should be the degree of existing and / or anticipated economic relations between the eligible tier-1 companies. Where the exchange of goods and services between the members of a potential MEC group is significant, a decision in favour of consolidation under MEC rules provides considerable benefits for the group members, since future intra-group

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[48] AASB, Urgent Issues Group, Abstract 39, September 2002 ('Effect of Proposed Tax Consolidation Legislation on Deferred Tax Balances'), Discussion, No. 21.

transactions will be regarded as tax neutral. On the other hand, MEC groups with more diversified / less complementary business activities, showing a bare minimum of connections between eligible tier-1 companies, may still opt for the consolidation under Division 719 considering the loss transfer opportunities which are available for consolidated MEC group members.

## 3. Business structures excluded from consolidation

The eligibility criteria stated within Division 703, consolidatable groups, and Division 719, MEC groups, allow for the consolidation of diverse types of domestic and foreign-owned groups, comprising companies, trusts and partnerships. At the same time, the mandatory legal form for a (potential) head entity, the incorporation as a company, limits considerably the number of groups that may opt for the application of the elective consolidation provisions.

This is true, particularly, for those types of groups predominantly used for the formation of small and family businesses. Entities headed by trusts, among them family trusts, cannot form consolidated groups. The appointment of a company for the position of a trustee does not have any impact on this exclusion, as the status of a trustee alone provides no beneficial entitlements. From this it follows that companies functioning as a trustee do not meet the wholly-owned requirement in relation to the subsidiary members unless they become themselves a beneficiary or unit holder of a relevant trust.[49] However, since the legal concept of trusts prevents trustees from being installed as the sole beneficiary of the trust property, groups directly headed by a corporate trustee are generally not eligible for consolidation.[50]

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[49] In a group situation, the trust property will be usually constituted by a company / companies.

[50] At the same time, groups are eligible for consolidation where a company, the head company and / or its wholly-owned subsidiary / subsidiaries, is interposed between the (corporate) trustee and the subordinated entities.

On the other hand, concluding from the wholly-owned criteria stated in subsection 703-30(1), a group of wholly-owned entities headed by a company, all of which are the sole beneficiaries of a trust, can constitute a consolidatable group including the trust property. A requirement of this constellation is, however, that no non-wholly-owned entities or private individuals are also beneficiaries of the trust. In relation to the trust property, the wholly-owned criterion is met only where all beneficiaries are members of the consolidatable group.

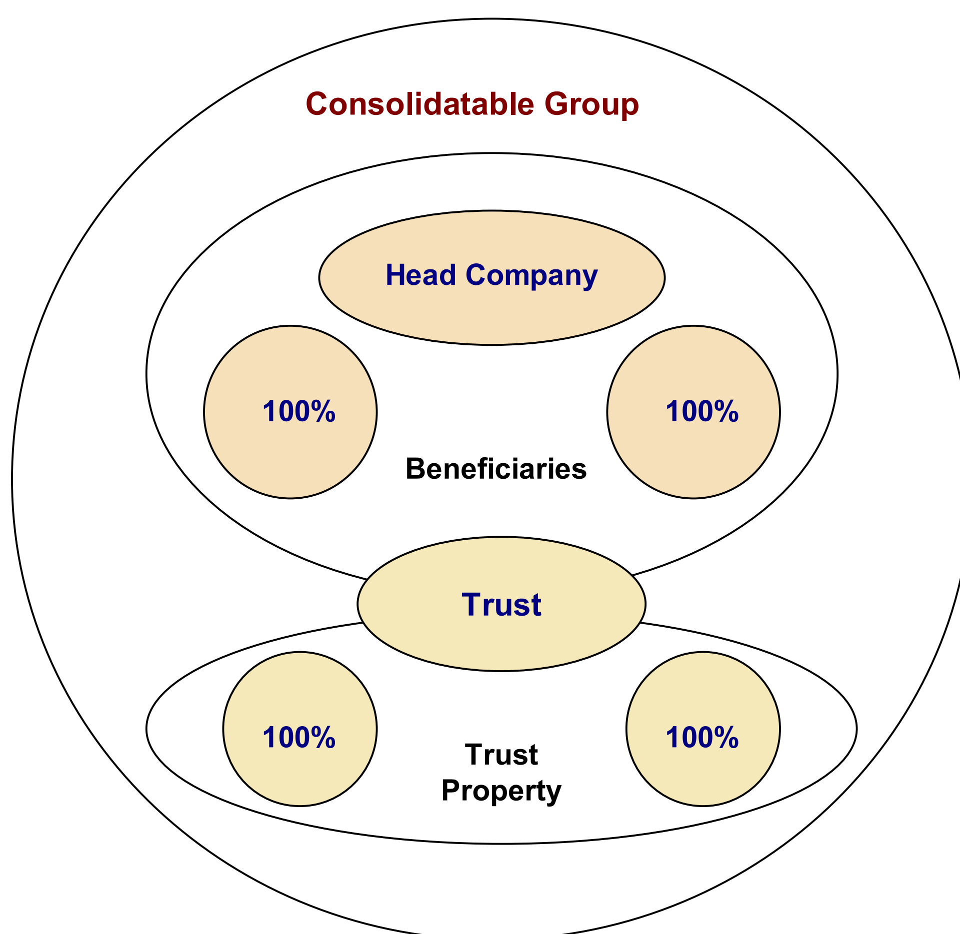


**Figure 2** Consolidatable group including a trust and subsidiaries

In the example depicted above, the trust qualifies as an eligible entity of the consolidatable group, as the only beneficiaries of the trust are the head company and its 100% subsidiaries. At the same time, the sub-group headed by the trust could not elect consolidation independently.

An important exception to this rule is the permission given to corporate unit trusts and public trading trusts to head consolidated groups, which was announced by the Minister for Revenue and Assistant Treasurer in a Media Release from 27th March 2003.[51] According to this statement, trusts, subject to Divisions 6B and 6C of Part III ITAA 1936, 'that elect to head consolidated groups (…) will be taxed the same as companies in all respects, wherever possible'. Importantly, once a relevant trust obtains the status of a "head company", it will 'continue to be taxed like a company even if the group it heads de-consolidates'.

Corresponding to the general conditions governing the consolidation of groups headed by corporate trustees, businesses managed in the hands of a partnership may only be eligible for consolidation if there are no other partners than the head company and its wholly-owned subsidiaries. The eligibility conditions are not fulfilled in cases where non-wholly-owned entities or individuals (sole traders) constitute members of a partnership.

[51] Senator the Hon. Helen Coonan, 'Consolidation – Corporate Unit Trust and Public Trading Trust', Media Release, C019 / 03 (27th March 2003).

Finally, it must also be recognised that the disqualification of the very top group member, a partnership or a trust, from the membership in a consolidatable group does not prevent subordinated entities, wholly-owned or controlled, from being eligible for consolidation. On the contrary, a subordinated company may itself hold a number of wholly-owned subsidiaries, which potentially makes it the head company of a consolidatable group. Although a head company cannot be a subsidiary of a consolidatable group or a member of a consolidated group, neither of these categories is relevant for a subsidiary of a non-consolidatable trust.

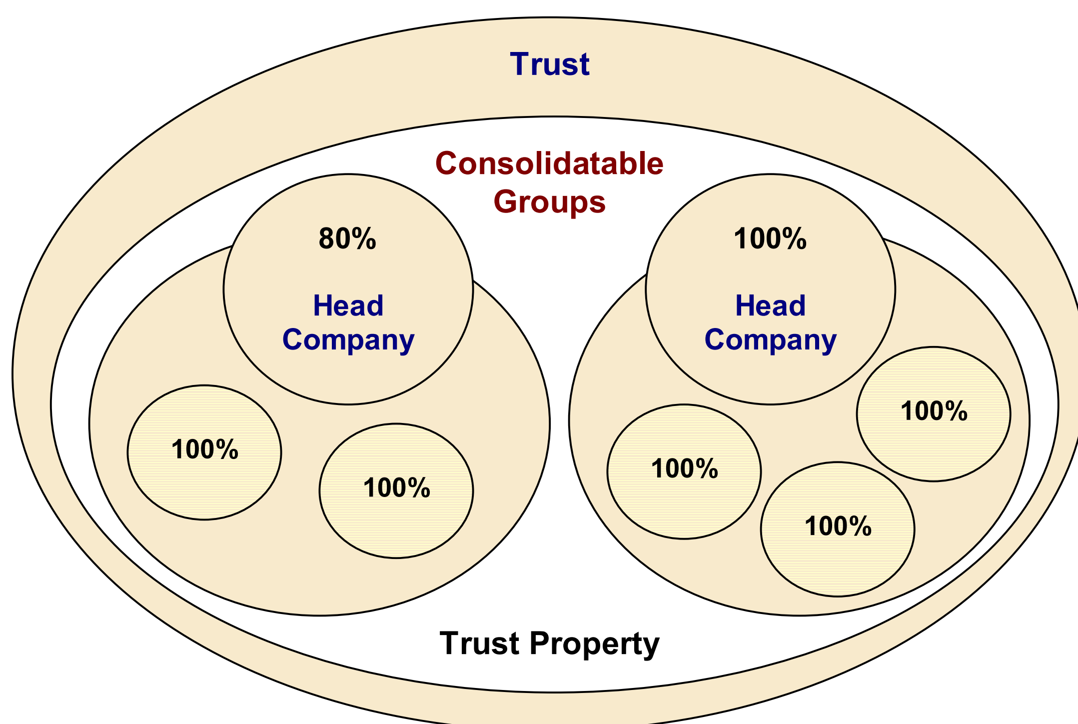


**Figure 3** Consolidatable groups held by a trust

Under these circumstances a relatively homogeneous group operated under the control of one ultimate top entity, trust or partnership, is divided into a number of separate consolidated sub-groups. Each sub-group must individually undertake all steps necessary to implement the consolidation system and subsequently ensure continual compliance with its requirements.

Considering the binding eligibility requirements, entities subordinated to a trust or partnership presumably incur higher transition and maintenance costs in the wake of a decision to consolidate than groups headed by a company.[52] Furthermore, the benefits available under consolidation are diminished as the transactions carried out between two sub-groups have to be taxed under the rules governing non-consolidated entities.

The exclusion of the top entity from consolidation also has a particular impact on the tax implications relating to the disposal of interests held in the group entities (CGT) and dividend transfers received from its (consolidated) sub-groups. Groups currently headed by a trust or partnership deciding in favour of tax consolidation should therefore consider transforming their business structure prior to the implementation of the consolidation rules, placing a company on the top of the group hierarchy.

[52] This is true in particular because of the potential need to split groups headed by a trusts or partnerships into two or more consolidating groups.

The many long-established groups currently set up with unit or discretionary trusts as the head entity and often also as subsidiary entities may consider restructuring in order to take advantage of consolidation. The costs and benefits of doing so are beyond the scope of this thesis. However, it is likely that the costs of restructuring such groups would be substantial, including stamp duty or transaction tax and potential loss of pre-CGT status in many instances.

## 4. Concluding comments

Concluding from the findings discussed above, the two leading policies expressed in the eligibility criteria are as follows:

- taxation of the group income at the general company tax rate (exclusion of certain types of entities from the head entity status); and
- access to consolidation only for head companies and wholly-owned subsidiaries (wholly-owned groups).

The latter condition is fully consistent with the consolidation core principle according to which the head company is the group's only income tax liable entity. As it is discussed within Part B Chapter III 1, subsequent to consolidation, groups are considered as single taxable entities (single entity rule). For the duration of their membership period, subsidiary members carry neither an obligation to calculate the amount of their taxable income / tax loss nor do they have to face the potentially resulting tax liabilities.[53] This concentration of all tax attributes in the hands of the head company is made possible through the strict application of the wholly-owned requirement and the virtual transfer of the subsidiaries' assets to the group (asset rules). The condition for the joining subsidiaries to be wholly-owned prevents entitlements based on minority interests, which are always present in

[53] However, direct tax liabilities may arise for the subsidiary members in cases where the head company defaults on its obligations against the Australian Taxation Office.
See Part B Chapter III 2.3.1.

the context of controlled entities, from clashing with the stipulated integration of all group assets in the accounts of the head company. Consequently, the eligibility rules correlate directly with the single entity rule and the related asset rules.

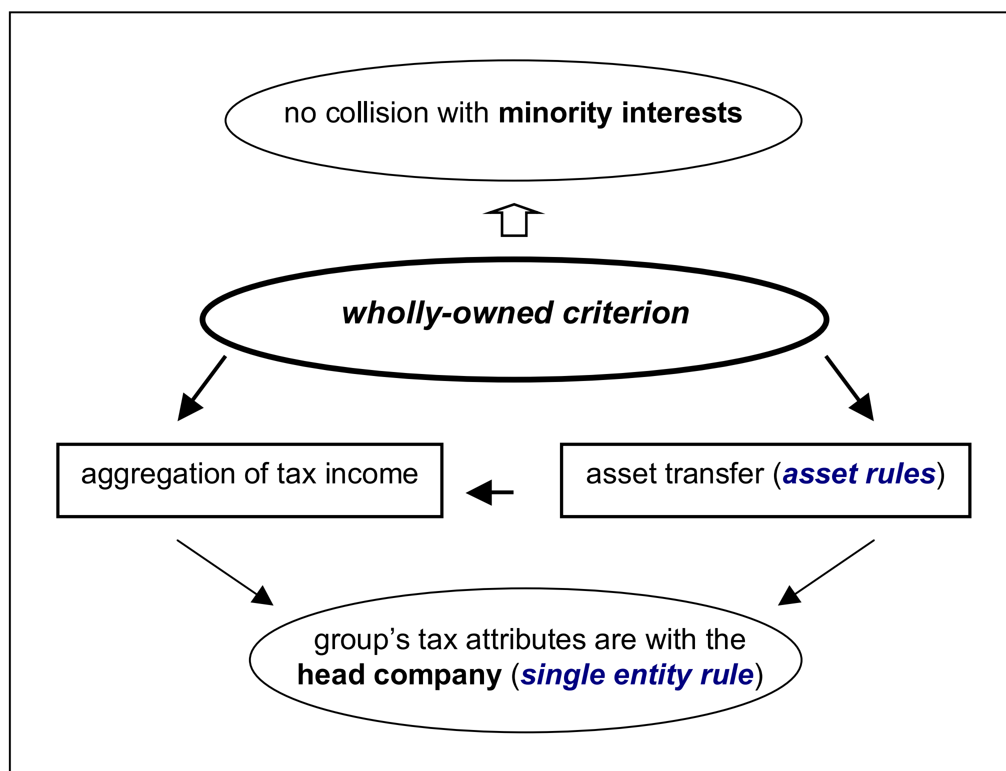


**Figure 4** Wholly-owned criterion

Admittedly, the exclusion of controlled entities potentially diminishes the benefits available under consolidation, since it is not consistent with the economic realities which are recognised under accounting regulations.[54] However, allowing controlled entities to join consolidating groups would require a considerable change in the overall concept underlying the consolidation legislation.

[54] See Part C Chapter I.

An example of a consolidation regime making controlled entities eligible for membership in consolidatable groups is the German consolidation legislation (*Corporation Income Tax Act*).[55] The consolidation of controlled group entities is practicable, since the group members retain their individual taxation status and the obligation to calculate their individual business income. In a second step, the individually established pre-tax profits, or losses, must be transferred to the head company. This means that the group profits can be set of against the group losses in the process of establishing the taxable group income. Under these conditions, no elaborate integration of the group's assets in the initial consolidation process is required. Importantly, minority shareholders affected by the mandatory profit transfers must be compensated by the head company.[56]

Finally, commenting on the diverging approaches to the formation of consolidated groups, it is necessary to refer to the differences in the general scope of application of the relevant provisions. In contrast to the Australian consolidation regime, the German consolidation provisions provide for the consolidation of joint-stock companies and limited companies only.[57] The protection of minority shareholders is based on rules stipulated by the corporations law.

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[55] See Part D Chapter I 2.
[56] See Part D Chapter III 1.
[57] The incorporation as joint-stock company or limited company is the requirement for the subsidiary membership in a group electing to consolidate for the Corporation Income Tax. See Part D Chapter I 2.

Such a direct coherence between the tax consolidation rules and the framework of the corporations law is not detectible under the Australian legislation.[58] Moreover, it appears to be questionable whether comparable mechanisms could be developed and applied in the context of a consolidation system including non-incorporated entities such as trusts and partnerships.

In terms of a practicable alternative to the current eligibility criteria, the wholly-owned requirement may be retained for trusts and partnerships, whereas companies would need to be merely, directly or indirectly, controlled by the head company. Considering the findings discussed in the following chapters, such a change in the mandatory eligibility rules could have a significantly positive effect on the implications resulting from the initial consolidation decision. For instance the rigid steps arising from the application of the single entity rule and the asset rules, which are analysed within *Chapter III*, may be replaced by a more open approach to the formation and operation of consolidated groups. As the example of the German consolidation regulations demonstrates, tax consolidation can also be implemented without the wholly-owned condition and the correlating requirement for a full integration of the groups' accounts.

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[58] Whereas the Australian tax consolidation regime does not refer to any consolidation conditions stipulated by the corporations law, the German tax consolidation rules are derived from both the taxation law and the corporations legislation.
See Part D.

### *Chapter II: Staying outside consolidation – mandatory provisions*

Commitment to the application of the consolidation rules is entirely optional for eligible corporate groups and is at the discretion of the relevant head company. However, when deciding against tax consolidation, wholly-owned group members cannot rely on the continuance of the concessional tax treatment. To the contrary, the almost complete removal of previous grouping provisions constitutes one of the key elements of the newly introduced consolidation legislation. Moreover, the optional single entity status of wholly-owned group members triggers the application of a range of modified anti-avoidance and integrity measures directly "penalising" intra-group operations undertaken outside the consolidation regime. Evidently, group relationships are only recognised where an irrevocable decision in favour of consolidation was made. The restrictive tools employed in order to pursue this agenda are the subject of this chapter.

*Section 1* analyses the removal of grouping provisions previously applicable, and now replaced by the elective consolidation regime. In the wake of this measure, the legal concept of group companies being taxed as separate legal entities but obtaining favourable treatment in relation to tax issues which arise from the group membership disappears.

A further assessment of the policies determining the tax treatment of non-consolidated groups is made in the second part of this chapter (s*ection 2*), where the modifications introduced into the rules governing value shifting, debt forgiveness and loss integrity are analysed in detail.

At the centre of the principles shaping the current consolidation legislation lays the strict distinction between the tax treatment of groups meeting the statutory eligibility criteria and electing to consolidate and such groups which cannot or decide not to consolidate. Consequently, undertaking an examination into the policies affecting the initial tax consolidation decision, it is necessary to understand the nature of the conditions for the tax treatment of non-consolidating business entities.

1. Removal of group regulations

In accordance with the recommendations made within the Ralph Report, parallel to the introduction of the new tax consolidation rules, the previous grouping provisions were removed. The *Consolidations Act (No.1)* stipulated the cessation of the *loss transfer* provisions and the *CGT asset roll-overs* for wholly-owned groups. The subsequent *Consolidation, Value Shifting and Demergers Act* repealed the existing *foreign tax credit transfer* provisions[59] and adopted a set of rules applicable only to consolidated group members. Finally, the *Consolidation and Other Measures Act (No.1)* phased out the *thin capitalisation*[60] grouping rules and completely removed the *inter-corporate dividend rebate.*

Due to their importance for the implementation of the policies underlying the consolidation regime, the following categories of removed and replaced grouping provisions are considered in the following sections:

- loss transfer provisions;
- CGT rollover relief; and
- inter-corporate dividend rebate.

[59] These measures were further supplemented and changed by the *Consolidation, Value Shifting and Demergers Act* in view of consolidated groups with a substituted accounting period.
[60] The grouping treatment in connection with the thin capitalisation measures became accessible only in connection with the establishment of a MEC group. Foreign bank branches are subject to specific rules allowing them to be regarded as a part of the head company of a MEC group.

### 1.1. Removal of loss transfer provisions

Prior to the introduction of the tax consolidation regime, Division 170 defined the conditions for the transfer of tax loss deductions between companies, members of the same wholly-owned group (Division 975). The major distinction in this context was made between:

- transfer of tax losses (Subdivision 170-A), and
- transfer of net capital losses (Subdivision 170-B).

Both types of loss transfer were subjected to numerous conditions (section 170-5 for tax losses and sections 170-130 to 170-160 for net capital losses) primarily concerning the ability to use the loss at the time of transfer, the residency of the companies involved in the transfer, the transfer agreement and loss recoupment tests. Moreover, subdivision 170-C stipulated adjustments to the cost base and reduced cost base of equity or debt interests in the transferor and transferee. This was an integrity measure aimed at the prevention of loss duplications within groups.[61]

The introduction of the consolidation regime made the loss transfer provisions redundant. Under the single entity rule, the group's taxable corporate income is generated solely by the head entity. Consolidated groups have their tax and net capital losses pooled in the accounts of the head company. The former loss transfer provisions could therefore

[61] See also Part B Chapter II 2.3.1.

not find any application in relation to consolidated group's losses. The removal of these provisions affects only non-consolidating entities which, under the current conditions, lack the opportunity to transfer their losses to members of the same group. This procedure implements the strict distinction between consolidated group treatment versus the non-consolidated individual status of group entities.[62]

[62] However, the removal of the loss transfer provisions is not complete. These provisions remain available to Australian branches of foreign banks under the conditions specified by the *Consolidation, Value Shifting and Demergers Act*.

## 1.2. Removal of the CGT rollover relief

Under the former grouping rules, Subdivision 126-B granted a principal CGT roll-over relief in relation to asset transfers between resident companies,[63] members of the same wholly-owned group. The roll-over provision had effects to:

- assets acquired by the originator before 20 September 1985, which retained their pre-CGT status in the hands of the recipient subsequent to transfer; and
- assets acquired by the originator after 20 September 1985, which price was deemed to equal the originator's cost base at the time of the transfer.

The application of the roll-over relief resulted in a CGT neutral asset transfer within wholly-owned groups. Such considerations are not relevant for consolidated groups. The formation of a group or the joining of new members triggers the aggregation of the subsidiary's assets in the accounts of the head company at the time of consolidation.[64] Due to this step, asset transfers between group

[63] The relief was also applicable in respect to assets having the 'necessary connection to Australia' where the transfer was taking place between non-resident companies or between a non-resident company and a resident company.
[64] See 'asset rules', Part B Chapter III 3.

members have no CGT implications.[65] The group's assets are deemed to be owned by the head company only.[66]

[65] See 'single entity rule', Part B Chapter III 1.1.
[66] At the same time, the removal of the CGT asset roll-over is not complete. The adjusted provisions of Subdivision 126-B ITAA provide roll-overs for asset transfers involving non-resident companies, members of the same wholly-owned group.

## 1.3. Removal of the inter-corporate dividend rebate

Under the previously applicable provisions, dividend payments made between companies, Australian residents, were subject to a rebate of the tax payable in relation to those dividends (section 46 ITAA 1936 and section 46 ITAA 1936 in relation to dividend stripping arrangements).[67] This rebate was available primarily for franked dividends. However, unfranked dividends qualified for the same rebate in cases where both the company paying the dividend and the company receiving the dividend were members of the same wholly-owned group (subsections 46F(2) and (3)).

The policy underlying the application of this rebate was the prevention of double taxation of corporate income. Subsequent to the removal of the inter-corporate dividend rebate, only the imputation tax offset under Division 207 prevents franked dividends from being double taxed.[68]

From the perspective of consolidating entities, the inter-corporate dividend rebate (sections 46 and 46A ITAA 1936) became fully redundant, since dividend payments between group members have no impact on the calculation of the assessable income of the head company.[69] For non-consolidated groups, however, the removal of the

[67] For rules applicable in relation to non-resident companies, see section 23AJ ITAA 1936.
[68] Division 207 had effect from 29 June 2002. It was designed as the replacement of the removed inter-corporate dividend rebate.
See Chapter 10 (Paragraph 10.7) EM, *Consolidation and Other Measures Act (No.1)*.
[69] See 'single entity rule', Part B Chapter III 1.1.

rebate in relation to payments of (unfranked) dividends triggers the potential for an increase in, or even the cascading of corporate income taxation.[70] Head companies of eligible corporate groups tending against the implementation of the consolidation system should therefore be aware of the adverse taxation effects that may potentially diminish the returns available to their ultimate shareholders.

[70] See also Rodney Fisher, 'The ties that bind: Operation of the proposed consolidated group provisions' (2001) 5 (1) *The Tax Specialist* 32, 35.

## 2. Anti-avoidance and integrity measures

In addition to the removal of the previous grouping provisions, corporate groups choosing not to consolidate also face a number of strict anti-avoidance and integrity measures relating to cost base adjustments (value shifting rules (*section 2.1.*)), debt forgiveness (*section 2.2.*) and loss integrity (*section 2.3.*). As the following analysis demonstrates, these measures not only pursue the policy of merely separating non-consolidated group entities. The rigidity of the principles under consideration allows the conclusion that groups deciding against consolidation are literally "punished" for not implementing the consolidation provisions.

## 2.1. Value shifting

The modified value shifting rules[71] are explicitly aimed to exclude any 'advantage in keeping less than 100 % controlled entities outside a consolidated group for the purpose of value shifting with them, or from electing not to consolidate groups of 100 % owned entities in the expectation of deriving advantages from value shifting'.[72]

The general value shifting regime (GVSR), applicable from 1 July 2002, penalises any kind of scheme[73] which materially changes the market value of entities[74] by means of shifting value of equity or loan interests in a company or trust to other equity or loan interests in the same company or trust (Division 725).[75] This category of a direct value shift (DVS) may result in the taxation of a deemed capital gain

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[71] See Schedule 15 *Consolidation, Value Shifting and Demergers Act*.
See also Ralph Report, Recommendations 6.12 to 6.16.
For a detailed discussion of the value shifting regime, see Michael Dirkis, 'The Nuts and Bolts of Value Shifting' (2003) 6 (4) *The Tax Specialist* 168.
[72] Chapter 7 (Paragraph 7.13) Revised EM, *Consolidation, Value Shifting and Demergers Act*.
[73] For the legal definition of "scheme", see section 995 ITAA 1997.
[74] The new value shifting rules are equally applicable to companies and trusts passing the controlling entity test (direct value shift) or the ultimate controller test (indirect value shift).
[75] This occurs either through the creation of new interest at a discount or through the variation of interests in existing rights.

(new CGT event K8)[76] or the realignment of the adjustable value (the cost base) of the interests[77].

On the other hand, the DVS regime stipulates that tax losses suffered in connection with the disposal of non-depreciating assets may be disregarded. This happens to the extent that a right created in favour of an associate of the asset owner decreased the sale proceeds (Subdivision 723-10), where the consideration received in return for the creating of such a right was considerably below its market value.[78]

Indirect value shifts (IVS), due to the transfer of economic benefits under a scheme between entities[79] held by the same ultimate controller, also trigger a correction of the adjustable value of interests.[80] Under the premise that the gaining entity provides no adequate compensation for the received benefit (no arm's length transaction), any loss suffered at the time of the disposal of the losing entity's interests must be reduced[81] by the value previously shifted

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[76] This happens when the value is shifted from post-CGT to pre-CGT interests or between interests of a different tax character, which are held by the same controlling entity.
Shifts of value between a controlling entity and its affiliates may also result in a capital gain deeming a disposal of (down) interests for their market value.
See section 725-245.

[77] Such realignment amounts to the market value of the interests acquired, which is calculated as the share of the (market) value shift attributable to the (up) interests held by the affected owner (associated entity).

[78] The difference between the market value of the right and the capital proceeds for its creation must exceed the amount of AUD 50,000 (subsection 723-10(1)(f)).

[79] Company or trust.

[80] However, indirect value shifts do not cause assessable gains or losses to arise.

[81] In cases where a non-depreciating asset is acquired under a roll-over, the reduced cost base has to be reduced (section 723-105).

away under the scheme[82] (*realisation time method*; Subdivision 727-G).[83] On the other hand, a gain made by the gaining entity through a realisation event also has to be reduced by a reasonable estimate of the amount by which the indirect value shift has increased the interests' market value.[84]

The application of the notably complex general value shifting regime can be avoided by implementing the consolidation regime. Groups deciding against consolidation, however, may proceed with value shifts and restructuring measures with regard to provisions which may exclude or reduce some of the tax related implications triggered by the above-mentioned principles.

In cases where the equity or loan interests, subject to a direct value shift, have the same character[85] and are held by the same affected owner, the operation may result in a mere correction of the adjustable value of the interests, without triggering any tax liability related to the

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[82] Section 727-615.
A reasonable estimate of the extent (if any) to which the interests' market value at the time of the realisation event still reflects the effect of the indirect value shift on the market value of equity or loan interests in the gaining entity is taken into account.
[83] The parties can also decide to apply the *adjustable value method* (Subdivision 727-H) under which all adjustments are calculated just before the indirect value shift time (the time when all the benefits under the scheme as well as all gaining and losing entities can be identified). This method allows a simultaneous reduction in interests of the losing entity and an uplifting in the interests of the gaining entity, both using the same amount which is calculated on the loss-focused basis (subsection 727-780(2)).
[84] Section 727-620.
A reasonable estimate of the extent (if any) to which the interest's market value at the time of the realisation event still reflects the effect of the indirect value shift on the market value of equity or loan interests in the gaining entity is also taken into account.
[85] The main distinction is made between CGT assets, trading stock and revenue assets.

event (section 725-220).[86] Since head companies of wholly-owned corporate groups fulfil the requirement of a common legal ownership of the interests, this provision limits the negative consequences of non-consolidation for direct value shifts.

At the same time, subsection 727-260(1) excludes the application of the indirect value shifting provisions if the gaining entity is a wholly-owned subsidiary of the losing entity throughout the IVS period.[87] Consequently, corporate groups eligible for consolidation but refusing to consolidate should be able to avoid measures imposed in connection with indirect value shifts.

Moreover, members of corporate groups comprising small business entities can also be fully exempted from the application of the indirect value shifting rules. According to subsection 727-470(2), interests held in the following entities will not be affected by indirect value shifts:

- entities eligible to be a Simplified Tax System (STS) taxpayer for each income year that includes any of the IVS period; or
- entities satisfying the maximum net asset value test (section 152-15)[88] throughout the IVS period.[89]

[86] See also Wayne Rogers, 'The general value shifting rules - an overview, Part I' (2002) *Taxation in Australia* 85, 87.
[87] From this it follows that value shifts from a wholly-owned subsidiary to its holding company, or to another group member do not fall under this exception. In the absence of this limitation the position of creditors of the wholly-owned entities could be affected.
[88] Threshold of AUD 5,000,000 for net value of CGT assets held directly or indirectly through connected entities or affiliates.
[89] However, the anti-avoidance provisions in Part IVA of the ITAA 1936 may be applicable to value shifting schemes where the prime purpose would be the creation of losses or reduction of gains on interests in entities.

Finally, the control requirements implemented within the GVSR practically exclude the application of the rules to large listed enterprises.[90] In the case of corporate groups eligible for consolidation, however, this fact remains irrelevant, as the potential value shifting entities are wholly owned.

[90] The tests applied for value shifting purposes are the 50% stake test, the 40% stake test and the actual control test (section 727-355).

## 2.2. Debt forgiveness

The introduction of the new value shifting rules triggered a complete removal of Division 139 (Value shifting through debt forgiveness). Transfers of economic benefits to a controlling entity without adequate compensation, such as debt forgiveness, are now subject to the indirect value shifting regime.

Currently, the integrity measures contained in Schedule 2C to ITAA 1936 (Div 245) are still applicable to commercial debt forgiveness. According to subsection 245-3(7) to Schedule 2C to ITAA 1936, 'the total net forgiven amount of all debts of a particular debtor that are forgiven in the same year of income (…) is to be applied in reduction of certain amounts that may otherwise be taken into account in assessing the debtor's taxable income'.[91]

Eligible groups choosing not to consolidate can only escape this rule on the grounds of section 245-90 of Schedule 2C to ITAA 1936. Companies under common ownership have the opportunity to enter into an agreement under which the commonly owned creditor forgoes an entitlement to a capital loss as a result of forgiving the debt or a deduction for a bad debt under section 8-1 or section 25-35. The sum

[91] The 'net forgiven amount' of commercial debts calculated in accordance with Sch 2C to ITAA 1936 (Div 245) for an income year is applied to reduce the debtors' tax deductions in the following order:

- deductible revenue losses (section 245-110);
- deductible net capital losses (section 245-125);
- deductible expenditure (section 245-140).

of the forgone entitlement can be applied in order to reduce the debtors' net forgiven amount, which determines the extent of the reduction of tax deductions in a particular income year.

## 2.3. Loss integrity

Where they wish to utilise losses, corporate groups deciding against consolidation face a range of integrity measures imposing (reduced) cost base adjustments and restricting the availability of deductions.

### 2.3.1. Inter-entity loss duplication

Under the old loss transfer provisions for wholly owned groups Subdivision 170-C prevented the duplication of net capital and tax losses by triggering adjustments to the (reduced) cost base of interests in the loss transferring entity[92] and in the group member receiving the loss.[93] Subsequent to the introduction of the consolidation regime, the main anti-loss-duplication rules are stated in the modified Subdivision 165-CD.[94]

According to section 165-115GB,[95] reductions and other adjustments have to be made to the *reduced cost base* of significant equity and debt interests held in a company that has realised or unrealised

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[92] Reduction of the (reduced) cost base of direct / indirect equity or debt interests held by group companies.

[93] The adjustment relating to the group member receiving the loss was an increase of the (reduced) cost base of direct / indirect equity or debt interests held by group companies. These adjustments were to be calculated immediately before the time when a CGT event happened to the share or debt interests.

[94] See Schedule 14 (Loss integrity rules: global method of valuing assets) *Consolidation, Value Shifting and Demergers Act*.

[95] Section 165-115GB replaced the previous anti-duplication provision section 165-115G.

losses[96] when an alteration takes place in the ownership or control of the company[97] (*alteration time*).[98] The value of the interests is taken to be decreased by the losses accrued by the wholly-owned or controlled entity. A capital loss suffered through the disposal of such interests would therefore constitute a duplication of losses available for deduction.

The estimation of unrealised losses accrued by the loss company at the alteration time may impose considerable compliance costs on the controlling entity. The initial method for the calculation of unrealised losses was the *individual asset market valuation*. The *global method of asset valuation* (subsection 165-115E(2)), which was made available in connection with the legislated consolidation measures, provides an effective alternative to this work intensive method.[99] However, although the valuation *"in globo"* does not have to be undertaken by a qualified valuer, 'the method used must be one that qualified valuers would regard as appropriate for use in the particular circumstances, having regard to the activities of the company, the

[96] 'An *adjusted unrealised loss* is the sum of unrealised revenue and capital losses in respect of CGT assets and unrealised trading stock losses.'
R L Deutsch, M L Friezer, I G Fullerton, M M Gibson, P J Hanley, T J Snape, *Australian Tax Handbook 2003*, (2003) 444.
[97] The application of this section is also triggered where the liquidator of the loss company declares that shares in the company are worthless, CGT event G3 (subsection 165-115GB(1)(b)).
[98] The selling entity must have owned, alone or with its associates, a controlling stake in the loss company. A further requirement is a direct or indirect equity interest of at least 10% in the loss entity or the existence of a debt of at least AUD 10,000 owed to the controlling company (subsection 165-155GB(2)(a) and (b)).
[99] The choice in favour of the global method of asset valuation triggers the application of section 165-11ZD (Adjustment (or further adjustment) for an interest realised at a loss after the global method has been used).

particular types of assets it holds, and any other relevant matters'[100]. The actual implementation of this rule in the future, particularly how the Australian Taxation Office (ATO) chooses to interpret it, will determine the practicability of the simplified loss calculation under the global method.

The mere existence of a choice between the global and individual asset valuation may also impose additional compliance costs on affected entities. After all, a reasonable decision in favour of the presumably most cost-efficient method can only be made after assessing the tax implications of both alternatives, as they arise in an individual case. This may result in considerable advisory expenses, a fact, which is typically relevant for small and medium sized businesses.

[100] See Chapter 13 Revised EM, *Consolidation, Value Shifting and Demergers Act*.

### 2.3.2. Transfer of loss assets within linked groups

Under the previous grouping rules, Subdivision 170-D deferred the recognition of a capital loss incurred by a company, member of a linked group,[101] in the course of the disposal of a CGT asset to another entity that was also a member of the same linked group or a connected entity,[102] or its associate. The loss could not be utilised until a new (CGT) event[103] happened.[104] This loss deferral rule counterbalanced the effects of CGT asset roll-overs, which were available for wholly-owned group entities. The deferred taxation of gains arising from disposals of assets to corporate group members went along with a deferred utilisation of losses made on sales of loss assets to linked companies. The removal of the CGT asset roll-over provisions made the application of the loss deferral rules redundant. Subdivision 170-D therefore ceased to operate at the end of the transitional period, 1st of July 2003, which was also the date of the final removal of the CGT asset roll-over. Nevertheless, the loss

[101] The term *linked group* was defined by subsection 170-260(2), where it was stated that 'two companies are linked to each other if:
- one of them has a controlling stake in the other; or
- the same entity has a controlling stake in each of them'.

A *controlling stake* was given if the entity or the entity and its associates are able to
- 'exercise, or control the exercise of, more than 50 % of the voting power in the company (…); or
- have (…) the right to receive for their own benefit (…) more than 50% of any dividends that the company may pay; or
- have (…) the right to receive for their own benefit (…) more than 50% of any distribution of capital of the company' (see subsection 170-260(3)).

[102] See section 170-265.
[103] See subsection 170-275(1).
[104] Section 170-270.

deferral rules are still applicable in relation to such losses, if they were already deferred prior to this date.

These deferred losses cannot be used until a new (CGT) event[105] happens.[106] The deductibility of such capital losses is therefore postponed until:

- the CGT asset ceases to exist;
- an entity that is not in the linked group or a connected entity (or associate) acquires a greater than 50% interest in the asset;
- the company holding the asset leaves the linked group;
- the company incurring the loss leaves the group; or
- a connected entity (or associate) holding the asset ceases to be connected (or to be an associate).[107]

However, this treatment of deferred losses for non-consolidating companies is not different from the rules governing the utilisation of such losses by consolidated entities. Under tax consolidation, the 'head company becomes the "originating" company in respect to the deferral event that happened under section 170-255'.[108]

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[105] See subsection 170-275(1).
[106] Section 170-270.
[107] See ATO, Tax Facts, 'Loss Integrity Measures: Transfer of loss assets within linked groups'.
[108] Glen Davis, 'Loss integrity value shifting interface' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 9.

## 3. Concluding comments

Under the principles introduced by the tax consolidation regime, group relationships with regard to loss utilisation, asset transfers, taxation of domestic and foreign business income and thin capitalisation regulations are recognised only in relation to members of consolidated groups. The almost complete removal of the previous grouping provisions confronts wholly-owned groups with a choice between full consolidation of eligible group entities and the single entity status of all group members.

Moreover, groups deciding against consolidation must cope with an array of anti-avoidance and integrity measures heavily affecting future intra-group transactions. The policy pursued by the consolidation legislation is not only to remove the grouping treatment in relation to non-consolidating entities. Eligible groups staying outside tax consolidation are virtually punished for such a decision. The current principles determining the taxation of groups support the implementation of the consolidation regime by heavily restricting the basis for an efficient operation of groups which decide to make no use of the elective provisions.

### *Chapter III: Opting for consolidation – elective provisions*

Corporate groups that are eligible to implement the elective consolidation provisions and do consider undertaking the steps necessary for their application, must understand and comply with a complex framework of policies, principles and rules sanctioned by the legislation. The analysis of how the relevant provisions affect the group on implementation should strongly influence the decision to consolidate.

The central policy underlying the consolidation legislation is expressed by the *single entity rule* (*section 1*). According to this rule, consolidated group members are regarded as one taxable business entity that is represented by the group's head company.

Accordingly, subsequent to the formation of a consolidated group, income tax liabilities arise only in the context of the entire group, not the individual group members, and must be assessed and settled primarily by the head company (*section 2*).

Furthermore, at the time of consolidation, tax values of assets owned by joining group members are restated, as they become group assets which tax values must be transferred to the accounts of the head company (*section 3*).

Consistent with the same policy, losses accrued prior to the time of consolidation are transferred to the group, unless the loss entity is not able to meet the requirements of at least one of the stipulated transfer tests. Subsequent to the transfer, these losses remain with the group's head company, even though the relevant subsidiary member may de-consolidate (*section 4*).

The single entity status of consolidating groups is further underlined through the creation of a uniform franking account in which changes to the group's franking debits and credits must be recorded (*section 5*). A uniform account must also be established for the group's foreign tax credits (*section 6*).

Importantly, the implementation of the single entity rule cannot be limited to certain group members, since the consolidation decision binds all eligible entities. At the same time, the decision to form a consolidated group is irreversible as long as the eligibility conditions are fulfilled (*section 1*).

Understanding the core rules stipulated by the legislation opens the view for the policies underlying the consolidation regime. Considering these policies, again, helps to find a more qualified access to the complex framework of the consolidation provisions. The following sections comprise an analysis into the variety of legal and, where directly related, economic implications arising from the elaborate consolidation process.

1. Consolidation core principles

The evident key policy shaping the framework of consolidation provisions is the irrevocable integration of all eligible group members. Accordingly, the following three principles take a central position within the introduced legislation:

- the *single entity rule* (*section 1.1.*);
- the *'once in, always in'* principle (*section 1.2.*); and
- the *'one in, all in'* principle (*section 1.3.*).

Implying the application of the wholly-owned approach, these principles constitute an effective basis for the transition of corporate groups into single taxable entities.

### 1.1. Single tax return (single entity rule)

The *single entity rule* is explicitly stated in subsection 701-1(1). According to this rule, a group of entities (the head company and its wholly-owned subsidiaries),[109] eligible for consolidation and choosing to consolidate, has to be treated as a single entity for the purpose of working out taxable income or loss. The subsidiary members initially forming a consolidated group or joining an already existing one lose their status as taxable entities. For taxation purposes the consolidated group members are regarded as a part of the head company. Consequently, subsequent to the implementation date of tax consolidation,[110] the single group members carry no obligation to lodge individual income tax returns. This happens at the level of the head company for the entire group, where losses, franking credits,[111] and foreign tax credits, previously held by the member entities, are pooled. The assessable income is derived and allowable deductions may be incurred only by the head company. This principle is further specified within the '*head company core purposes*'. According to subsection 701-1(2), the head company has to calculate its income

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[109] Such entities can be companies and trusts or partnerships.
[110] For income tax purpose, the implementation date coincides with the joining / formation date notified to the ATO.
The term "implementation date" is also specified by the Australian Accounting Standards Board (AASB), as 'the date from which the tax consolidation system will be applied to the taxation obligations of the entities in the tax-consolidatable group, that is, the date from which a consolidated tax return will be prepared'.
AASB, Urgent Issues Group, Abstract 52, May 2003 ('Income Tax Accounting under the Tax Consolidation System'), Discussion, No. 20.
[111] A single franking account is held and administered by the head company for the entire consolidated group. See Part B Chapter III 5.

tax liability or loss for any time during which it heads the group, or any later income period.

Since the wholly-owned subsidiaries are regarded as mere divisions of the head company, their assets and liabilities are also deemed to be acquired or to be taken over by the top entity.[112] Transactions carried out between the consolidated entities merely constitute group internal value shifts,[113] having no effect on the taxable income of the group.[114]

The following events occurring within a consolidated group therefore have no external tax effect:

- asset transfers,
- payment of management fees between group members,
- dividend payments,
- share cancellation and buy back, and
- liquidation of a group entity.[115]

[112] See Asset Rules (section 705 ff.).
[113] These "value shifts", however, trigger no application of the value shifting provisions of the ITAA 1997, as 'an entity cannot transact with itself'.
See Chapter 2 (Paragraph 2.12) EM, *Consolidations Act (No.1).*
[114] This rule corresponds with the accounting standard AASB 1024, No. 23, where the following is stated: 'In preparing the consolidated accounts, the effects of all transactions between entities within the economic entity shall be eliminated in full.'
[115] See Chapter 2 (Paragraphs 2.18 and 219) EM, *Consolidations Act (No.1)*.
Fisher, above n 70, 34.

The single entity rule is applicable from the moment the subsidiary becomes a member of the consolidated group, and retains its validity for the duration of its membership. Under the assumption that an entity's membership does not extend to the entire income year, the year has to be broken into time segments eligible for the tax return under the single entity rule and the time for which the entity has to lodge its individual tax return / returns.[116] According to the so called '*entity core purposes*' (subsection 701-1(3)), a subsidiary member has to calculate its income tax liability or loss for the period of the group membership and any later income year. This principle underlines the obligation of subsidiary members to determine their income tax obligations which originate in the income periods preceding or following group membership. Importantly, these obligations resulting from the distinction between tax treatment as an individual entity and as a group member are reinforced by the entry history rule and the exit history rule, which are both stated within Division 701. These rules are of equal relevance for subsidiary members and head companies.

[116] In the case that an entity joins and leaves a consolidated group within one financial year, there will be three income year segments. One return must cover the time before the joining time. Within the second, which is the consolidated group return, the income from the time as a member of the group is recognised. The third return deals with the period after leaving the group until the end of the (income) year (section 701-30).
See Fisher, above n 70, 34-35.

## 1.2. Irreversibility of consolidation ('once in, always in')

Subsection 703-50(2) determines that the decision to form a consolidated group is irrevocable after it has been reported to and approved by the Commissioner.[117]

This *'once in, always in'* principle stands in strong contrast to the flexibility provided by the previous group provisions under which group members could choose at the end of each income year whether to make use of the specific group rules or regard themselves as distinct entities for taxation purposes.[118] Effectively this means that under the new consolidation regime a consolidated group member will only be able to opt out of the scope of consolidation if it ceases to meet the stipulated eligibility criteria. Such a change, however, triggers a number of adjustments within the accounts of the head company and the exiting subsidiary members.[119]

[117] The irrevocability condition also relates to consolidation date notified to the ATO. Subsequent to the notification, this date cannot be amended.
[118] See Fisher, above n 70, 33.
[119] See exit history rule (section 701-40) and tax cost setting rules for membership interests of exiting group members (Division 711).

## 1.3. Scope of consolidation ('one in, all in')

Corporate groups choosing to consolidate must take into account that this step will affect all eligible (consolidatable) group members. According to subsection 703-50(1), the notification made by a head company to the Commissioner about its intention to consolidate must refer to the *consolidatable* group. The term 'consolidatable group' is defined within section 703-10 as consisting of a single head company and all subsidiary members of the group.[120]

Once the irrevocable decision to consolidate is made by the head company, all its wholly-owned subsidiaries automatically become subjects to the consolidation regime. The *'one in, all in'* principle removes the flexibility available under the previous grouping provisions enabling each individual group member to decide for each income year whether to avail itself from the group treatment.[121]

[120] The term "subsidiary" refers only to wholly owned companies, trusts or partnerships that are resident in Australia (section 703-1).
[121] See Fisher, above n 70, 33.

## 1.4. Concluding comments

The operation of groups applying these consolidation core principles builds directly on the integration policy pursued under the wholly-owned approach.

Importantly, the notion of groups as one homogenous tax entity whose eligible subsidiary members have no power to opt against the initial consolidation decision or to distance themselves from such a decision subsequent to the formation of a group is made available through the condition for the joining entities to be wholly-owned. The wholly-owned criterion enables the group's head company namely to pursue the grouping concept defined within the single entity rule and absorb all assets, liabilities and tax attributes (for instance losses and franking accounts) at the time of consolidation.

The policies, principles and rules underlying this absorption and integration process, which affect the group's initial consolidation decision are analysed further in the following sections.

## 2. Income tax liability

Corresponding to its declared area of application (section 700-1), the consolidation regime affects only liabilities relating to the taxation of the group's corporate income. Accordingly, head companies of consolidated groups have to comply with specific provisions governing the assessment and payment procedures for the group's annual income tax liabilities, the quarterly pay as you go (PAYG) instalments,[122] franking deficit tax, deficit deferral tax and general charges and penalties in respect to unpaid amounts of any of these liabilities.[123]

On the other hand, consolidation has no impact on non-income tax related tax liabilities. For example, GST liabilities must be dealt with separately by individual entities or within the relevant GST group, which may include members not eligible for consolidation.[124] Moreover, transactions regarded to be neutral for income tax purposes under the consolidation regime may trigger liabilities in connection with the indirect taxation of business activities. This is true in particular for the exchange of goods and services between entities of the same income tax consolidated group. For income tax purposes,

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[122] The Taxation Office issues a consolidated PAYG rate after receiving the group's first consolidated income tax return.

[123] For tax liabilities affected by consolidation see subsection 721-10(2).

[124] Eligibility for membership in a GST group is assessed using a 90 % stake test.
For an overview about issues arising from the interaction of GST with the consolidation regime see:
Celeste Enslin and Henry Enslin, 'GST and Consolidation – Never the two shall meet?' (2002) 5 *The Tax Specialist* 227.

the assets held by subsidiary members are considered to be owned by the head company (single entity rule). Consequently, asset transfers within the group cannot trigger any income tax liabilities. However, the deemed ownership acquired by the head company on consolidation does not establish a legal ownership for the purpose of GST. Asset transfers and services carried out between consolidated group members can therefore be considered as taxable supplies[125] and may thus result in GST liabilities.[126]

In relation to the income tax liabilities, the consolidation regime stipulates the individual and joint responsibilities of the group members, explicitly taking into consideration events affecting the composition of the group, which are the joining and / or exiting of eligible group members. As a general principle underlying tax consolidation, the head company of a wholly-owned group is required to self-assess the group's tax liability, the 'group liability' (subsection 721-10(1)(a)), and is *prima facie* liable for the resulting income tax related liabilities. In cases where the top entity fails to meet all of the

[125] Under the conditions stipulated in section 9-5 *A New Tax System (Goods and Services Tax) Act (1999)*. Subsequent references to the *A New Tax System (Goods and Services Tax) Act (1999)* will be made as to the *GST Act*.
However, as was already the case prior to the introduction of the consolidation regime, input taxed or GST-free supplies do not trigger any GST liabilities. Moreover, entities electing to form a GST group under Division 48 *GST Act* carry no GST obligations in relation to intra-group supplies.
[126] Of particular importance for the calculation of the GST liability will be the transfer prices which the consolidated group members may agree on, and the proximity of these prices to the actual market value of the goods / services under consideration. A similar example for tax liabilities arising in this context is stamp duty. However, in the case of the sale of a group entity, the "going concern" concession (Subdivision 38-J *GST Act*) may apply.
On the other hand, the transfer of assets on consolidation and the resetting of their values in the hands of a head company will have no GST implications.
See C Enslin and H Enslin, above n 124, 239.

liabilities by the time they become due and payable, the group's subsidiary members, the 'contributing members' (subsection 721-10(1)(b)), become jointly and severally liable for the outstanding tax amounts (subsection 721-15(1)). At the same time, this statutory liability of subsidiary members can be modified by the means of a tax sharing agreement (TSA) contractually defining the portion in the group's liability potentially carried by individual entities, subsection 721-15(3) in connection with section 721-25.

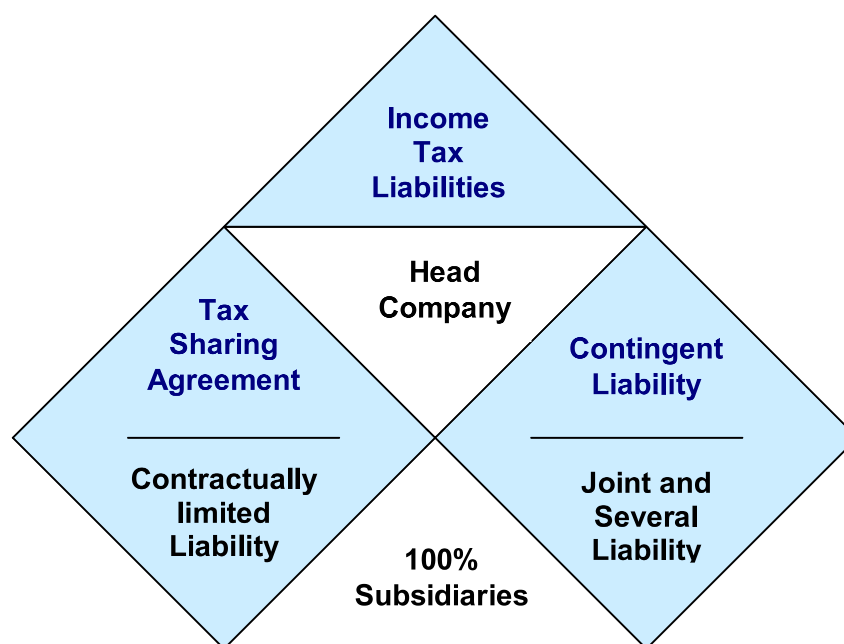


**Figure 5** Income tax liability under tax consolidation

The illustration above displays in a simplified manner the potential for statutory imposed and contractually determined co-dependencies between consolidated group members with respect to the group's income tax liabilities. The potential exposure of group members to tax

liabilities and the ways of managing this risk with the help of a TSA are analysed within the following sections.

Importantly, the formation of a consolidated group affects not only the conditions under which group members may be exposed to income tax liabilities. It also extends the responsibility of individual group members to tax obligations originating with the business activities of the entire group, even though the group's head company is primarily liable in the first instance.

The extent of, and conditions for the tax liability of the head company are analysed under *section 2.1*. The second main emphasis lies with the liabilities of subsidiary members (*section 2.2.*). The conditions for this secondary liability are discussed in *section 2.2.1*. Moreover, the potential for legal tensions arising from the simultaneous application of the liability of consolidated entities and the existing group guaranties is analysed in *section 2.2.2.*

Finally, *section 2.3.* outlines the statutory conditions allowing consolidating groups to distribute future income tax liabilities in accordance with a TSA (*section 2.3.1.*). A discussion of the opportunity for a "clean exit" under such an agreement, *section 2.3.2.*, concludes the analysis of the tax liability implications arising under the introduced consolidation policies.

## 2.1. Liability of the head company

The head company of a consolidated group carries the primary responsibility for the group's income tax liabilities, including some liabilities that result from events occurring prior to the joining time of subsidiary members (entry history rule, *section 2.1.2.*). Entities leaving a consolidated group, on the other hand, are regarded to be solely liable for the upcoming income tax liabilities to the extent that these liabilities originate from events, which happened in relation to the substance[127] taken over from the group's head company (exit history rule, *section 2.1.3.*). Upon analysis, the entry history rule and exit history rule follows an outline of the complementary obligations underlying the head company's liability (*section 2.1.1.*).

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[127] The term "substance" is used in this section as a short description for the subjects covered by the section 701-40, which are assets, liabilities and business taken over by an exiting group member.

### 2.1.1. Obligations underlying the liability

A number of complementary duties arise from the income tax liability of the head company; these include record keeping, tax assessment, payment of PAYG instalments and the reconciliation of PAYG credits with the annual tax liability resulting in balancing payments or refund requests.[128]

All of these measures are carried out by the head company on behalf of the entire consolidated group. The head company's obligations imposed by the tax consolidation regime, however, do not require it to take charge directly for the actual administration of all income tax relevant accounting procedures. Presumably, the wholly-owned subsidiaries will still process the raw (pre-consolidated) accounting data, leaving the head company with the task of adjusting these preliminary records in order to establish a basis for the calculation of a group's consolidated assessable income.[129]

Critical to the decision whether to consolidate is the practical issue of the availability of records. Where records are poor or prior tax liabilities unclear in a subsidiary, it may colour this decision. Poor prior record-keeping will add to the costs of consolidation. Consequently, consolidatable groups need to undertake careful risk analysis

[128] For the record keeping requirements, see section 262A ITAA 1936 and section 121-20 ITAA 1997.
[129] Such adjustments include primarily the elimination of intra-group transactions falling into the relevant income period.

identifying such potential deficiencies before making the irrevocable decision to consolidate.

### 2.1.2. Head company's liability for joining entities (entry history rule)

According to section 701-5, everything that happened to a subsidiary before joining a consolidated group is taken to have happened in relation to the group's head company for the purposes of calculating its future income tax liabilities or tax losses.[130]

In cases where services are provided entirely or partially subsequent to the joining time of the subsidiary, the relevant revenues generated prior to the consolidation date will be included by the head company in the group's assessable income. At the same time, the head company may also be entitled to deductions for expenditures incurred by the wholly-owned subsidiary prior to its joining time, where the entitlement to the deductions is spread beyond the joining time.[131] Finally, the entry history rule does not affect the joining entity's responsibility for tax liabilities relating to events finalised in the pre-consolidation period.[132]

[130] However, section 701-85 indicates that other consolidation provisions can modify this rule, e.g. Division 707 in relation to loss transfer and utilisation.
[131] See ATO, Consolidation Reference Manual (May 2003), Chapter C9-5-150, 1.
[132] The joining entity therefore lodges an individual tax return for the period from the beginning of the income year until its joining time.

This consolidation rule, the entry history rule, corresponds with the general income taxation principle stipulating that income is derived and can be assessed not before the services / goods to which the payments relate are provided / delivered.[133]

[133] Arthur Murray (NSW) Pty Ltd v FC of T (1965) 114 CLR 314.
'The word "income", being used without relevant definition, is left to be understood in the sense which it has in the vocabulary of business affairs (…) Nothing in the Act is contradicted or ignored when a receipt of money as a prepayment under a contract for future services is said not to constitute by itself a derivation of assessable income. On the contrary, if the statement accords with ordinary business concepts in the community (…) it applies the provisions of the Act according to their true meaning.'
At the same time, earnings without receipt do also not constitute income.
See Commissioner of Taxes (S.A.) v. Executor Trustee and
Agency Co. of South Australia Ltd. (Carden's Case) (1938) 63 CLR 108

### 2.1.3. Head company's liability for exiting entities (exit history rule)

The exit history rule, section 701-40, exempts the head company from recognition of any income tax implications relating to

- any asset,
- any liabilities, including anything that is regarded as a liability according to generally accepted accounting concepts, and
- any business,

that become part of a subsidiary leaving the consolidated group.

The exiting entity inherits the tax history attributable to the substance taken over from the head company, including the history which was initially inherited by the group under the entry history rule at the joining time of the subsidiary (subsection 701-40(3)).[134]

At the same time, section 701-75 stipulates adjustments to the taxable income of the entities affected by a de-consolidation in order to 'align the income tax position of the separating entities at the leaving time' and avoid an imbalance due to the ceasing of the application of the single entity rule.[135] These adjustments have to be taken into consideration in relation to expenditures incurred or income derived subsequent to de-consolidation. The relevant expenditures or income must arise from arrangements made between two leaving entities or a

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[134] At the same time, provisions dealing with the treatment of franking credits and losses modify this rule in accordance with section 701-85.
[135] Subsection 701-75(2)

leaving entity and the group's head company. In practical terms, the total sum of the contractual obligations / proceeds is apportioned between the time prior and post de-consolidation. The amounts falling into the post de-consolidation period are included by the consolidating head company as well as the de-consolidated subsidiary member in their respective income statements.[136]

Finally, the exit history rule has no impact on the income tax liability of the head company and the consolidated group members in relation to transactions initiated by the subsidiary prior to its de-consolidation, which are not covered by the single entity rule, since a non-consolidated third party was involved. In relation to such liabilities, the head company remains the prime liable group member. The leaving entity, however, does not achieve a "clean exit" at the time of de-consolidation. It remains co-liable under the contingent liability of all consolidated group members.[137] This liability extends to all events, including those initiated by other consolidated group members, which occurred during the membership period of the exiting entity.

[136] See also Conwell, above n 33, 14-15.
[137] However, the extent of such liabilities may be limited under the application of a valid Tax Sharing Agreement.

## 2.2. Liability of subsidiaries

In principle, subsidiary members of a consolidated group are discharged from any current or deferred income tax liabilities. Under the consolidation regime, the entire consolidated group is subject to taxation and not the individual members whose income tax obligations have to be assessed and settled by the (provisional) head company alone.[138] From their joining time on, subsidiary members are, however, exposed to a potential income tax liability, which materializes in the event of the group's head company defaulting on its obligations against the Australian Taxation Office (section 721-1).[139] This joint and several liability[140] not only reinstates the direct tax exposure as it is in place prior to consolidation of wholly-owned subsidiaries. It also extends the scope of their potential obligations which, subsequent to joining the consolidated group, relate to the full amount of the income tax-related liability of the group that arose during the period of membership.[141]

[138] This fact does not affect the ability of the group members to agree on a contractual basis for the distribution of tax expenses carried by the head company. Such "tax funding arrangements" can be concluded independently or in connection with a TSA.
See Matt Hayes and Murray Aldridge, 'Tax sharing arrangements' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 16.
[139] See also ATO Receivables Policy (April 2003), Paragraph 35.4.3.
[140] Section 265-45 of Schedule 1 of the *Taxation Administration Act 1953* specifies the term joint liability.
[141] This joint and several liability is unimpaired by payments made in connection with tax funding arrangements. The liable group members are therefore potentially exposed to a double liability, which may result in a double income tax payment.
See Hayes and Aldridge, above n 138, 10 and 15.
At the same time, group members may limit their exposure to future tax liabilities using a tax sharing agreement.
See section 2.3.

In practice, such pending obligations are of particular importance for prospective purchasers of subsidiary members.[142] A "due diligence" process needs to carefully address the risk of the de-consolidating entity becoming liable for the group's income tax obligations accrued prior to the time of exiting the group. However, this task may prove difficult and require an analysis of the entire group, as risks related to tax liability will be recognised within the financial accounts of subsidiary members only in cases where the default of the head company is considered probable.[143]

The contingent income tax liability may also become relevant for (corporate) trustees owing fiduciary duties to trust beneficiaries, all of whom are members of a consolidated group.[144] The trustee of a trust which is wholly-owned and therefore eligible for consolidation, itself not a member of the group, is regarded as 'the entity responsible for the activities carried on for the purpose of the trust', which directly exposes it to the tax liabilities of the entire consolidated group.[145] A subsequent reimbursement of the trustee out of the trust assets, reimbursement to all reasonable expenses incurred in administration of the trust,[146] may fail, as it appears doubtful whether such tax liabilities of the head company can be classified as reasonable

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[142] See Grant Cathro, 'Consolidation – Contractual issues arising for Buyers and Sellers of Companies' (2003) 6 *The Tax Specialist* 135, 138.
[143] AASB, Urgent Issues Group, Abstract 52, Consensus, No. 12.
See also Part C Chapter I 3.2.
[144] For the obligations of trustees in relation to the trusts' tax liabilities see section 254 ITAA 1936.
[145] Hendriks, above n 28, 12.
[146] *Worrell v Harford* (1802) 32 ER 250, 252.

expenses in administration of the trust. Moreover, such reimbursement may not be economically feasible, since a consolidated group's income tax obligations have the potential to considerably exceed the value of the trust property.[147]

Finally, companies facing the group liability may engage in insolvent trading without being aware of the situation. This possibility must be thoroughly monitored by company directors, whose duty is to prevent the company from trading while insolvent (section 588G *Corporations Act 2001*). At the same time, creditors considering the financial capacities of a subsidiary member may not recognise an imminent or already materialized threat resulting from the group liability.[148]

[147] Hendriks, above n 28, 12
[148] See also Chapter 11 (Paragraph 11.3) EM, *Consolidations Act (No.1).*

### 2.2.1. Conditions for the contingent liability

The statutory rules governing the contingent income tax liability of consolidated entities are mandatory only in the absence of an effective TSA (subsection 721-5(a)). Lacking such agreement, group members carry severally and jointly the responsibility for the head company's unsettled group liability (subsection 721-10(1)(a)), unless the liability relates to periods which are not congruent with the relevant membership periods of the subsidiaries under consideration (subsection 721-10(1)(b)).[149] At the same time, entities which, by virtue of Australian law, are prohibited from entering into arrangements under which they become subject to such liability, cannot be considered contributing members (subsection 721-15(2)).[150] Where such exclusion is not applicable, the liability of a particular group member becomes due and payable 14 days after receiving a written notice from the Commissioner (subsection 721-15(5)).

[149] Concluding from the wording of subsection 721-10(1)(b), 'entities (…) where subsidiary members of the group for at least part of the period to which the group liability relates', subsidiaries exiting the group part way through a period are liable for taxes with respect to the entire period.
See also Cathro, above n 142, 139.
[150] However, such entities are likely to become liable under a TSA, where their activities contributed towards the accrual of the group liability.
See Chapter 11 (Paragraph 11.24) EM, *Consolidations Act (No.1)*.
See also ATO Receivables Policy (April 2003), Paragraph 35.3.13.

### 2.2.2. Contingent liability and cross group guarantees

Regardless of the contingent liability for income tax amounts, consolidatable group companies may already be bound by a joint liability prior to the implementation of the consolidation regime. Under the conditions determined by the Australian Securities & Investments Commission (ASIC) Class Order (CO) 98/1418, among them mainly the conclusion of an agreement under a deed of cross guarantee between wholly owned subsidiaries, their head company and an independent trustee, wholly-owned group members are relieved from preparation, auditing and distribution of individual financial, directors' and auditors reports. The group's disclosure requirements are confined to the issuing of consolidated accounts. In return, pursuant to the guarantee and in accordance with the deed, the companies involved are required to make payments to creditors for any future unsettled group debts. This obligation is sealed by a covenant with an initially nominated trustee.

The wholly-owned eligibility criterion establishes a close association between the composition of groups operating under cross group guarantees and those having the choice to elect tax consolidation. Despite this parallel, however, the differences between the two legal constructs should dominate in practice.

Foremost, in contrast to the tax consolidation rules, a group entity becomes party to the deed through an individual and revocable decision. Furthermore, such a step will only be undertaken by incorporated group members, previously exposed to wide reporting obligations.[151]

The conditions under which a guarantee becomes effective also differ substantially from those triggering an obligation under the contingent tax liability (Division 721). The purpose of a deed is to provide security to creditors in the case of an insolvency of a liable group member.[152] The contingent liability, on the other hand, becomes relevant when the head company is not fulfilling its duty to pay an outstanding income tax amount or such failure is anticipated.

From this it follows that, under the present legal conditions, consolidated group members may become liable for income tax amounts originating from activities undertaken by group members operating beyond the scope of an existing guarantee. Moreover, such liabilities become due and payable independently from the fulfilment of conditions specific to the claims arising under a deed.

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[151] Trusts and partnerships, potentially members of a tax-consolidated group, will not constitute parties under the covenant.
[152] *Westmex Operations Pty Ltd (in liq) and Ors v Westmex Ltd (in liq) and Ors* (1992) 8 ACSR 146, 151-152.
See also Damien Murphy, 'Holding company liability for debts of its subsidiaries: corporate governance implications' (1998) 10 *Bond Law Review* 241.

Consequently, the joint liability under tax consolidation potentially affects the position of creditors relying on the group's resources, subject to claims under a guarantee in the event of the insolvency of a group member. The use of guarantees under the ASIC CO 98/1418, at the same time, cannot trigger detrimental effects on the Australian Taxation Office's (ATO) revenue collection.

## 2.3. Tax Sharing Agreement (TSA)

The income tax related risks arising for group members, with joint and several liability for the unsettled group liabilities potentially threatening the economic substance of the wholly-owned subsidiaries, have the potential to dominate the considerations made prior to a decision on whether or not to implement tax consolidation. Importantly, as the discussion of the current rules illustrated, these risks continue to be relevant even after the de-consolidation of a group entity.

The only tool for managing exposure to this risk, that is made available for members of consolidated groups, is the conclusion of a TSA, in which the head company and its subsidiaries are able to predetermine their responsibilities in regard to the group's future income tax related liabilities.[153] For the participating entities, the TSA constitutes a binding contractual obligation whose purpose and scope of application is defined and sanctioned by consolidation provisions (section 721-5).[154]

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[153] The quarterly PAYG installments and the income tax liability resulting from the final assessment need to be addressed separately, since these obligations are separate group liabilities.
See Hayes and Aldridge, above n 138, 16.
[154] The Australian Accounting Standards Board (AASB) has also adopted the concept of TSA for income tax accounting issues.
See Part C Chapter I.
Already prior to introduction of the tax consolidation legislation, similar agreements were drafted as a precursor to disinvestments.
See Tony Stolarek, 'M & A due diligence' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 18.

Regardless of the existence and contents of such an agreement, the head company always remains primarily liable. Consistent with the general principle stated by subsection 721-10(1), the TSA may be called upon only in the event of the head company defaulting on the group's tax liability. If applicable, however, a TSA overrides the discretionary powers regularly exercised by the ATO pursuant to the statutory imposed, joint and several liability of consolidated group members. The due and payable tax liability must be recovered in accordance with the contractually stipulated contribution amounts.

Admittedly, in practice, such agreements will presumably be subjected to close scrutiny by the ATO. The numerous explicit and unspecified conditions imposed by Division 721 allow the Commissioner to challenge the validity of a TSA. To date, the ATO has not released a "*pro-forma*" TSA and it cannot be assumed that such a template will be introduced in the foreseeable future.[155] On the other hand, the Receivables Policy (April 2003) released by the ATO provides detailed guidelines concerning the required form of TSA and the reasonable allocation of the group's tax liabilities.[156]

The drafting process of a TSA requires a thorough analysis and understanding of the statutory framework relevant to its effectiveness as well as the binding conditions set by the taxation authorities.

[155] Hayes and Aldridge above n 138, 6.
[156] See also Chapter 11 (Paragraph 11.29) EM, *Consolidations Act (No.1).*

The following analysis, *section 2.3.1.*, concentrates on the various conditions determining the effectiveness of TSA. *Section 2.3.2.* provides an insight to the rules governing a “clean exit“, allowing subsidiary members to de-consolidate clear of a group liability, which can be achieved under the application of a valid TSA.[157]

[157] For comments on issues arising from group liability and application of TSA, including the perspective of purchasers acquiring group entities, lenders and directors of both head companies and subsidiary members, see also
Jane Trethewey, Stephen Barkoczy, ‘Dealing with tax-related liabilities and tax-sharing agreements under the consolidation regime’ (2003) *Keeping Good Companies* 429, 430-431.

### 2.3.1. Effectiveness of TSA

The legal and economic implications of a TSA make its effectiveness a highly sensitive issue. It has far-reaching consequences for entities maintaining their status as subsidiary members as well as those leaving a group under the assumption of a "clean exit". On one hand, a successful challenge to a TSA may undermine the liquidity of subsidiary members that did not participate in the agreement and were consequently relieved from any future income tax liabilities,[158] or whose obligations were limited to a reasonable amount. On the other hand, subsidiary members exiting a group and paying a "contribution amount" (section 721-35) to their head company in order to clear themselves of the group's tax obligations, may nevertheless share the joint and several liability with the remaining group members for tax amounts accrued prior to their leaving time.

At the same time, it can be difficult to comply with the present conditions relevant for the drafting of a TSA, since a number of crucial issues remain vague or subject to continuing discussions. In the absence of Australian precedent, the effectiveness of a TSA can be ensured primarily through correct interpretation and implementation of the statutory rules and careful consideration of guidelines provided by the ATO in its Receivables Policy. Section 721-25 takes a central

[158] Since the application of a TSA makes the joint and several liability redundant, group members not bound under the agreement carry no immediate obligations in relation to the group's income tax liabilities.
See Cathro, above n 142, 139.

position in this context, determining principles in relation to the following issues:

- time of conclusion (*section 2.3.1.1.*);
- allocation of liabilities (*section 2.3.1.2.*);
- purpose of arrangements (*section 2.3.1.3.*); and
- submission in approved form (*section 2.3.1.4.*).

These conditions are subject to close analysis in the following sections.

### 2.3.1.1. Time of conclusion

According to subsection 721-25(1)(a), a tax liability is covered by a TSA, if, just before the head company's due time (section 204(1A) ITAA 1936), an appropriate agreement between the group members was in place. This condition implies that groups operating under such an agreement should regularly reassess its contents and ensure prior to the lodgement of the consolidated tax return that the updated TSA correctly reflects the composition of the group and the intended distribution of tax liabilities among its members. This would mean, for the majority of consolidating entities, that the updating process, including the necessary consultations between the contributing entities, must be completed no later than 1. December of the relevant income year.[159] However, in the case of a contributing member exiting its consolidated group prior to this date, the time of leaving should be regarded as the deadline for finalising the contractual regulations under a TSA.[160]

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[159] This date refers only to the annual income tax liability. Different due dates will apply to TSA dealing with the quarterly PAYG installments.
[160] Hayes and Aldridge above n 138, 13.

#### 2.3.1.2. Allocation of liabilities

A TSA is considered valid and functional only if all contributing members are assigned a defined amount in relation to the group liability (subsection 721-25(1)(b)).[161] At the same time, the freedom to contract exercised by the parties under the agreement is limited by the statutory requirement for the allocation of the tax liabilities to be "reasonable" (subsection 721-25(1)(c)).

The consolidation provisions do not provide any explicit criteria for an objective assessment of the reasonability of the tax allocation. Concluding from the anti-tax-evasion perspective, the distribution of liabilities should take into account the economic capacities represented by each contributing member entering a TSA. Furthermore, although it is not mandatory for all consolidated group entities to become parties under the agreement, an involvement of all members should contribute considerably to the prospect of a TSA being considered reasonable.[162] Importantly, according to the ATO Receivables Policy, the method for the allocation of the tax amounts should reflect the actual contribution to the group profits or the actual or expected proportion of the group liability originating with each group member.[163]

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[161] This means that the TSA should specify a mechanism for the apportioning of group liability among the contributing members or name explicit contribution amounts.
[162] Hayes and Aldridge assume that 'the language of the Division 721 suggests there is an "all in" principle when drafting a TSA'.
Hayes and Aldridge above n 138, 9.
[163] ATO Receivables Policy (April 2003), Paragraph 35.4.34.

When faced with only vague specified conditions, consolidating groups should give high priority to a balanced distribution of tax obligations, as even the failure to allocate tax liabilities reasonably in relation to only one contributing member will presumably effect the complete termination of a TSA. The same consequence may be triggered in cases where it is considered unreasonable that only a limited number of group members entered a TSA and where economically significant entities declined to participate in the agreement.[164]

Finally, since the composition of consolidated groups and the economic capacities represented by respective members may be subjected to considerable changes, a TSA regarded to provide a reasonable allocation of liabilities in a previous income year would, if unchanged, not necessarily be accepted by the ATO for subsequent periods.[165] Group entities concluding such an agreement should therefore implement a practicable mechanism for its regular updating, paying attention to the upcoming legislative developments and the interpretation of the existing principles employed by courts and tax authorities.

[164] See Cathro, above n 142, 139.
Hayes and Aldridge above n 138, 9.
[165] See ATO Receivables Policy (April 2003), Paragraph 35.4.34.

#### 2.3.1.3. Purpose of arrangements

A TSA is void where it has been concluded as part of an arrangement with the purpose 'to prejudice the recovery by the Commissioner of some or all of the amount of the group liability or liabilities of that kind' (subsection 721-25(2)(b)). In practical terms, a TSA must not be considered as a legalised opportunity for arrangements aiming at tax evasion. This comprehensible principle correlates with the remaining conditions stipulated by section 721-25. Concluding from the findings discussed above, the following factors can indicate the existence of a permissible purpose underlying such an agreement:

- all consolidated entities with a substantial involvement in activities generating income / holding significant assets become contributing members (the assigned tax liability is roughly equivalent to the proportion of income generated by the respective contributing members);

- the allocation of tax liabilities can be aligned with the financial capacities represented by the contributing members (the solvency of contributing members matches the extent of the assigned tax liabilities); and

- the TSA is updated in order to reflect the current state of the above-mentioned conditions for income periods following its initial drafting.

In summary, a TSA should be based on conditions making it foreseeable for the contributing members[166] that the accruing income tax liabilities, including such liabilities due to changes in the assessment for previous income periods, will be fully settled as they become due and payable.[167]

In this context, it remains questionable, however, to what extent a stipulated contribution of the head company will be considered reasonable and consistent with a sound purpose of such agreement. A TSA is called upon only in cases where the head company defaults on the group liability. One of the major reasons for such default may be insolvency. Under such circumstances, the application of a TSA will inevitably trigger a renewed default on the side of the head company which remains unable to pay the contribution amount assigned to it by the agreement. At the same time, this amount of group liability cannot be recovered from other contributing members, since the joint and several liability does not affect a group operating under a TSA.[168]

[166] The wording of the provision, 'agreement (…) was entered into as a part of an arrangement', indicates that the subject matter should be assessed primarily with regard to the actual objectives of the contracting parties, as they can be deduced from the allocation procedure stipulated by the TSA and the resulting distribution of liabilities among the contributing members.
[167] The TSA functions solely as a means for the distribution of the existing group liability. It cannot have any influence on the assessment of the annual income tax obligations. Therefore, the purpose of its conclusion has to be analysed with regard to its impact on the ATO's capacity to recover tax revenue.
[168] In order to avoid such outcome, the contributing members may agree on conditions under which they would cover the group liability making payments beyond the defined contribution amounts. Unsettled liabilities could be covered by the solvent contributing entities using their initial contribution amount as a measure for the proportion of their obligation relating to the remaining group liability.

#### 2.3.1.4. Submission in approved form

The distribution of tax liabilities under a TSA will be taken into account by the ATO only in cases where a copy of the agreement was submitted to the Commissioner not later than 14 days after the group's head company receives a written notice (subsection 721-25(3)).[169]

Furthermore, the submitted TSA must comply with requirements concerning its form. The term "approved form" (subsection 721-25(3)(b)) is not specified by the consolidation legislation, but within the ATO Receivables Policy. According to ATO, a TSA meets the "approved form"-requirement only when it:

- is in writing;
- shows the date of execution;
- specifies what group liability / liabilities it covers;
- provides for a reasonable allocation of entire group liability and summarises the method used to allocate this liability;
- is executed by the head company and each contributing member that is party to the agreement; and
- enables the Commissioner to precisely determine the individual contribution amounts assigned to the contributing members.[170]

[169] The 14 day term corresponds to the period between receiving of a written notice from the ATO and becoming jointly and severally liable under subsection 721-15(5), which is applicable in the absence of a TSA or in cases where such agreement is not forwarded to the ATO and is therefore deemed to be non-existent.
[170] ATO Receivables Policy (April 2003), Paragraph 35.4.27.
In practical terms, the contribution amount of each contributing member can be determined as a fixed or variable percentage of the group liability.
See ATO Receivables Policy (April 2003), Paragraph 35.4.32.

### 2.3.2. Clean exit under TSA

Pursuant to section 721-35, an exiting group member that is a party to a TSA can leave the group clear of pending income tax liabilities, provided that:

- the group liability is covered by a valid TSA;
- the exiting entity (contributing member under a TSA) leaves the group before the group's liability becomes due and payable;
- the cessation of the membership was not part of an agreement with the purpose of prejudicing recovery of the group liability; and
- prior to leaving the consolidated group, the contributing member paid to the head company an amount attributable to the group liability, or, in cases where an exact contribution amount cannot be determined, an amount which is a reasonable estimate of, and attributable to such an amount.

Immediately prior to exiting the group, the respective entity "pre-pays" the tax-amount equivalent to its obligation under the TSA. With this step, the exiting group member is freed from any further obligations concerning liabilities covered by the TSA.

No such “liability clearing” applies, however, to obligations which become due prior to the leaving time of the contributing member. This principle correlates with section 721-25 and the postulate for the conclusion of a valid TSA prior to the head company’s due time. From this it follows that a leaving group member remains liable for the group liability beyond the conclusion of its membership where

- the head company already defaulted in payment of a group liability, or
- the group receives an amended assessment relating to a previous income period.[171]

The calculation of a reasonable contribution amount payable to the head company on exit from the consolidated group may also constitute a difficult task. Depending on the leaving time of the entity, the determination of its correct share in the group liability will have to rely more on estimated than actual figures. According to the general liability conditions, membership in a consolidated group for only a part of an income period triggers a responsibility for group liabilities relating to the entire period.[172] An entity leaving the group at the beginning of the income year should find it very difficult to estimate its reasonable involvement in the annual group liability.

[171] See also Cathro, above n 142, 139.
Hayes and Aldridge above n 138, 15.
[172] See also Trethewey and Barkoczy, above n 157, 430.

At the same time, under the rules governing the validity of TSA, the contribution amount has to be “reasonable”; a term which can relate strongly to the income generating capacities of a particular group member. A reasonable estimate of the “reasonable contribution amount” may therefore be based on the ascertainable share in the group’s income generating activities as they occurred prior to the leaving time. However, in the absence of further clarifying statements from the side of the ATO, any calculation of the contribution amount should rather be orientated on a “generous” estimate of the reasonable share in the group’s annual income tax liability.

Finally, an exiting group entity will only achieve a clean exit where the TSA fulfils all validity conditions stated in section 721-25. Payments made bona fide under the assumption of the validity of a TSA cannot discharge a leaving entity from the statutorily imposed joint and several liability for the group liability in cases where the agreement will subsequently be found not to fulfil its mandatory effectiveness requirements.[173]

Moreover, despite the existence of a valid TSA, a leaving contributing member may still be made responsible for the group liability if the head company fails to timely submit the TSA in a form approved by the ATO (subsection 721-25(3)).

[173] For example, the TSA may be declared void, since the contributing amount assigned to one of the group members is regarded to be not reasonable. The fact that the contribution payment made by the exiting entity reflected its reasonable share in the group liability does not affect the arising joint and several liability for the amount due and payable to the ATO.

Under such circumstances, payments made to the head company prior to exiting the group will be considered irrelevant in relation to the group liability, since the TSA will be deemed to be non-existent. Consequently, entities applying the clean exit provision face events which they can hardly predict, or such which remain beyond the scope of their influence.

### 3. Asset rules

According to the single entity rule, all members of a consolidated group are considered to be a part of the head company. Under this assumption, the tax value of interests held in the joining subsidiaries has to be eliminated on consolidation, to be replaced by (reset) tax values of the group's assets. Consequently, the tax cost of the joining subsidiaries' assets are restated on consolidation with the main focus on the cost of membership interests in the accounts of the head company and remaining group entities, the liabilities incurred prior to the joining time, certain economic losses and (pre-consolidation) retained profits.[174] In other words, in the process of consolidation, the tax cost of membership interests is virtually "pushed down" to the member's assets and liabilities,[175] which results in an evaluation of the actual costs incurred by the group "acquiring" the joining entity.[176] This alignment of the asset values with the tax cost of membership interests allows for a tax neutral transfer of assets between consolidated group members.[177] Subsequent to the implementation of the consolidation asset rules, CGT asset transfers are regarded as group-internal value shifts.

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[174] However, transitional rules allow for the maintenance of the historic tax cost base of assets.
For the rules governing the cost setting process for consolidating partnerships, see Subdivision 713-E.
[175] See Dominic Smith, 'Consolidations – comments on the Asset Rules' (2002) 36 (10) *Taxation in Australia* 532, 533.
[176] See subsection 705-10(2).
[177] See Fisher, above n 70, 41.
Subsection 705-10(3).

In its primary form, the method for the calculation of reset tax cost of assets that are brought into a consolidated group has already been outlined within the *Ralph Report* (Paragraph 15.5). The *ongoing model*, or *ongoing method* as it was subsequently named, which was introduced in the report, has been adopted into the consolidation legislation. The tax cost setting rules have to be applied in cases where

- an entity joins an existing consolidated group (Subdivision 705-A),[178]
- a consolidated group is initially formed,[179] and
- a consolidated group joins an existing consolidated group or multiple entities linked through membership interests are joining a consolidated group.[180]

[178] Subject to modifications applicable for MEC groups (Subdivision 719-C).
[179] Subject to modifications governed by Subdivision 705-B:
- subsection705-145(2); adjustment to the Step 1 ACA calculation – order for working out the cost setting amounts where subsidiary members have membership interests in other subsidiary members;
- section 705-150; adjustment to the Step 3 ACA calculation – decrease / increase of the Step 3 amount for the head company CGT roll-over recipient (subsidiary member) and interposed entities;
- section 705-155; adjustment to the Step 4 ACA calculation – no reduction of the ACA amount of an interposed entity for profits received from a subordinated entity that reduced its ACA amount by the sum of the distribution;
- section 705-160; adjustment to the calculation of the reset cost base assets – the market value of an entities interests in a subordinated entity is increased by the loss subtraction amount (subsection 705-160) where the second entity's ACA was decreased by a loss subtraction amount determined by Step 5 ACA calculation;
- section 705-163 – numerous modifications to the application of section 705-57;
- section 705-165 – adjustment to the method of working out pre-CGT factors under section 705-125 (pre-CGT factor to be worked out from top to down).

[180] Subject to modifications governed by Subdivision 705-D; due to the narrow scope of this thesis, these rules cannot be discussed in detail.

According to subsection 701-10(4), 'each asset's tax cost is set at the time the entity becomes a [wholly-owned] subsidiary member of the [consolidated] group at the asset's tax cost setting amount'. The meaning of the expression 'an asset's tax cost is set' is determined by section 701-55 specifically in relation to depreciating assets, trading stock and CGT provisions. In relation to the procedure for working out the tax cost setting amount for assets brought into a group, item 1 of section 701-60 refers to Division 705 (section 705-20). In the cost setting process the main distinction is made between the assets whose value remains unchanged, *retained cost base assets* (section 705-25), and such assets whose cost must be reset on consolidation, *reset cost base assets* (section 705-35).

The calculation of a head company's acquisition costs for assets, the reset asset values, is in accordance with two main steps which are both defined by Subdivision 705-A. These steps are:

- the evaluation of the *Allocable Cost Amount* (ACA), which constitutes the maximum sum of asset values post-consolidation; and
- the calculation of a *deemed payment* for each of the assets, in the process of which the ACA is allocated to group's retained and reset cost base assets.

These deemed acquisition costs for consolidated assets determine the amount of capital gains or losses made at the time of disposal of the group's equity. In this context, the application of the *ongoing method* aims to eliminate any differences in income tax implications in the case of the disposal of either member interests or assets held by consolidated entities.[181] Such an outcome can be achieved, since the asset values established on consolidation reflect the historic tax cost, respectively the market value of member interests, increased by accrued liabilities and adjusted by taking into account certain profits and losses:

*Assets = Member Interests + Liabilities + (certain profits – losses)*

On the other hand, the termination values of assets held by a consolidated entity are taken to be the basis for the reconstitution of the tax cost of interests held by the same group member in the case that these interests are disposed of (subsection 711-20(1); Step 1).[182] This means that, at the time of de-consolidation, the value of member interests reflects the terminating value of assets, reduced by accrued liabilities and adjusted in relation to certain deductions, receivables and unrealised net losses:

*Member Interests = Assets – Liabilities + (certain deductions + receivables from group members – unrealised net losses)*

[181] See Northeast, above n 21, 76.
[182] See Note to subsection 705-10(3) and subsection 701-15(2).

The use of terminating values of assets for the calculation of the tax value of member interests on de-consolidation ensures that the cost base underlying the assessment of potential capital gains or losses made by the group on the disposal of interests corresponds with the cost base applied in connection with the disposal of consolidated assets held by a subsidiary member.[183] In other words, subsequent to consolidation, the tax value of interests and assets is the same.

At the same time, the implementation of consolidation rules does not imply the complete removal of the existing differences between the tax implications following the disposal of interests and the sale of assets / trading stock. A disposal of interests is still taxable on capital account, in which case the CGT provisions stipulate the calculation of potential gains or losses. For asset sales involving depreciable assets, on the other hand, gains and losses will be on revenue account and be influenced by balancing adjustment provisions.[184]

Moreover, changes in the trading stock account are considered with regard to the tax-neutral value (subsection 701-35(4)) set at the joining time, respectively the current market value in the case of the so called 'continuing majority-owned entities' (subsection 701A-5(2)).[185]

[183] See also Mark Northeast, 'Consolidation – SMEs' (2002) 36 (9) *Taxation in Australia* 481, 484.
[184] See Amanda Leckie, 'Buying and selling a business' (2002) 37 (1) *Taxation in Australia* 32, 37-38.
[185] See Part B Chapter III 3.2.1.

The procedure for the establishment of the reset tax cost, the tax cost setting amounts for reset assets, is set out by section 705-35. This provision determines that 'for each asset of the joining entity (a reset cost base asset) that is not a retained cost base asset or (…) an excluded asset (…), the asset's tax cost setting amount is determined by:

(a) first calculating the joined group's allocable cost amount for the joining entity in accordance with section 705-60; and

(b) then reducing that amount by the total of the tax cost setting amounts in accordance with section 705-25 for each retained cost base asset (but not below zero); and

(c) finally, allocating the result to each of the joining entity's reset cost base assets (other than excluded assets) in proportion to their market values'.

The following analysis deals with policies and provisions determining the extent of efforts arising directly or indirectly from the implementation of the asset rules at the time of consolidation and / or during the income periods subsequent to that event.

*Section 3.1.* shows the details of the remarkably complex and potentially expensive procedure for the calculation of the ACA. The rules for the subsequent distribution of this amount, in the process of which the tax cost of assets owned by joining entities are reset, are discussed within *section 3.2*. Referring to the distinction provided

by the legislation, the ACA distribution rules are analysed separately in relation to retained (*section 3.2.1.*) and reset cost base assets (*section 3.2.2.*). In the context of resetting the assets' tax cost, *section 3.2.2.1.* identifies the deferred tax assets to be the main group of assets which tax cost must not be changed on consolidation. Moreover, *section 3.2.2.2.* demonstrates the importance of the correct allocation of the relevant value to the goodwill existing at the time of consolidation, which, in the absence of specific provisions, may constitute a difficult and costly task.

Importantly, the resetting of pre-consolidation tax cost is not mandatory during the transitional period stipulated by the legislation. The use of the transitional option to retain the existing asset values is discussed within *section 3.3.*

The last section (*section 3.4.*) to deal with asset rules provides a critical assessment of the potential effects arising from the implementation of ACA provisions, among the most important of which are significant tax cost reductions and diminishing depreciation claims. Admittedly, the assessment of these effects and the extent of costs and benefits potentially associated with the changes occurring in the wake of the implementation of the asset rules should constitute the core factors determining the willingness of companies heading consolidatable groups to opt for the application of the elective consolidation provisions.

### 3.1. ACA calculation

The (acquisition) cost amount allocable to the reset tax cost of consolidated group assets is determined in accordance with the nine steps stipulated in section 705-60. Compliance with this procedure constitutes a major compliance hurdle in the process of consolidation.

#### 3.1.1. Step 1 (cost base of interests)

As discussed above, the process of consolidation requires the elimination of the book value / tax cost assigned to the member interests held by the head company and / or other group entities. Assets owned by entities forming a consolidated group become the head company's assets. These assets' cost are restated with prime regard to the eliminated cost base of member interests. The process of the calculation of the allocable cost base of interests is stipulated by Step 1 ACA (section 705-65).

The cost used for membership interests is the amount that would be the cost (the relevant cost) for determining the CGT outcome if the membership interest were disposed of at the joining time.[186] That definition implies a potential for adjustments in the established

[186] Chapter 5 (Paragraph 5.56) EM, *Consolidations Act (No.1)*.

(reduced) cost base of interests through the application of value shifting and / or tax loss transfer provisions (subsection 705-65(3)).[187]

In cases where the cost base of member interests exceeds the amount of the market value or the market value exceeds the reduced cost base, the market price for member interests determined on consolidation constitutes the first element of the allocable costs. The valuation of unlisted companies and trusts or partnerships may prove difficult in this context, since, as a rule, no established market valuation can be obtained. The resulting market values must nevertheless be accurate, as the amount that is determined under Step 1 constitutes the basis for further calculation of the allocable costs. Moreover, the ATO applies a number of formal principles for the valuation process which should be considered by consolidating groups:

- compliance with the ATO's documentation and record keeping guidelines;
- independence and qualification of the person undertaking the market valuation process; and
- observance of the ATO's requirements stipulating the way in which the market valuation has to be commissioned and carried out.[188]

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[187] See Part B Chapter III 3.4.2.1.
See Chapter 5 (Paragraph 5. 62) EM, *Consolidations Act (No.1)*.
[188] ATO, Consolidation Reference Manual (May2003), Chapter C4-1, 12.

Compliance with these formal requirements is likely to constitute a costly element of the consolidation process.

According to section 139FB ITAA 1936, a valid valuation of unlisted shares can be carried out by a “qualified person”, a registered company auditor (section 139FG ITAA 1936). In cases where such valuation was carried out in connection with shares previously issued under an employee share acquisition scheme (ESAS shares), the established market value can be used in relation to all remaining membership interests.[189]

Finally, the ATO does not recognise a general responsibility for providing comprehensive guidance, which would cover all relevant aspects of the valuation process.[190] Admittedly, the *Consolidation Reference Manual* does provide formal requirements, valuation short cuts as well as references in relation to managing risks and compliance in the valuation process. However, where no objective market values are already established, the consolidating entities have no other choice than to commission an independent company auditor with the valuation of the member interests.[191] The burden of proof in relation to the correctness of the calculated market values lies after all solely with the taxpayer, which is the group’s head company.

[189] See ATO, Consolidation Reference Manual (May 2003), Chapter C4-1, 24.
[190] See ibid Chapter C4-1, 29.
[191] According to Tax Determination TD 2003/10, expenditures for such market valuations are considered as tax-related expenses for the purpose of section 25-5 and are therefore deductible.

### 3.1.2. Step 2 (liabilities)

The consolidation of the entire asset values owned by joining subsidiaries in the hands of their head company results in the requirement to pay attention to the sources of their financing, which can be either equity or debt capital.

The debt capital accrued in accordance with the accounting standards or statements of accounting concepts formulated by the AASB constitutes an obligation of the group and must therefore be added to the allocable costs evaluated under Step 1 (section 705-60 in connection with subsection 705-70(1)).[192] At the same time, some of the liabilities may constitute obligations owed only to consolidated group members. Since such liabilities cease to be assets of the group, they should also be recognised as a component of the costs incurred at the time of consolidation.[193]

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[192] Importantly, small businesses, generally operating through non-reporting entities, are often not required to comply with AASB accounting standards. The identification of liabilities in accordance with such standards requires therefore an elaborate process of transforming the existing figures, including a reassessment of past events and the consideration of potential future obligations.
See also Wayne Rogers, 'Consolidations - entities' (2002) 36 (9) *Taxation in Australia* 476, 478.
See Northeast, above n 21, 75.
[193] Chapter 5 (Paragraph 5.65) EM, *Consolidations Act (No.1)*.
The value of a liability is the relevant value for the consolidated group, not the value for the joining entity alone. At the same time, according to the note to subsection 705-70(1), 'liabilities that the joining entity owes to members of the joined group would not be excluded even though the standards or statements require that they be eliminated in consolidated accounts of a parent entity and its subsidiaries'.
See also Peter Murray and Sid Hammel, 'Capital allowance' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 6.

In order to reflect the economic costs for obtaining ownership in joining subsidiaries, the established amount of accounting liabilities has to be adjusted in accordance with rules stipulated by sections 705-70 to 705-85.

According to subsection 705-70(2), liabilities attached to assets, which on disposal of the assets are transferred with the assets must be deducted from the amount in Step 2. The legislation provides an example following this provision, in which the liability to rehabilitate a mining site reduces the total amount of liabilities taken into consideration. Nevertheless, it is difficult to follow the logic underlying this rule and its example.

On the disposal of consolidated assets the accrued liability that is transferred together with the asset to the new owner diminishes the market value of the asset. In the case that the liability accrued after the asset was acquired or produced by the consolidating entity (the seller), the transfer of the liability to the buyer happens only in a legal sense. The seller who receives a market price for the goods, which is reduced by the liability, carries the economic burden of the liability.

**Example 1**: Reduction of the ACA by liabilities attached to assets

> Subco is the owner of a mining site with a market value of AUD 45,000,000. The future rehabilitation costs are estimated at AUD 500.000. At the joining time, Subco's accrued liabilities are AUD 1,000,000.
>
> According to subsection 705-70(2), the liabilities used for the calculation of the ACA must be reduced by AUD 500,000 which would be transferred with the joining entity's asset (the mining site) in the case of its disposal.
>
> However, disposing the site, the group can expect to receive the amount of only 44,500,000 (the market value of 45,000,000 reduced by the accrued rehabilitation costs of 500,000).
>
> Consequently, the buyer of the site carries merely the legal responsibility / liability for the rehabilitation costs. The economic costs / liability are not transferred with the disposed asset.

On the other hand, where the liability accrued completely or partially prior to the acquisition of the goods, the liability belonged to the costs for the ownership of the object carrying the liability. These costs can be "transferred" on subsequent disposal of the asset.

Considering these arguments, the deduction of such liabilities from the ACA may unfairly diminish the basis for the resetting of the consolidated assets to the extent that the liability was incurred during the time of ownership of the asset.[194]

[194] See also Smith, above n 175, 534.

A further reduction of the amount calculated under Step 2 has to be undertaken in relation to liabilities that trigger tax deductions when discharged (subsection 705-75(1)). Among others, employee leave provisions fall under this category of liabilities.[195] With this deduction, the costs for the acquisition of the consolidated assets are correctly reduced by the amount of future tax benefits which will result from liabilities accrued prior to joining time. This measure aims to ensure that 'only the net cost to the group of the liability is taken into account as a cost of acquiring the entity'.[196] Consequently, the deduction amounts to the sum of the tax benefit arising from the particular liability, reduced by a double-accounting adjustment which accounts for any reduction that has already been made in relation to the accounting liability to take into account the future deduction.

One of the main conclusions arising from the application of Step 2 is the assumption that the general use of debt capital eventually boosts the amount of allocable costs in the event of consolidation. Such speculation should nevertheless not invite group entities to seek arrangements and incur debts from group entities prior to joining time.

According to subsection 705-75(2), an intra-group liability will be considered for the purpose of Step 2 only to the extent that it does not exceed the members' cost base in respect to the same liability. In the

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[195] Smith, above n 175, 534.
See the example in subsection 705-80(1)(a).
[196] Chapter 5 (Paragraph 5.70) EM, *Consolidations Act (No.1).*

context of the whole group, the amount of allocable liabilities of one entity (debtor) is neutralised by lower market values assigned to interests held in other group members (creditors). The sum of intra-group liabilities reflects the tax costs incurred by the creditors. In this way, debt financing through intra-group liabilities is made unsuitable for influencing the reset tax cost of assets at the joining time.

Moreover, corresponding to the calculation of the allocable amount under Step 1, outstanding cost base adjustments have to be made to some of the liabilities as they would be required in relation to cost bases of membership interests (subsection 705-75(3)).

Employee share interests that are disregarded under section 703-35 are considered as liabilities of the joining entity,[197] whose value amounts to the market value of those interests at the joining time (subsection 705-75(1)). The allocable market value of the interests has to be reduced by the "reduction amount", which accounts for the difference between market value of the employee share interest at the time it was acquired by the employee and the consideration paid or given for the acquisition. This amount is worked out in accordance with a formula provided in subsection 705-85(2).

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[197] Chapter 5 (Paragraph 5.75) EM, *Consolidations Act (No.1)*.

Furthermore, any rights or options to acquire membership interests in a joining entity that were issued to a person other than a member of the consolidated group increase the amount established under Step 2 by the market value of the option at the joining time of the issuing entity (subsection 705-85(3)(a)). This market value is considered to be a liability of the joining entity, since the consolidated group has to acquire the particular rights or options prior to execution, in order to retain the wholly-owned status of the joining entity. This measure is comprehensible. However, it does not take into account that the issuing of such rights or options may diminish the market value of the membership interests held by consolidated group entities. In such cases, the "liability" arising from issuing these rights or options could have already been accounted for under Step 1 of the ACA calculation.

Subsection 705-85(3)(b) stipulates that the amount of Step 2 worked out under section 705-70 has to be increased by the market value of existing debt interests. Such liabilities are explicitly excluded from the definition of membership interests. At the same time, these interests are also not covered by the accounting definition of liabilities and can therefore not be automatically included into the amount calculated under Step 2. Nevertheless, such interests constitute an obligation of the group and are therefore considered in the calculation of the ACA.

Finally, liabilities or changes to the extent of liabilities which are recognised under the accounting standards prior to consolidation but deferred for income tax purposes, must be added to, or deducted from the sum of the liabilities calculated under Step 2 (subsection 705-80(1)). The timing differences between tax accounting and financial accounting are lifted at the joining time to the extent that they influence the ACA amount calculated under Steps 3 and 5 (subsection 705-80(1)(b)).

### 3.1.3. Step 3 (post-acquisition / pre-consolidation profits)

Under Step 3 the sum of frankable dividends[198] accumulated by joining subsidiaries and transferable to the head company at the joining time has to be calculated and added to the ACA amount established under Steps 1 and 2, where the following hypothetical conditions are fulfilled:

- the established amount of undistributed profits is the sum of retained profits accrued in accordance with accounting standards, or statements of accounting concepts made by the AASB, which could be recognised in the joining entity's statement of financial position if that statement were prepared as at the joining time (subsection 705-90(2));
- the undistributed profits have been franked to the maximum extent (subsection 705-90(3), after the franking accounts of the joining entities were adjusted for payments of income tax liabilities relating to the current year and previous income periods (subsection 705-90(4)(a)), excluding years earlier than those starting after a joining entity ceased to be a subsidiary member of another consolidated group (subsection 705-90(4)(b));

[198] Subsection 46FA(11) ITAA 1936.

- the frankable undistributed profits accrued to the wholly-owned group before joining time (subsection 705-90(6)(a) in connection with subsection 705-90(7)); and
- the undistributed profits did not recoup losses accrued to the group before the joining time (subsection 705-90(6)(b)).[199]

Pursuant to Step 3, the reset tax cost of consolidated assets account for the amount of the subsidiary's profits income taxed or taxable at the joining time. This is only the case, though, in relation to frankable profits accrued / earned since the head company (directly or indirectly) continuously owned membership interests in the joining group members. Such a condition is reasonable, since the cost base of membership interests should already account for the value of assets held by an entity at the time of its acquisition, including the value of assets originating from profits retained prior to that time. Hence, this amount must already be considered in Step 1.

For profits accrued to the group, on the other hand, Step 3 aims to avoid a double taxation of group income. This rule is consistent with the principles introduced by the imputation system.[200] Double taxation of income is avoided through the addition of the established share of the retained pre-consolidation profits to the reset tax cost of

[199] However, the conditions stipulated by section 705-90 are not applicable for trusts, which are not a corporate tax entity, joining a consolidated group. Undistributed, accrued realised profits that could be distributed tax free to discretionary interests are to be calculated in accordance with section 713-25.
[200] See Chapter 5 (Paragraph 5.87) EM, *Consolidations Act (No.1).*

consolidated group assets. The retained profits become a part of the "costs" which are recognised on consolidation of wholly-owned subsidiaries. Consequently, on subsequent disposal of group assets, the amount of retained, taxed profits constitutes a part of the assessable cost base, reducing the extent of potential taxable proceeds.

According to subsection 705-90(6), the sum of undistributed profits allocable under Step 3 has to be reduced by the amount of profits that recouped pre-consolidation losses.[201] This provision eliminates tax-sheltered distributions from being included within the ACA calculation and contributing to the amount of reset asset values.[202] Questionable in this context remains, however, whether and to what extent group losses transferred under Division 170 should be applied for the purpose of Step 3. Such losses must already be considered within Step 1 (subsection 705-65(3) in connection with Subdivision 170-C), triggering a reduction of the allocable cost base of member interests in the loss transferring group entity and an increase in the cost base of the transferee member interests. A subsequent reduction of the transferee's ACA amount (Step 3) may be considered reasonable, since the transferred losses screen an equivalent amount of profits from being taxed. Consequently, Step 3 should ensure that the reset tax cost would not account for the amount of frankable profits

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[201] The definition of such losses is stipulated by subsection 705-90(8).
[202] See Murray and Hammel, above n 193, 8.

recouping transferred losses. Admittedly, the consolidation rules provide no guidance into this subject matter. Subsection 705-90(9)(c) merely specifies that the amount of a loss accrued to a joined group during a particular period has to be determined using the 'most reliable basis for estimation that is available'. This provision, however, can presumably not be applied for "gap filling" in relation to whether or not to include an identified loss amount. It rather can be employed to overcome the lack of comprehensive accounting / historical data for a reliable estimate of losses recouped prior to the joining time.

Finally, the consolidation rules do not specify any method for the calculation of retained profits accrued / earned during the time between the acquisition of a subsidiary and its joining time. Moreover, in the initial draft of section 705-90, *Consolidations Act (No.1)*, the term "earned" profits is frequently quoted, whereas in its amended wording, *Consolidation, Value Shifting and Demergers Act*, Step 3 deals with profits that are "accrued". The use of the different *terminus technikus* allows different conclusions to be drawn with respect to the correct estimation of a particular profit amount.[203] A possible solution to such uncertainty may be provided by the general reference to the AASB accounting standards. According to paragraph 7 Accounting Standard AASB No. 1004 (Revenue), 'where the outcome of a contract to provide services can be estimated reliably, revenue arising

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[203] See also Murray and Hammel, above n 193, 8.

from the contract must be recognised by reference to the stage of completion of the contract' where the following conditions have been satisfied:

- the entity controls a right to be compensated for its services;
- it is probable that the economic benefits comprising the compensation will flow to the entity;
- the amount of the revenue can be reliably measured; and
- the stage of the transaction can be reliably measured.

Under the application of this standard, also known as the percentage of completion (POC) method, the consolidating entities must be able to determine the extent / status of the completion of projects, services, etc. at the time of the acquisition as well as at the joining time, since both dates mark the relevant "cut off" for revenue recognition. The percentage of completion can be measured with regard to the estimated total cost and the costs actually incurred at a particular time.[204] The percentage resulting from this comparison can be used as the allocable share of the determined total revenue amount. The following formula illustrates this method:

**X** – total estimated costs

**Y** – actual incurred costs

**Z** – total estimated revenue

**N** – allocable profits

$$N = (Y / X) * Z$$

**Formula 1** Percentage of completion

[204] AASB 1004 'Revenue', No. 7.1.4 (c).

The amount **N** (N1) calculated for the acquisition time constitutes the profit share which did not accrue to the group and cannot be recognised under Step 3. The amount **N** (N2) established at the time of consolidation, on the other hand, is the maximum allocable amount. In cases where a particular transaction stretches from the pre-acquisition period to the post-consolidation time, the difference between N1 and N2 makes up the profit fulfilling the conditions stipulated by section 705-90.

### 3.1.4. Step 3A (pre-consolidation roll-over from foreign resident)

Step 3A (section 705-93) stipulates adjustments to the ACA for pre-joining roll-overs of capital gains or losses, in cases where the originating company (Subdivision 126-B) or the transferor (section 160 ZZO ITAA 1936) was a foreign resident.

The recipient company must have been an Australian resident at the time of the roll-over, which, however, did not subsequently obtain the status of the head company of a joined group. Furthermore, no CGT event must have happened in relation to the roll-over asset prior to consolidation time. Where these conditions are met, the following adjustments have to be made to the ACA under Step 3A:

- increase by the amount of capital losses that were disregarded as a result of the relevant roll-overs; and
- reduction for the amount of capital gains that were disregarded as a result of the relevant roll-overs.

These adjustments ensure that the relevant roll-overs made prior to consolidation time are considered and the tax cost of the consolidated asset account for the deferred tax attributes.[205]

[205] See also ATO, Consolidation Reference Manual (May 2003), Chapter C2-4-270, 1.

The condition for the originating company to be a foreign resident is reasonable. Such an entity is excluded from membership in a consolidated group. Consequently, the deferral of gains / losses made by such an entity is not considered in the scope of the ACA calculation and remains not accounted for in the context of the group. The deferral triggered by domestic group members applying the roll-over provisions, on the other hand, is recognised in Steps 3 or 5 ACA,[206] since the relevant gains / losses indirectly contribute to the calculation of the consolidated asset tax cost. The deferral of these amounts alters the amount of gains or losses which are added or subtracted in the process of the ACA calculation. This is not the case for wholly-owned subsidiaries which, due to their residency, remain outside the consolidated group. The adjustments within Step 3A eliminate that difference.

[206] Only the post acquisition gains and losses are considered, since pre-acquisition times do not qualify for CGT roll-overs.

### 3.1.5. Step 4 (pre- / post-acquisition profits)

Step 4 of the ACA calculation, section 705-95, stipulates the deduction of an amount equal to certain pre-consolidation distributions which were made by joining members to the group's head company, or interposed group entities.

Distributions made out of pre-acquisition earnings have to be deducted to the full extent, since such dividends constitute a virtual repayment of the costs incurred by the group for the acquisition of member interests.[207] The allocable cost base of interests, which is established under Step 1, has therefore to be reduced by the sum of pre-consolidation payments that were made out of pre-acquisition profits. This deduction amounts to the difference between the sum of post-acquisition distributions and the total of the after tax profits made by the joining entity.

On the other hand, dividends made out of profits which accrued to the group must also be deducted from the ACA amount in cases where they recouped post-acquisition / pre-consolidation tax losses. The allocable cost amount calculated under Step 1 is based on the sum incurred for the acquisition of member interests / assets. In the period between the acquisition of member interests and the joining time, the value of these assets which, subsequent to the resetting of the

[207] See Fisher, above n 70, 43.

underlying tax cost, become those of the group, may be decreased by economic losses suffered by the joining entity. At the same time, profits that recouped such losses may be distributed to the group prior to the joining time. In the context of the previously recouped losses, such distributions constitute an out-payment of values previously lost and must not be retained as an element of the amount allocable to consolidated assets.

The necessity for this deduction may, however, be questioned when referring to the fact that the lost asset values in the joining entity will already reduce the market value of member interests considered under Step 1. In cases where the lost value was recouped through pre-consolidation profits that were subsequently distributed, the market value of member interests should account for the loss of economic substance suffered by the joining entity. The amount that is calculated under Step 4 might therefore constitute a double deduction.

The calculation process of the deduction amount itself may be considered problematic. Concluding from the wording of section 705-90, the application of this rule requires an ability to determine which profits were used for the distribution of dividends prior to joining time.[208] Only profits that recouped post-acquisition / pre-consolidation losses have to be deducted pursuant to Step 4. The process of identification of such profits may, however, prove to be a complex

[208] See also Murray and Hammel, above n 193, 11.

task, since no established accounting tools provide an appropriate insight into this issue.

On the other hand, the objectives underlying the deduction under Step 4 should also be met without the necessity for an exact identification of particular profits recouping losses prior to consolidation. The appropriate deduction of the ACA is already realised where the amount calculated under Step 4 equals:

- the sum of losses accrued to the group prior to consolidation, where the loss amount is less than the amount of profits accrued and distributed to the group; or
- the sum of profits accrued and distributed to the group, where the loss amount is higher than the amount of the dividends accrued and distributed to the group.

In either case, the resulting deduction to the ACA represents the amount of lost asset value in the joining entity that has been recouped and subsequently distributed to the group members prior to consolidation.

**Example 2**: Step 4 deduction for profits recouping losses

Subco is wholly-owned by Headco. With regard to the ownership period, the calculation of the Step 4 amount looks as follows:

| | (post-acquisition) Losses | (post-acquisition) Profits | Step 4 deduction |
|---|---|---|---|
| | 4,000 | 10,000 | 4,000 |
| or | 4,000 | 3,000 | 3,000 |

The maximum amount of post-acquisition losses recouped by profits which were made by the joining subsidiary member prior to the consolidation time is the total amount of the accrued losses.

Finally, Step 4 does not specify in which respect the formerly applicable transfer of loss provisions (section 80G and Division 170) affect its implementation. Primarily, the sum of losses accruing to the group prior to the joining time can be increased through the intake of loss amounts received from group members. It remains questionable in this context, whether such losses must still be recognised by the transferring entity or by the loss receiving entity. In any case, recognition by both group members would trigger an obvious duplication of the deduction stipulated within section 705-95.

### 3.1.6. Step 5 (post-acquisition / pre-consolidation losses)

At this stage of ACA calculation, the allocable cost amount is reduced by the post-acquisition / pre-consolidation carry forward tax losses and net capital losses incurred and accumulated by a joining group member. This deduction has to be equivalent to losses that accrued to continuously held membership interests, which makes the deduction amount 'a groups owned component of the losses'.[209]

However, losses accrued to the group are included in the Step 5 amount only to the extent that they did not constitute a reduction to the undistributed profits that are considered under Step 3 (subsection 705-100(2)). Consequently, losses that were recouped by profits accruing to membership interests before joining time must not be included in the amount calculated under Step 5.

The purpose underlying the deductions in Step 5 is to avoid a double benefit that would be potentially available in connection with the consolidation of loss entities. In the absence of this provision, accrued and transferred losses could be utilised by the group's head company, whereas the tax cost of consolidated assets would be uplifted by the value of assets lost before joining time.[210]

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[209] Chapter 5 (Paragraph 5.88) EM, *Consolidations Act (No.1).*
[210] See Rogers, above n 192, 478.
Chapter 5 (Paragraph 5.91) EM, *Consolidations Act (No.1)*.

On the other hand, since subsection 705-100(1) refers explicitly to “unutilised losses”, the deduction amount also prevents certain losses, which are potentially not transferable at the joining time and are therefore lost for the group, from granting the group a benefit reflecting these losses.[211]

[211] See Chapter 5 (Paragraph 5.92) EM, *Consolidations Act (No.1)*.
The EM refers at this stage to the prevention of benefits ‘from an owned loss being reinstated through a higher cost for remaining assets where the loss is not permitted to be transferred to the head company or is cancelled by the head company’.

### 3.1.7. Step 6 (pre-acquisition / pre-consolidation losses)

Within the sixth step of the ACA calculation, losses incurred by a joining group member have to be considered to the extent that they have not already been eliminated under Step 5. These are losses that did not accrue to member interests held by group entities, which, on the other hand, are transferable at the time of consolidation (acquired tax losses).

The losses must pass the transfer criteria defined by Subdivision 707-A and not be subjected to a cancellation of transfer made by the head company (section 707-145).

The deduction amount under Step 6 is then worked out by multiplying the sum of identified losses by the general company tax rate (subsection 705-110(1)), which results in reducing the ACA by the amount of tax benefits available through future utilisation of these losses.

The reasoning behind such a deduction is based on the assumption that the cost base of member interests did not account for the value of the carry forward losses at the time of acquisition.[212] It remains questionable therefore, whether the ATO will require the execution of this rule under circumstances where the Step 6 deduction amount constitutes a portion of the amount determined for Step 1 of the ACA

[212] See also Fisher, above n 70, 43.

calculation. After all, carry forward losses that contributed to the cost base of interests at the time of acquisition should be considered as deferred tax assets and, as such, should be recognised at the joining time.

### 3.1.8. Step 7 (pre-consolidation expenditures)

According to Step 7 (section 705-115), an amount reflecting the sum of deductions for expenditures inherited by the head company pursuant to the entry history rule (section 701-5) has to be subtracted from the allocable costs. The Step 7 amount consists of the sum of the “owned deductions”, deductions which accrued to member interests, and the amount equal to the “acquired deductions” (subsection 705-115(1)) multiplied by the general company tax rate. In either case, the amounts under consideration relate ‘to unclaimed deductions for expenditure incurred prior to the joining time where the expenditure [was] not allowed in full as a tax deduction when incurred’.[213]

This final reduction of the ACA is reasonable. Pursuant to Step 3, profits accruing to member interests have to be added to the ACA basis. Step 7 corrects this amount, subtracting pre-consolidation expenses which can be claimed by the head company after the joining time. From an economic point of view, the events triggering these deductions occur prior to the joining time and should therefore reduce the amount of retained profits allocable to the tax cost of reset assets. In the absence of this step, the consolidating entities could be entitled to a “double deduction” which would arise from the tax cost of reset assets, containing an “overestimated” retained profit amount, and the allowance for expenditures inherited by the head company (“owned

[213] Chapter 5 (Paragraph 5.97) EM, *Consolidations Act (No.1)*.

deductions").[214] Following the same reasoning, the subtraction amount which results from the "acquired deductions" accounts for the tax benefit "accrued" at the time of the acquisition of member interests. The cost base of member interests regularly includes the sum of tax benefits available subsequent to their acquisition. Since this amount is considered under Step 1, it has to be deducted under Step 7 in order to avoid a double benefit for the consolidated group.

Concluding from the background of this provision, the expenditures under consideration are in general such which can neither be recognised as depreciating assets,[215] nor are they instantly fully deductible as business expenses. Such expenditures are apportioned over the effective life of the asset, that is, for the duration of the event for which they were incurred. The Explanatory Memorandum to the *Consolidations Act (No.1)* provides a number of examples falling under the application of section 705-115:

- software development pool expenditures;
- borrowing expenses;
- cultural, environmental and heritage gifts; and
- capital expenditures covered by Subdivision 40-I.

[214] Consistently, subsection 705-115(2)(c) excludes the application of the Step 7 deductions in expenditures which 'reduced the undistributed profits comprising the step 3'.
See also ATO, Consolidation Reference Manual (May 2003), Chapter C2-4-340, 1.
[215] In accordance with subsection 705-115(2)(a), expenditures which form part of or reduce the cost of an asset of a joining entity that becomes an asset of the head company cannot constitute the Step 7 deduction.

### 3.1.9. Step 8 (allocable cost amount)

Step 8 (table in section 705-60) stipulates that ‘if the remaining amount is positive, it is the joined group's allocable cost amount. Otherwise the joined group's allocable cost amount is nil’. The main rules governing the process of the allocation of the ACA are discussed in detail within the following section.

### 3.2. Allocation of ACA

According to section 701-10(3), the objective of Division 705 is to recognise the cost to the head company for assets brought into the consolidated group 'as an amount reflecting the group's cost of acquiring the entity'.

In order to determine the deemed acquisition costs, the ACA has to be allocated to the joining entity's assets. This process directly affects the tax cost of the consolidated assets. Consequently, groups assessing future tax implications resulting from consolidation, for instance changes in the availability of depreciation claims and potential CGT liabilities arising on the disposal of group assets, should develop a sound understanding of the ACA allocation procedure.

Importantly, the distribution of ACA relates not only to items that are recognised in financial statements or in fixed asset registers. The Explanatory Memorandum to the *Consolidations Act (No.1)* employs a broad definition stating that 'an asset, for the purposes of the cost setting rules, is anything of economic value which is brought into a consolidated group by an entity that becomes a subsidiary member of the group'.[216]

[216] Chapter 5 (Paragraph 5.19) EM, *Consolidations Act (No.1)*.
From this it follows that internally generated goodwill must also be recognised at joining time.
See Murray and Hammel, above n 193, 16.

Under the application of the cost setting rules, the identified assets are classified as:

- retained cost base assets (section 705-25); or
- reset cost base assets (section 705-35).

### 3.2.1. Retained cost base assets

Section 705-25 stipulates which assets, the retained cost base assets, must retain their pre-joining tax value at the time of consolidation. According to subsection 705-25(5), retained cost base assets are:

- Australian currency (except Australian currency held as trading stock or as collectables);
- Australian dollar receivables;
- qualifying securities (other than marketable securities with the meaning of section 70B); and
- prepayments.

Moreover, according to section 701A-5, trading stock can be classified as a retained cost base asset where it is owned by a 'continuing majority-owned entity'. The majority ownership requirement is met if the consolidated group members beneficially own, directly or indirectly through one or more interposed entities, membership interests in the entity, and the ownership period stretches from the start of 27$^{th}$ June

2002 until the entity's joining time (section 701A-1). The value of the trading stock amounts to the costs that are established by the entity at the end of the last income period prior to consolidation (subsection 701A-5(2)(b)).[217] Under these conditions (subsection 701A-5(2)(a)), the value of trading stock cannot be set at a tax-neutral amount in accordance with subsection 701-35(4). Revenue implications may therefore arise for the "continuing majority owned" joining subsidiaries. At the same time, the trading stock retains its tax value when transferred to the head company on consolidation (subsection 701A-5(3)), which means that the ACA can be allocated to the remaining assets without regarding the stock's current market value.[218]

The total tax value of the retained cost base assets, that is the joining time termination value, is subtracted from the ACA. The resulting balance, as long as it does not amount to less than zero (subsection 705-35(1)(b)), is then allocated to the remaining assets, the reset cost base assets. From this it follows that a further allocation will not take place, where the sum of the tax cost setting amounts for retained assets exceeds the determined ACA amount. In such cases, the excess amount constitutes a capital gain realised by the group's head company (CGT Event L3 (section 104-5)).[219]

[217] See trading stock valuation provisions: sections 70-45 to 70-70.
[218] See also Jim Targett, 'ACA steps & revenue protection measures' (Paper presented at the Taxation Institute of Australia 1st National Consolidation Symposium, Leura, NSW, 3-4 February 2003) 8.
[219] See Note to subsection 705-25(4).

### 3.2.2. Reset cost base assets

According to subsection 705-35(1), assets not classified as retained cost base assets or excluded assets are reset cost base assets. Furthermore, subsection 705-35(3) explicitly refers to goodwill as 'an asset of the joining entity that becomes an asset of the head company' whose 'tax cost is set at the joining time at its tax cost setting amount'. The tax cost of each identified reset cost base asset is assigned a share of the remaining ACA balance. This share reflects the proportion of the joining time market value, as it is individually established for each asset, in the total market value of all reset cost base assets.

This relation is illustrated by the following formula:

$$\textbf{(ACA - retained cost base assets)} \times \frac{\textbf{Market value of the asset}}{\textbf{Total market value of reset cost base assets}} \leq \textbf{market and termination value of the asset}$$

**Formula 2** Allocation of ACA to reset cost base assets

The extent of the allocation of the ACA to assets held on revenue account, trading stock, depreciating assets or revenue assets, is limited by the condition that the determined tax setting amount must

not exceed the greater of the asset's market value and the joining entity's termination value for the asset (subsection 705-40(1)).[220]

**Example 3**: Resetting asset cost

A wholly-owned subsidiary joins a consolidated group on 1st July 2003 (the date on which the group was established, following notification made by the group's head company).

Assets pre-consolidation:

Retained cost base assets
Cash: AUD 50
Receivables: AUD 100

Reset cost base assets
Asset A: AUD 270 termination value; AUD 300 market value
Asset B: AUD 150 termination value; AUD 150 market value
Asset C: AUD 410 termination value; AUD 300 market value
Goodwill (entity market value ./. asset net value): AUD 150
Total (market values): AUD 900

At the time of consolidation the tax costs of the subsidiary's assets are reset as follows:

Calculated ACA: 1.350
Reduction by the retained cost base assets (50+100): 150
ACA available: 1.350 ./. 150 = 1.200

[220] The termination value of trading stock has to be determined in accordance with principles set by subsection 705-30(1).
The termination value of a depreciating asset equals the asset's adjustable value just before the joining time (subsection 705-30(3). However, the restriction of the tax setting amount relates only to depreciating assets to which Division 40 applies. From this it follows that certain capital works as well as indefeasible rights to use international telecommunications cables and films are not subject to the limitation imposed by section 705-40.
See Murray and Hammel, above n 193, 21.

Reset goodwill cost on consolidation: 1.200 x 150/900 = 200

Reset cost of asset A:
ACA allocation: 1.200 x 300/900 = 400
The reset cost of asset A is its market value of 300 (the tax setting amount must not exceed the greater of the termination value and market value of the asset). The reduction of the reset cost is 100.

Reset cost of asset B: 1.200 x 150/900 = 200
The reset cost of asset B is its termination value and market value of 150 (the tax setting amount must not exceed the greater of the termination value and market value of the asset). The reduction of the reset cost is 50.

Reset cost of asset C: 1.200 x 300/900 = 400
The reset cost of asset C is 400 (the termination value (410) exceeds the calculated reset cost). No reduction of the reset cost is necessary.

The total reductions to the reset cost amount to 150 (asset A: 100; asset B: 50). This sum must be allocated to the remaining reset cost base assets whose reset cost is not affected by the reduction (goodwill and asset C). The allocation of the relevant sum happens in proportion to the market values of the assets (subsection 705-40(3)).

Asset C: 150 x 300/450 = 100
The amount can be added to the asset cost only to the extent that the reset cost does not exceed the greater of the termination value and market value of the asset. From this it follows that the reset cost of asset C amounts to: 400+10 = 410.

The remaining amount (AUD 140) is added to the goodwill cost. Reset cost of goodwill amounts to: 200+140 = 340.

A further principle applies to accelerated depreciation assets acquired on or before 21st September 1999 and held continuously until joining time. According to section 705-45, the accelerated depreciation can be retained subsequent to the joining time only where the tax cost setting amount is adjusted not to exceed the termination value of the asset. From this it follows that a joining entity must decide whether it prefers to further utilise accelerated depreciation amounts, retaining the pre-consolidation tax cost,[221] or to uplift the asset's tax value to the potential maximum of its current market value.

Moreover, prior to any distribution of the ACA to the reset cost base assets, joining entities need to establish whether a deduction relating to over-depreciated assets (section 705-50) is necessary. The tax cost setting amount has to be adjusted in cases where the following cumulative conditions are met:

- the tax cost setting amount of an asset exceeds the joining entity's termination value / adjustable value for that asset (subsection 705-50(2)(a)); the market value must exceed the adjustable value at the joining time; and

[221] The relevant asset becomes a retained cost base asset. The excess cost amount that is not allocated to the asset cannot be allocated to the remaining reset cost base assets.
See Chapter 5 (Paragraph 5.43) EM, *Consolidations Act (No.1)*.

- the joining entity paid an unfranked or partly franked dividend to a recipient who was entitled to the inter-corporate dividend rebate (subsection 705-50(2)(b));[222] and
- the distribution was made in relation to profits tax deferred by over-depreciation (subsection 705-50(2)(c) in connection with subsection 705-50(3)(a)).

Finally, a complete absence of reset cost base assets to which the excess of the ACA could be allocated triggers a capital loss (CGT Event L4). The relevance of this rule is presumably limited, since the absence of net identifiable assets would indicate the existence of a goodwill value, which must be recognised at the joining time.

[222] In practical terms, this condition means that the dividends under consideration are those paid not later than 30th June 2004.

#### 3.2.2.1. Excluded assets

Excluded assets are assets which, under any of the steps used for the ACA calculation, result in a reduction of the ACA (subsection 705-35(2)). To this category of assets belong entitlements to deductions, for which there is a reduction under Step 2 (subsection 705-75(1)).[223] Consequently, amounts relating to liabilities which are deductible after joining time, among them deferred tax assets resulting from employee leave provisions or foreign exchange losses, must not become reset assets of the head company.

Furthermore, timing differences in the recognition of liabilities under the accounting standards and the income tax accounting, deferred tax assets, that influence the ACA amount established under Step 5[224] and must therefore be deducted from the amount in Step 2 (subsection 705-80(1)) are also regarded to be excluded assets.[225] This exclusion is necessary since the reduction of the liability considered under Step 2 is equal to the value of the deferred tax assets recognised prior to the joining time.

[223] See Note to subsection 705-35(2).
[224] In this case only the Step 5, not Step 3, is taken into consideration, since a reduction of the amount in Step 2 in relation to an (tax) asset can only be triggered through the recognition of a deferred tax asset reducing the amount of losses which are later attributed to the Step 5 amount. The same amount could potentially increase the sum of profits considered under Step 3, this, however, would trigger an increase of the Step 2 amount and is therefore not relevant for the purpose of the identification of excluded assets. Furthermore, the accrual of deferred tax liabilities may also trigger a deduction of the Step 3 amount, however, this fact does not relate to any (excluded) assets of the joining entity.
[225] See also Murray and Hammel, above n 193, 20.

On the other hand, deferred tax assets recognised by the joining entity may reflect tax benefits arising from (accounting) losses which reduce the ACA through Step 5 and 6 deductions. Such assets do not qualify for the distribution of the ACA, since the ACA has already been reduced in order to take these assets into account.[226] Finally, deferred tax assets that represent a sum of inherited future tax deductions which reduce the ACA in accordance with Step 7 (section 705-115) must also be considered as excluded assets.

In the context of tax accounting, the deferred tax assets must be de-recognised by the wholly-owned subsidiary, to be recognised by the group's head company at the joining time.[227] The value of these assets remains with the group, however, it does not contribute to the ACA calculation and therefore has no impact on the reestablishment of the tax cost base of interests at the time of de-consolidation of the particular subsidiary.

In conclusion, although the consolidation legislation and the explanatory materials do not explicitly state this fact, the rules governing the identification of excluded assets concentrate primarily on the elimination of deferred tax values.

[226] See Chapter 5 (Paragraph 5.31) EM, *Consolidations Act (No.1)*.
[227] See Part C Chapter I 3.1.

#### 3.2.2.2. Goodwill

'Any excess of the market value of the joining entity at the joining time over the market value of the net identifiable assets of the joining entity at that time' is considered as goodwill, a reset asset that has to be recognised by the head company.[228] This value accrues to the assets or business of the wholly-owned subsidiary subsequent to the acquisition of its interests by a group member / members, and is therefore not recognised for accounting or taxation purposes. Furthermore, using the goodwill definition employed by accounting standards, goodwill is constituted by only those (unidentifiable) assets, which are not 'capable of being both individually identified and separately recognised'.[229] Consequently, intangible assets such as patents, licenses, rights and copyrights cannot contribute to the assessed goodwill value.[230]

However, since the consolidation event constitutes only a deemed "disposal" of the subsidiaries' assets, no actual / updated market value or purchase price for the goodwill generating entity is available. The calculation of the goodwill amount must therefore rely primarily on speculative and theoretical assumptions.[231] To which extent the value assigned to the goodwill reflects the service potential or 'future economic benefits controlled by the entity as a result of past

[228] Chapter 5 (Paragraph 5.35) EM, *Consolidations Act (No.1)*.
[229] AASB 1013 'Accounting for Goodwill', No. 5.1.1.
[230] Ibid.
[231] See also Murray and Hammel, above n 193, 21.

transactions or other past events'[232] is questionable under such circumstances. The head companies of consolidating groups will face the challenging task of establishing a relationship between the calculated goodwill amount and the following two general asset recognition criteria found in the accounting standards:

- sufficient probability 'that the future benefits embodied in the unidentifiable assets will eventuate'; and, more importantly,
- the fact that the goodwill 'possesses a cost or other value that can be measured reliably'.[233]

After all, a correct assessment of the goodwill amount is not only relevant for immediate consolidation measures, for instance, correct allocation of the ACA to the reset assets. The relevant tax cost base that is recognised at the joining time also has potential capital gains tax implications triggered by the subsequent disposal of the company goodwill, which constitutes a CGT event (section 104-10 (Event A1) in connection with subsection 108-5(2)(b)). These facts suggest that, even though the accounting principles are only of secondary relevance for the goodwill calculated under tax consolidation provisions, the very vague definition provided by the Explanatory Memorandum should not be regarded as a basis for a "flexible" approach to the subject matter.

[232] Statement of Accounting Concepts 4 (SAC 4) 1995 'Definition and Recognition of the Elements of Financial Statements', Paragraph 14.
[233] AASB 1013 'Accounting for Goodwill', No. 5.1.3.

Besides the recognition of goodwill attached to assets, or businesses owned by the joining group member, the consolidation rules also require the consideration of the “synergistic” goodwill ‘accruing to assets or businesses of a group, other than assets and businesses brought into the group by the joining entity’.[234] The identification and valuation of this goodwill should cause the most difficulties, since its amount is determined by elusive criteria such as the benefit of the group members arising from the ownership and control of the joining entity.[235]

Importantly, allocation of the goodwill value must be considered in direct connection to the prior steps undertaken for the calculation and allocation of the ACA. After all, the sum of the established market values of reset cost base assets (excluding goodwill) together with the value of retained cost base assets constitutes the basis for the

[234] Chapter 5 (Paragraph 5.34) EM, *Consolidations Act (No.1)*.

[235] This analysis dealing with goodwill as a reset cost base asset implicates a distinction between two goodwill categories, goodwill of the joining entity and synergetic goodwill of the group, both of which constitute the total goodwill amount that must be recognised at the time of consolidation. The EM (*Consolidations Act (No.1)*) as well as subsection 705-35(3) appear to include only the synergetic goodwill into the distribution of ACA. Both sources speak about ‘a goodwill asset associated with assets or businesses of the joined group’ (subsection 705-35(3), respectively ‘goodwill accruing to assets or businesses of a group, other than assets and businesses brought into the group by the joining entity’ (EM). At the same time, the EM (Paragraph 5.35) states that it is ‘appropriate to treat all elements of this goodwill as reset cost base assets of the entity even though some of the added value may accrue to assets or businesses already owned by the joined group’. This wording indicates that the relevant goodwill amount includes values accruing to the joining entity as well as to other group members. Finally, the distinction between the joining company’s goodwill and the group’s synergetic goodwill has no further practical significance, since the relevant goodwill amount is calculated with prime regard to the excess of the market value of the joining entity at the joining time over the market value of the net identifiable assets held by that entity at the same time.

calculation of the amount allocable to the goodwill.[236] From this it follows that the goodwill market value used for the allocation of a share of the ACA to the goodwill reset cost base must be consistent with the market valuations made for the remaining assets held by a joining entity. Admittedly, the elaborate and costly process of identification and documentation of the relevant asset market values constitutes one of the core elements in the consolidation effort.

According to the EM goodwill definition quoted above, the calculation of the reset cost base of goodwill requires the market valuation of the entire entity. This figure has to be determined also for the calculation of the relevant amount under Step 1 ACA (*section 3.1.1.*). Furthermore, as discussed in a later stage (*section 4.3.4.*), the use of losses after consolidation time is based also on that entity market value. Consequently, the establishment of a correct market value of consolidating group members affects not only the reset cost base of goodwill, but also the basis for the calculation of the reset tax cost of all remaining assets and the rate at which accrued losses can be used by the group. For non-listed entities, whose time of establishment or acquisition does not coincide with the consolidation time, a reliable market valuation will be difficult and costly to obtain.

[236] As discussed above, the market value of the goodwill must equal the difference between the market value of the entity's assets (reset and retained cost base assets), reduced by the accrued liabilities, and the total market value of the entity.

In fact, as discussed in *section 3.4.3.*, the extent of the valuation efforts required at the joining time depends directly on the length of the period between the acquisition / establishment of the relevant entity and the time of consolidation. Therefore, the costs resulting from the need for the calculation of the pre-consolidation goodwill values should vary in practice, depending on the individual structure and history of the groups implementing tax consolidation.

### 3.3. Transitional asset rules

Groups coming into existence not later than 30th June 2004 can make use of concessions made available in relation to the asset rules. These transitional options are accessible to all consolidated entities (transitional entities) which had the status of a wholly-owned subsidiary of the relevant head company before 1 July 2003 and remained wholly-owned until the time of consolidation (subsection 701-1(3) *Income Tax (Transitional Provisions) Act 1997 (ITTP 1997)*).[237] Moreover, entities wholly-owned by the head company on 1st of July 2002 or a later date must have continuously retained the 100% subsidiary status in order to be eligible for the concessions. Importantly, the concessions are applicable only to entities (chosen transitional entities) to which the head company irrevocably decides to make use of the relevant provisions. There is no requirement for the uniform application of the transitional rules in the context of an entire consolidated group (subsection 701-5(1) *ITTP 1997*).

According to section 701-15 *ITTP 1997*, 'section 701-10 (cost to head company of assets that entity brings into group) and subsection 701-35(4) (setting value of trading stock at tax-neutral amount) do not apply to the assets of a chosen transitional entity'. In other words, the

[237] The transitional asset provisions were introduced within Schedule 7 *Consolidation, Value Shifting and Demergers Act*.

joining time tax cost (terminating values) of the subsidiary's assets are retained.

Retaining the existing tax cost may be preferred in cases where:

- the sum of the calculated ACA is lower than the total sum of joining time asset values, which can be the result of the membership interests' cost base exceeding their market value (implications for CGT (disposal of assets or membership interests) and capital allowance), or / and
- a significant share of the ACA is allocated to (non-recognised) non-depreciation assets (e.g. goodwill), and / or
- the allocation of the ACA results in a shift from depreciating assets (lower market value) to (recognised) non-depreciating assets (higher market value).[238]

Moreover, choosing not to apply the complex ACA provisions and the relevant market valuation rules may be regarded as having the potential for substantial cost savings compared to the scale of efforts usually resulting from the implementation of the obligatory asset rules. This follows from the assumption that, even though a vast number of the figures that are needed for the ACA calculation can be derived directly from existing accounting data, the gathering and processing of

[238] See also Wayne Rogers, 'Pre-consolidation planning' (2002) 37 (5) *Taxation in Australia* 243, 246.
See also the following discussion about the effects of the asset rules (section 3.4. of this Chapter).

this information should require considerable expenses. Moreover, the market valuation of all assets brought into the group constitutes a measure stretching far beyond the scope of accounting and reporting tools employed prior to consolidation. Such factors make the transitional concession very attractive for entities operating with a minimum of human and financial resources. SME groups therefore belong to the main beneficiaries of the relevant provision.[239]

On the other hand, even though a group which is formed during the transitional period may decide against the implementation of the asset provisions, the decision making process should include calculations based on the general rules stipulated by the legislation. In other words, in order to determine whether the cost savings achieved through the application of the transitional measures outweigh the tax benefits potentially available subsequent to the restating of the existent asset tax cost, a group entity needs to undertake both calculations, including market valuation measures. The transitional options may therefore result in a double effort which allows a conscious choice for the evidently more attractive alternative. In cases where the transitional rules are preferred, the main potential for benefits constitutes the opportunity to retain the joining time tax cost.

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[239] In its submission to the Exposure Draft, ICAA argued in favour of a permanent extension of the transitional concessional rules in a formation case scenario for SMEs entering consolidation.
Institute of Chartered Accountants in Australia, 'New Business Tax System (Consolidation) Bill 2002 Comments on Exposure Draft', Submission to Mr Mark Jackson, First Assistant Commissioner, 18th March 2002, 4.

In conclusion, the costs of the consolidation process itself are presumably not diminished but increased due to the existence of this transitional option.

## 3.4. Effects of asset rules

According to the elements of the consolidation legislation already discussed, corporate groups have a choice until 1st of July 2004 between retaining existing tax values of assets, the *'stick method'*, or resetting them, the *'spread method'.*[240]

The resetting of tax cost in the wake of a voluntary decision prior to the end of the transitional period or the subsequent mandatory application of the asset rules, both result in either a *step-up* or *step-down* in the tax values of the group's assets.[241] However, these changes do not necessarily affect the depreciable and non-depreciable assets to the same extent.

Besides an overall rise or fall in the tax values, there may be a shift from one category to the another, determining the sum of depreciation deductions eventually available for a consolidated group. The resetting of tax cost of revenue assets though, remains confined to established market or termination[242] values. The potential of tax consolidation measures to boost future depreciation claims is therefore limited.

[240] See Lowry, above n 23, 44.
[241] Of course, there is still a theoretical chance that, after the completion of the complex process of resetting the asset values, the sum of consolidated tax cost bases equals the values prior to consolidation.
[242] For the legal definition of the term "termination value", see section 42-205.

The following discussion provides an insight into selected areas affecting the tax value of depreciable assets, starting with the connection between the tax and market value of membership interests held in joining group members and the reset value of the group's assets (*section 3.4.1.*). The second set of issues under consideration is the necessity for loss deductions in the process of the ACA calculation. Besides the legitimate reduction of the calculated ACA amount, the stipulated asset rules bear the potential for a, presumably unintended, double deduction of losses which may have detrimental effects on the tax values of (depreciating) assets (*section 3.4.2.*). This analysis is followed by a discussion of questions concerning the allocation of the ACA (*section 3.4.3.*). The recognition of goodwill values and the potential occurring of shifts in the availability of depreciation claims are of particular interest in this context. Finally, the potential for negative tax implications at the time of the disposal of group equity resulting from changes to tax cost that are necessary at the time of consolidation are considered in *section 3.4.4*.

### 3.4.1. Value of interests and resetting tax cost

In accordance with the single entity rule, the book values of shares held by group members in wholly-owned subsidiaries have to be eliminated on consolidation, as the underlying assets are deemed to be acquired by the head company. The tax values of assets are therefore aligned with the cost base of interests. This occurs in the process of calculating the ACA and the subsequent resetting of tax values of the group's assets. Prior to this step, however, the tax cost base of the interests has to be related to their actual market value. Only the lower of those two amounts is to be taken into account (subsection 705-65(1)), unless the market value is less than the reduced cost base, in which case the reduced cost base is used. Consequently, a low tax cost base of interests or a current decline in their market value has the potential to diminish the group's asset values to a minimum of their reduced cost base.

### 3.4.2. Tax cost reductions

One of the main characteristics of the operation of a consolidated group is the concentration of all tax attributes in the hands of the head company. This fact generally makes the application of integrity measures in connection with (loss) asset transfers and loss duplication redundant. Nevertheless, at the time of the creation of a consolidated group or at the joining time of a wholly-owned subsidiary, anti-loss-duplication measures trigger the deduction of both realised and unrealised losses in the process of the ACA calculation.

Importantly, the deduction of realised and unrealised losses under Step 1 ACA (*section 3.4.2.1.*) and the following deduction of realised losses within Step 5 and 6 ACA (*section 3.4.2.2.*) must be considered in the context of a potential duplication of loss deductions (*section 3.4.2.3.*).

### 3.4.2.1. Deduction of realised and unrealised losses – Step 1 ACA

Subsection 705-65(3)(a) (Step 1 ACA) stipulates the application of loss anti-duplication provisions in connection with the (reduced) cost base of interests held by group members in a joining entity. Loss entities with a market value of interests below their cost base joining a consolidated group are subjected to the application of section 165-115GB. The trigger event assumed by the legislator in this context is a deemed disposal of the member interests directly prior to the joining time.[243] All unrealised and realised capital losses accrued by such a group member have to be deducted from the interests' reduced cost base, the core-element in the calculation of ACA, to the extent that the resulting amount is not less than the actual market value of the entity's interests.[244]

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[243] The wording of the EM indicates that the deductions in connection with loss anti-duplication and integrity measures apply primarily in cases where the cost base adjustments are "outstanding". Loss transfers or value shifts that happened immediately before the joining time and did not yet trigger an adjustment of membership interests have to be considered on consolidation.
See Chapter 5 (Paragraph 5.60) EM, *Consolidations Act (No.1)*.
On the other hand, however, the text of subsection 705-65(3) suggests that already the "assumption" of disposing of the interests before the joining time, which covers cases of actual or deemed disposal, may trigger the application of cost base adjustments. Murray and Hammell state in this context that the adjustments made at the joining time have to be made, 'as if the joining entity had been disposed of just before that time'.
Murray and Hammel, above n 193, 5.
The findings discussed in this chapter concentrate therefore on the case of a deemed disposal.
[244] According to subsection 705-65(1) Item 2, a market value exceeding the reduced cost base of the interests in the group member is to be used for the purpose of ACA calculation. From this it follows that loss deductions remain relevant only to the extent that the resulting allocable (reduced) cost base is not less than the market value of the interests.

Since these cost setting provisions are also applicable to the initial formation of consolidated groups, similar anti-duplication measures become relevant at the very start of the consolidation pathway. The adverse effects of the application of anti-duplication rules can therefore not be averted through the initial decision to consolidate. This may result in considerable compliance costs related to loss calculations as well as a potential reduction in the reset tax cost of group members' assets, affecting the amount of future depreciation claims and the calculation of capital gains or losses. After the completion of the consolidation process, however, no further cost base adjustments will be required in connection with the disposal of equity or debt interests held in group-members carrying realised and / or unrealised losses.

### 3.4.2.2. Deduction of realised losses – Step 5 and 6 ACA

Regardless of the loss deductions undertaken in connection with Step 1 ACA, realised but unrecouped losses accrued by wholly-owned group members prior to consolidation time, among them realised capital losses, are considered again in Steps 5 and 6 ACA. Step 5 requires the ACA to be reduced by losses accrued to membership interests that were directly or indirectly owned by the head company and were continuously held until the joining time.[245] The amount of losses realised subsequent to the acquisition of interests in the subsidiary is held to be attributable to the cost base of those interests and therefore diminishes the amount allocable to the reset value of consolidated assets. Under Step 6, losses transferable to the head company, which did not accrue to the membership interests, finally reduce the ACA amount calculated under previous steps. These losses can be utilised by the consolidated group; their amount should therefore not be included in the reset tax cost of assets.

[245] Chapter 5 (Paragraph 5.88) EM, *Consolidations Act (No.1)* uses the phrase of the 'groups owned component of the losses of a joining entity'.

### 3.4.2.3. Duplication of loss deductions

The application of the anti-duplication provision under Step 1 ACA provides for the deduction of not only unrealised but also realised capital losses. Since realised losses are subsequently tackled by Steps 5 and 6 ACA, the amount deducted under Step 1 potentially constitutes an unjustified duplication of loss deductions.

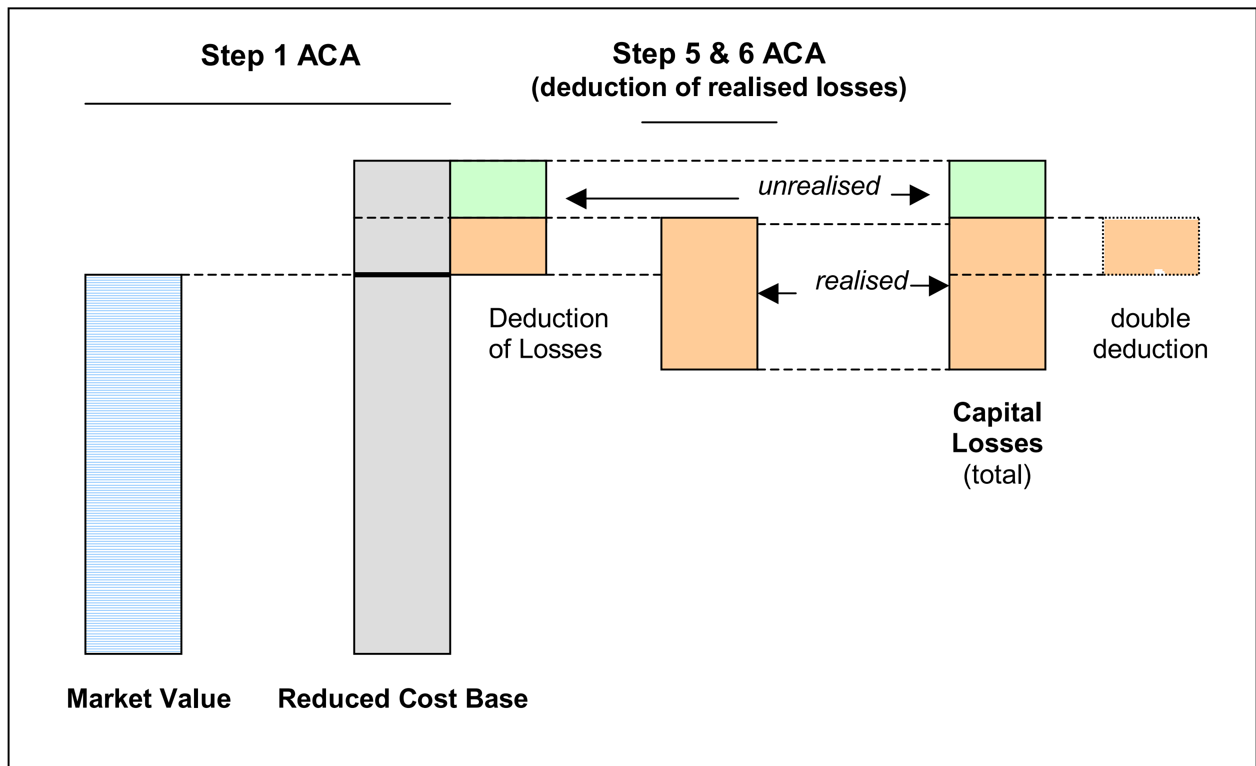


**Figure 6** Double deduction of realised losses on ACA calculation

As the example above shows, the reduced cost base of interests exceeds their market value and, in accordance with subsection 705-65(1), is used as the Step 1 amount in the ACA calculation. In this case, subsection 705-65(3) in connection with

section 165-115GB triggers the deduction of unrealised and realised capital losses. The maximum deduction amount equals the difference between the reduced cost base and the market value.[246] The realised losses are subsequently deducted under Steps 5 and 6 ACA. The realised (capital) losses already deducted under Step 1 ACA constitute therefore a potential double loss deduction.

The existence and extent of the duplication of loss deductions in an individual case can be assessed using the following formula:

**X** – market value of interests

**Y** – reduced cost base of interests

**Z** – unrealised capital losses

**R** –realised capital losses

**Q** – realised capital losses – potential double deduction

$$Q = Y - X - Z$$

$$0 < Q / R <= 1$$

**Formula 3** Amount of double deductions for realised capital losses

The formula above is based on the assumption that after the deduction of unrealised capital losses, the reduced cost base of

[246] The reduced cost base amount after the deduction of the capital losses cannot be less than the amount of the market value of the interests. This follows from the fact that a market value that is higher than the reduced cost base will be used as the Step 1 amount (subsection 705-65(1) Item 2).

interests remains higher than their market value. In this case, the established difference between the reduced cost base and the market value of interests is available for a deduction of realised capital losses. The same amount also constitutes an element in the loss deductions under Steps 5 and 6 ACA. A double deduction of the loss amount is established under these circumstances.

In summary, subsection 705-65(3) referring to the general anti-duplication rule lacks a limitation of the scope of its application to the deduction of unrealised losses, which would make its use more consistent with further steps of the ACA calculation. At the same time unrealised losses also diminish the amount allocable to the restated cost base of member interests on de-consolidation (Step 5; subsection 711-20(1)). The application of section 165-115GB in connection with the calculation of the reset tax cost of consolidated assets therefore triggers a further duplication of loss deductions in the event of a group member leaving the group. Potential adjustments to the reduced cost base of interests on consolidation are therefore inappropriate. They are sanctioned, though, by the rules governing the calculation of Step 1 ACA. This unfair consequence can be avoided by opting for the retention of current asset values on consolidation. That option, however, ceases to be available after the end of the transitional period.

### 3.4.3. Reset tax cost of depreciating assets

The ACA, established primarily on the basis of the tax cost base or the market value of interests, has to be distributed with regard to the relative market value of the subsidiaries' assets. This measure includes both recognised and unrecognised current and capital assets of a joining entity. From this it follows that a proportion of non-depreciating assets with a high market value may result in a shift of the recognised tax values away from the depreciable asset amounts, even if the overall tax value of assets rises or remains unchanged. The formation of a consolidated group or a wholly-owned subsidiary joining such a group may trigger the initial recognition of non-depreciating capital assets, for instance goodwill,[247] which potentially diminishes the amount allocable to the remaining depreciation revenue assets.

At the same time, a relatively low or virtually non-existent[248] tax cost base for interests held in a joining entity inevitably reduces the scope for the calculation of the ACA, the basis for the calculation of reset tax values of all depreciable and non-depreciating assets. A considerably higher cost base for interests in that entity, however, may potentially neutralise the impact which the recognition of non-depreciable assets can have on depreciation claims available under the consolidation

[247] See section 705-35(3).
[248] This will be the case if the joining entity was established by the group's head entity or one of its wholly-owned subsidiaries.

regime.[249] In practice, nevertheless, this chance appears to be rather remote.

Presumably, a relatively high tax cost of interests will already go along with a low level of unrecognised non-depreciation assets. This correlation is dependent mainly on the time period for which the interests were already held, considered at the date of ACA calculation. Following economic ratios, the existence of a gap between the tax value of shares and the actual or estimated market value of the same interests in a subsidiary may be related to the following two major factors:

- *allocation of revenues and investments into company assets* – no negative impact on the depreciation basis on consolidation; or
- *aggregation of (self generated) goodwill* (e.g. brand reputation) – potential for a decrease in the depreciation basis on consolidation;

both occurring subsequent to the acquisition of interests in the entity.

*Argumentum e contrario*, a high tax cost for interests, relatively equivalent to the current market value, should correlate with a substantial goodwill amount being recognised already at the time of the acquisition of the entity. From this it follows that where goodwill

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[249] However, the allocable cost base for interests cannot exceed the established market value.

exists at the time of the formation of the consolidated group or the joining time of a subsidiary, it should not trigger any major shifts in the accessibility of pre-consolidation depreciation claims for the subsidiary's assets consolidated in the hands of the head company.[250] This, however, is primarily due to the short time period lying between the acquisition of interests and the time of consolidation. In fact, the relatively high tax cost of interests, which is used for the calculation of the cost amount allocable to all depreciating and non-depreciating assets of a joining subsidiary, should account for the goodwill amount[251] generated by the wholly-owned group member prior to its acquisition. At the time of the allocation of the ACA, the percentage proportion of the goodwill amount on the market value of all assets brought by the joining entity should correspond with the relation between the net amount of assets and the goodwill expressed in the price paid for the interests in the entity. Consequently, the amount finally allocated to the goodwill, in accordance with its share in the total amount of the relative market value of assets, should be covered by the corresponding sum included in the tax cost base of interests. This is primarily relevant under the assumption that the times of the acquisition and consolidation fall together. The conclusion in this

[250] In contrast to the view expressed, Baxter assumes that the recognition of high goodwill amounts on consolidation unavoidably triggers a decline in the sum of depreciating assets. See Tony Baxter, 'Consolidations: the other side of transition' (2002) 37 (2) *Taxation in Australia* 95, 95.
[251] Goodwill is defined in this context as the excess of the market value of the interests over the market value of the entity's net assets.
See Chapter 5 (Paragraph 5.35) EM, *Consolidations Act (No.1)*.

context is therefore that corporate groups operating a number of long established entities will face diminishing depreciation claims. The low tax costs for interests and potentially high goodwill amounts, self generated and therefore not recognised prior to consolidation, will limit the sum available for allocation to the (reset) tax values of depreciating revenue assets.

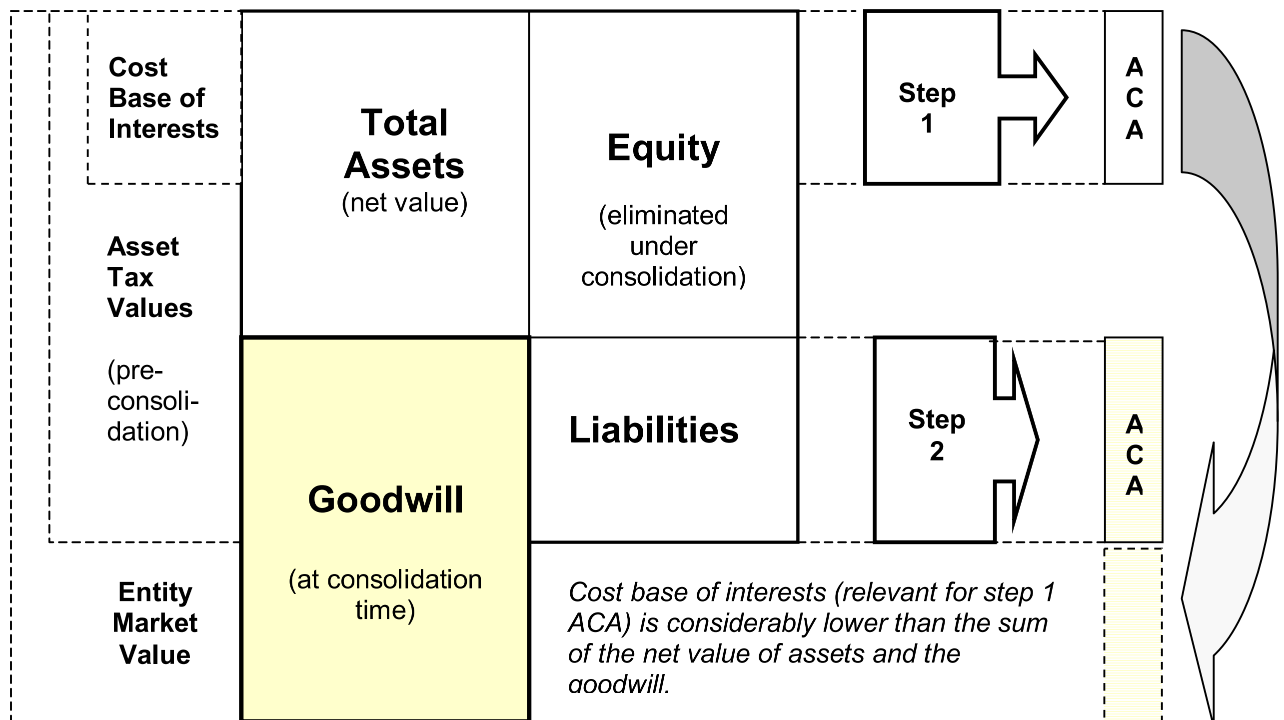


**Figure 7** ACA calculation – acquisition and consolidation times diverging

As this diagram illustrates, the entire ACA Step 1 and 2 amounts have to be allocated to the goodwill, the initial recognition of which occurs at the time of consolidation, and are not available for the resetting of the tax costs of the remaining depreciating and non-depreciating assets.

In the case of a simultaneous acquisition and consolidation of a subsidiary, the effect on the reset tax cost of depreciable assets may be the virtual opposite. Here the allocable cost amount is primarily composed of the share price incurred by the group (Step 1 of the ACA calculation), presumably the sum of net value assets and goodwill, and the amount of liabilities accrued by the subsidiary (Step 2 of the ACA calculation). In this case, the ACA distributes the goodwill amount included in the acquisition price of the interests to the existing goodwill value established at the time of consolidation. The sum of liabilities and the net value of assets are available for allocation to the depreciable revenue assets and remaining non-depreciating assets, respectively the retained cost base assets.

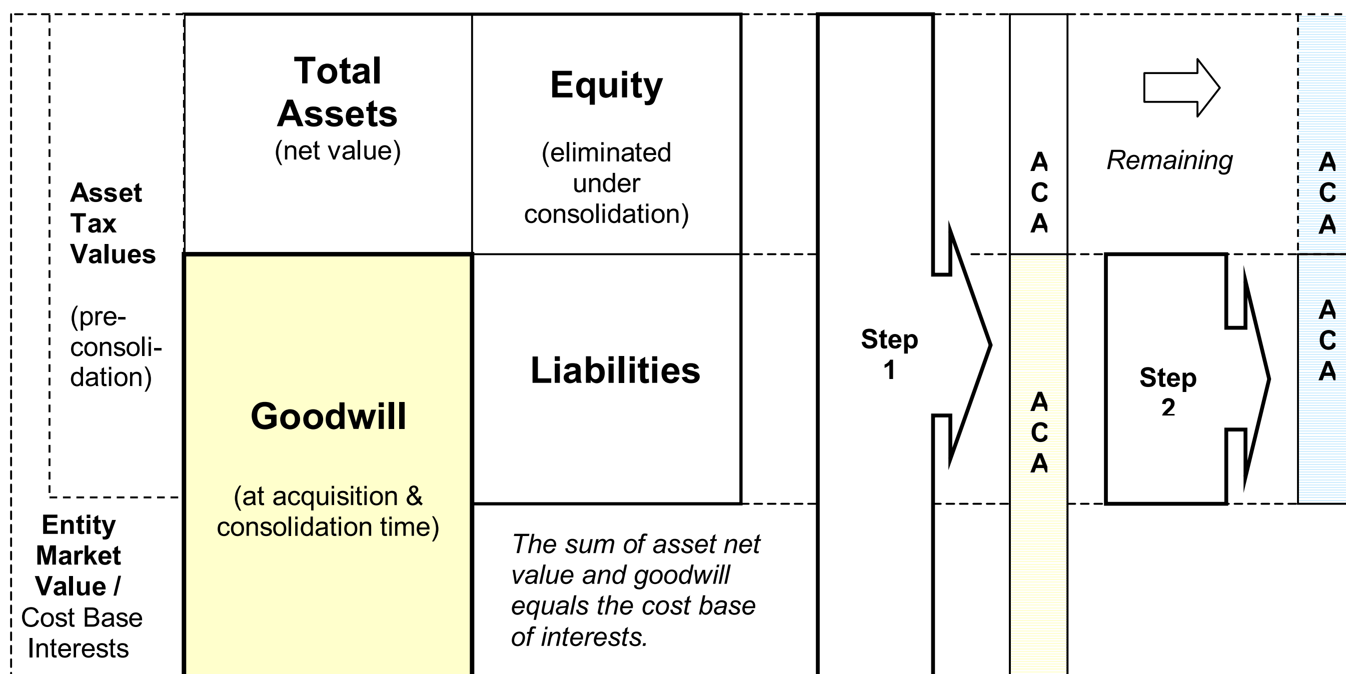


**Figure 8** ACA calculation – acquisition and consolidation times identical

In relation to revenue (depreciating) assets, the maximum ACA is the assets' market or termination value.[252] In the case illustrated above, the sum of depreciated book values constitutes the ACA amount allocable to the entity's (pre-consolidation) assets. A decline in the tax value of depreciating assets may therefore be triggered primarily by market or termination values being assessed lower than the pre-consolidation tax costs.

The relative dependence of the post-consolidation depreciation claims on the time distance lying between the acquisition of the interests and the time of the calculation of the reset asset values on consolidation can be illustrated by the following formula:

**Y** – reset asset value (simplified)

**Yz** – value of reset depreciating assets

**X** – cost base of shares (if lower - market value), plus liability; the basis for ACA calculation (simplified, only Step 1 and 2 of ACA calculation)

**Z** – market value - depreciating assets (recognised pre-consolidation)

**R** – market value – non-depreciating capital assets (recognised pre-consolidation)

**Q** – goodwill - post acquisition of interests (recognised on consolidation)

[252] See section 705-40(1).

$$Y = \frac{(Z * X) + (R * X) + (Q * X)}{Z + R + Q}$$

$$Yz = \frac{Z * X}{Z + R + Q}$$

**Formula 4** Calculation of reset asset value[253]

In the case that acquisition and consolidation times fall together, **Q** has a value of nil. The ACA is allocated solely to the already recognised, depreciable and non-depreciable, assets. However, the longer the interests in the subsidiary were already held by the head company or another wholly-owned group member, the more factor **Q** will presumably increase in relation to **Z** and **R**. Moreover, factor **X** (cost base of interests) will not account for the amount expressed by **Q**, which originated subsequent to the acquisition of the interests. The depreciation claims should therefore decrease as the pre-consolidation ownership time of the interests extends.

[253] This formula is strongly simplified. The calculation is made under the assumption that the value of the *retained cost base assets* is either nil or has already been deducted from the sum calculated under factor **X**. Moreover, the calculated reset asset values are assumed not to exceed the assets' market or termination values.

### 3.4.4. Disposal of equity

The resetting of asset tax cost at the time of consolidation should have no practically significant impact on the CGT implications arising at the time of the disposal of the group's equity. In the event of selling the membership interest held in a consolidated group member, the interests' tax cost base must be recalculated primarily taking into consideration the existing (reset) asset values and liabilities. The re-constitution of the tax value of equity interests held by group members reverses the procedure of calculation of the reset cost base assets, which itself is based on the tax cost base or reduced cost base of membership interests, plus liabilities accrued at joining time. Assuming that there is no notable time difference between the event of consolidation and the subsequent disposal of equity (de-consolidation), the consolidation and de-consolidation of the equity interests should result in tax cost resembling the pre-consolidation value.

The main notable exception to this rule is the case where certain realised and / or unrealised loss amounts (Step 5 ACA) or tax benefits, available through future utilisation of losses (Step 6 ACA), must be deducted from the allocable cost base of interests. The result of these reductions is that the cost base of interests reconstituted at the time of de-consolidation is lower than the cost base at the joining time. This negative effect is neutralised, however, since the head

company retains the losses transferred at the time of consolidation, even though the loss entity is leaving the group. Consequently, the disposal of equity cannot have any serious negative tax implications due to changes to the cost base of interests that become relevant at the time of de-consolidation, unless substantial loss amounts do not meet the loss transfer criteria stipulated by the legislation.

Importantly, losses deducted under Step 5 ACA are both, transferable and non-transferable losses. The amount of non-transferable losses, which are deducted at the time of consolidation, reduces the basis for the subsequent reconstitution of the cost base of interests, whereas no corresponding loss deductions can be claimed by the group's head company in order to be "compensated" for the reduction in the relevant tax attribute. Consequently, certain losses that are not transferable at the time of consolidation have two major areas of impact:

- reducing the reset tax cost of assets at the time of consolidation (CGT and depreciation related implications); and
- diminishing the tax attributes available to the group at the time of de-consolidation (no losses matching the reduction of the (reconstituted) cost base of interests).

The following analysis provides insight into the procedure governing the transfer and recoupment of losses accrued by consolidating entities.

4. Loss rules

Subsequent to the introduction of the consolidation regime and the consequential removal of previous loss grouping provisions, a corporate group is eligible to utilise losses incurred by its wholly-owned subsidiaries only where it elects to consolidate. Corresponding to the obsolete loss transfer rules, the accessibility of a group's losses on consolidation is subject to complex loss transfer and recoupment tests.

According to the single entity rule, consolidated groups are taken to be one entity for the purpose of working out the taxable income or loss of a group. In conformity with this rule, unused losses incurred or transferred prior to becoming a consolidated group member cease to be losses of an individual entity at the joining time.[254] At the time of consolidation, such losses can be transferred to the head company which is subsequently deemed to have incurred these losses in the year of transfer (subsection 707-140(1)(a)) and is therefore, if it passes a recoupment test, entitled to use them.[255]

[254] This happens at the time of election to consolidate (formation case), the joining time of an entity into an existing consolidated group and at the time of one consolidated group being acquired by another consolidated group.
[255] At the time of the establishment of a consolidated group, the head company also "transfers" its accrued losses to the group. Consequently, losses brought by the head company into the consolidated group are also deemed to be incurred by the head company at the time of the transfer.

In cases where loss transfer tests fail or the head company cancels a potential transfer (subsection 707-145(1)), the loss amount cannot be carried forward and used for an income year ending after joining time. In the absence of a loss transfer at the joining time, the accrued losses are irrevocably lost for the loss entity and for the consolidated group (section 707-150). On the other hand, losses transferred on consolidation which are carried forward but not used by the group until the time of de-consolidation remain with the group and cannot be re-transferred to the leaving entity (section 707-410).

To be transferred at the time of consolidation, accrued losses must be classified as available for transfer. The questions surrounding this crucial issue are analysed in *section 4.1*.

Importantly, the available losses are subjected to the relevant transfer tests (*section 4.2.*), which determine the categories of losses recoupable by the group's head company. In this context, modified versions of the known loss transfer tests, the continuity of ownership test (COT) and the same business test (SBT), are employed. As the following discussion demonstrates, the prolonged test period for COT loss transfers (*section 4.2.1.*) in connection with the retroactively applicable same business conditions under the SBT for losses incurred after 30th June 1999 (*section 4.2.2.2.*) has the potential to undermine the ability of groups to retain and use the relevant tax attributes at and after the time of consolidation.

This detrimental effect of the loss rules is analysed in *section 4.5.1.1.* Further critical issues under consideration are the transfer of SBT losses post consolidation (*section 4.5.1.2.*), delays in the recoupment of transferred losses (*section 4.5.1.3.*). Finally, rules improving access to group losses (*section 4.5.2.*) are discussed.

The opportunity for the transfer of trust losses constitutes one of the most positive developments in relation to the use of losses arising in the wake of the implementation of consolidation provisions. Such transfers were not possible under the previous grouping rules. The transfer and use of trust losses will therefore be of particular interest in the following discussion.

Finally, groups considering the option to consolidate must understand the rules governing the so called “loss factors” (*section 4.3.4.*), which stipulate the annual rate at which losses can be recouped, and the implications resulting from the statutory sanctioned order of use of losses available subsequent to the consolidation time (*section 4.3.3.*). For the duration of the transitional period, however, consolidating groups can make use of concessional provisions considerably improving the opportunities for the use of transferred losses. These rules are analysed in *section 4.4*.

In conclusion, the assessment of the policies and rules governing the accessibility of group losses, which result in the operation of transfer and recoupment provisions, belongs to the core considerations that should be made prior to a decision for or against consolidation. After all, the treatment of losses at the time of consolidation does not only determine the future availability of tax deductions. As the previous analysis of the asset rules illustrated, the loss provisions also interact with the rules governing the calculation of the tax costs of assets of a group and the subsequent reconstitution of the cost base of membership interests which is eliminated at the time of consolidation.

### 4.1. Losses available to be transferred

According to section 707-100, unused losses accrued to joining subsidiaries[256] for income years ending prior to the joining time (subsection 707-115(1)(b))[257] which, assuming the consolidation had not taken place, could be used by these group members, are available for transfer to the group's head company. The availability of the accrued losses is determined with regard to the joining time, the time when all joining entities, including the head company in the case of the initial formation of a consolidated group, must prepare individual tax returns for their non-membership periods (subsection 701-30(3)).[258] In the last pre-joining tax-return, the accrued and recoupable losses are offset against the assessable income or exempt income of the joining entities (subsection 707-110(2)(a)); only the remaining recoupable (net) losses are available for transfer to the group (subsection 707-115 (2)).

[256] These are losses incurred by (subsection 701-30(3A)(b)(i)) and transferred to the entities (subsection 701-30(3A)(b)(ii)).
[257] In cases where the joining time does not coincide with the end of an income year, losses incurred during the non-membership period, the time between the end of the last income year and the joining time, are taken to be made for an income year matching the length of the non-membership period (subsection 701-30(8)). Losses transferred to an entity during this period are also available for transfer upon consolidation (subsection 701-30(3A)(a)).
[258] These are the pre-consolidation period and the period starting with de-consolidation, where the entity joined the group and left it during the same income year.

However, even though the "cut off" time for the determination of the transferable loss amount is the joining time of the loss transferring group members, the pre-joining recoupment test for these losses stretches beyond that time (subsection 701-30 (3A)).[259] The unused pre-consolidation losses are transferable to the group only if they pass the COT or the SBT and the control test. The tests' periods end just after the date of the consolidation event. From this it follows that potential ownership changes occurring at the joining time will have to be taken into consideration.[260] In cases where a significant ownership change of more than 50% of a subsidiary's membership interests becomes the trigger for the consolidation of an entity, the unused losses are available for transfer to the group only if the same business condition is satisfied.[261]

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[259] This measure was not included in the first draft of the loss transfer rules, *Consolidations Act (No.1)*; it was introduced in the *Consolidation and Other Measures Act (No.2)*.
[260] ATO, Consolidation Reference Manual (May 2003), Chapter C3-3-105, 1.
[261] However, the extended test period does not affect the application of the SBT, since the loss entity is taken to have carried on the same business at the time just after the consolidation event as at the time prior to that event (subsections 701-30(3A) and 707-120(3)).
At the same time, the application of the extended test period for COT in relation to losses which can potentially be offset against the taxable (non-membership) income may increase the joining entities' exposure to income taxation, compared with the outcome originally provided by the consolidation loss transfer provisions. According to the Federal Treasurer, Subsection 701-30(3A) has been introduced in order to 'synchronise the application of the COT as a recoupment test (for a pre-joining period) with its application as a transfer test'. See Chapter 6 (Paragraph 6.16) EM, *Consolidation and Other Measures Act (No.2)*.
Such synchronisation is achieved. However, the accrued losses can only be utilised in the pre-consolidation tax return, where the COT for the extended test period is passed, assuming that no (significant) change to the ownership of membership interests occurred at the joining time, or the SBT requirements are met. The extended test period ensures therefore that joining entities may utilise losses to the same extent, as they would be entitled to if they remained outside the scope of the consolidation regime.
See also Part B Chapter III 4.5.1.1.

Where the recoupment test conditions are met, the following kinds of losses can potentially be used by the head company (subsection 701-1(4)):

- revenue or ordinary tax losses incurred under Divisions 36 and 375 (film losses);
- net capital losses incurred under Division 102 and 165; and
- overall foreign losses (section 160 AFD ITAA 1936).[262]

However, a consolidating group obtains these losses only where the conditions of one of the stipulated transfer tests are met.

[262] Importantly, foreign losses were not transferable under the previous grouping provisions. See also Jenny Clarke, 'Transferring losses' (Paper presented on Taxation Institute of Australia Conference, Sydney, 7th March 2002) 4.

## 4.2. Losses transferable to the group (transfer tests)

The major underlying purposes of the loss transfer rules are, on one hand, to convert the single joining entities' tax losses into losses of the consolidated group and, on the other hand, to prevent pre-consolidation losses being used at a greater rate than under rules applicable to individual tax paying entities (subsection 707-110(1)).[263] Corresponding to the availability requirements, the remaining unused pre-consolidation losses originating with the wholly-owned subsidiaries or the head company[264] are transferable to the group's head company only to the extent 'that the loss could have been utilised by the joining entity for an income year consisting of the trial year, [which comprises twelve months prior to consolidation and the time just after joining time (subsection 707-120(2)], if:

(a) at the joining time, the joining entity had not become a member of the joined group (but had been a wholly-owned subsidiary of the head company if the joining entity is not the head company); and

(b) the amount of the loss that could be utilised for the trial year were not limited by the joining entity's income or gains for the trial year'.[265]

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[263] See Clarke, above n 262, 3.
[264] The losses accrued by the head company are subjected to the same availability and transfer conditions as those of the joining subsidiaries.
[265] Subsection 707-120(1).

For companies, the transferability of losses depends mainly on the compliance with modified versions of either the COT, Division 165, or the SBT, Division 166, each considered with regard to the trial year (subsection 707-120(1)). Accordingly, a joining company may transfer its losses to the group only if:

- there is a greater than 50% continuity of beneficial ownership in the company at all stipulated times (COT); or
- the transferring company carries on the same business as it did just before the change in majority beneficial ownership(SBT); and
- no person obtained control over the company's voting power with the intention to gain a tax benefit or advantage (this condition is equally relevant for COT and SBT).

Finally, (non-fixed) trust losses can be transferred to the group on compliance with the conditions of the (modified) pattern of distributions test (section 267-30 of Schedule 2F ITAA 1936 in connection with section 707-130), the control test (section 267-45 ITAA 1936) and the 50% stake test (sections 267-40 and 267-70 ITAA 1936) which resembles the COT.

Fixed trust losses are subject to the 50% stake test only. Adapting the general fixed trust loss deduction rule, the test period stretches from the beginning of the loss year until the end of the income year

(subsection 266-25(1)(b) ITAA 1936), where the joining time is deemed to be the end of the income year.[266]

Moreover, losses incurred by widely held (fixed) unit trusts (Schedule 2F, section 272-105 ITAA 1936) are subject to the SBT. However, since such entities are not wholly-owned, they do not qualify for consolidation.

In conclusion, trust losses are only transferable where the conditions of the applicable ownership test, which is the 50% stake test, and, where applicable, the control test and the modified pattern of distributions test are satisfied. An alternative SBT is not available in relation to the transfer of trust losses under tax consolidation.

[266] This period includes the trial year (subsection 707-120(2)).

### 4.2.1. Modified continuity of ownership test (COT) and control test

When applying the general COT rules (Subdivision 165-A) for the purpose of loss transfers under the consolidation regime, the following cumulative requirements have to be met in relation to the relevant testing period:

- more than 50% voting power is held by group members;
- rights to more than 50% of dividends are held by group members; and
- rights to more than 50% of capital distributions are also held by group members.[267]

The extent of the ownership test period, the period between the start of the loss year and the end of the (recoupment) income year (subsection 165-12(1)), is modified for the purpose of loss transfers under consolidation. The applicable transfer test period, the trial year, coincides with the conditions stipulated by the availability (recoupment) requirements and ends just after joining time (subsection 707-120(2)(b)). Consequently, losses which pass the COT

[267] See section 165-12.
The voting power criterion is redundant where the COT is applied to corporate limited partnerships.
See Fisher, above n 70, 36.

in relation to their availability should also satisfy the COT transfer test.[268]

Losses accrued by joining entities which pass the COT can only be transferred where they meet the conditions of the control test (subsection 165-15(1)). Accordingly, a person's intention to gain a tax advantage or benefit must not constitute the purpose for obtaining control over the joining entity, if, for some or all of the loss year, this person did not have voting control or lost control over the member votes. In practical terms, the control test is passed where the group controls the entity's voting power for the entire test period, beginning with the start of the loss year. When applied to non-fixed trusts, the control test is failed if the group did not continuously control the trust from the beginning of the loss year until the joining time of the trust (section 267-45 ITAA 1936).

[268] For the differences in the implementation of the COT for non-listed and listed public companies see Rachael Keech, 'Consolidation – navigating the loss provisions' (2002) 5 (4) *The Tax Specialist* 177, 178.

### 4.2.2. Modified same business test (SBT)

The SBT constitutes an alternative transfer test. It can be used in relation to company losses passing the control test, but not qualifying for a transfer under the COT. The conditions of the SBT required for the transfer of losses on consolidation are determined with regard to the date on which the losses were incurred. Losses incurred in years of income starting before 1st of July 1999 are subjected to the general SBT rules (sections 165-13 and 165-210) which are altered with reference to the trial year. On the other hand, losses incurred in years of income starting after 30 June 1999 have to pass the SBT under strongly modified, stricter conditions (section 707-125).

#### 4.2.2.1. Losses incurred before or on 30th June 1999

In order to transfer losses incurred on or before 30th June 1999, the business carried on by the joining subsidiary in the trial year (section 707-120(2)) must be:

- the same as the business carried on just before the COT was first failed, or
- the business carried on just before it was first established that there was no substantial continuity of ownership when tests were conducted at the prescribed times (listed public companies).[269]

With the exception of the trial year period, the conditions for the transfer of losses under consolidation are based on the recoupment provisions applicable to individual entities. The inherent difficulty of this approach is the correct determination of the required degree of similarity between the business activities under consideration.[270]

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[269] Subsections 707-125(1) and (4).
See Chapter 6 (Paragraphs 6.74) EM, *Consolidations Act (No.1)*.
[270] See Fisher, above n 70, 37.

#### 4.2.2.2. Losses incurred after 30th June 1999

Losses incurred after 30th June 1999 are subjected to an extended test period. The transfer of such losses under the SBT depends on the consistency of business carried on by the joining entity during the trial year, the (entire) income year in which the COT was first failed, or the income year in which it was first established that there was no substantial continuity of ownership (listed public companies), and the time just before the end of the income year for which the loss was made (subsection 707-125).

The use of the trial year is to ensure a sufficient length of application of the SBT for cases where the joining time and the change of the ownership coincide.[271] However, referring to the activities conducted during the entire income year in which the continuity of ownership was initially interrupted and, even more important, the business carried on at the end of the loss year, there is the potential for an unjust treatment of joining entities holding SBT losses at the time of consolidation.[272]

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[271] See Chapter 6 (Paragraphs 6.55 and 6.69) EM, *Consolidations Act (No.1)*.
[272] See also previous section; Part B Chapter III 4.2.2.1.

#### 4.2.2.3. Losses previously transferred as SBT losses

SBT losses that were previously transferred to the joining entity as the SBT was passed must undergo additional testing (section 707-135). Such losses are only transferable at the joining time where, in addition to meeting the conditions for losses incurred or received through transfer before 30th June 1999, the joining entity carried on the same business in the trial year and at the end of the income year in which the losses were transferred to this entity. Losses transferred after 30th June 1999 are not exposed to additional test periods.[273] Moreover, losses previously transferred under the SBT do not qualify for the application of the COT, even though for the time between the initial (SBT) loss transfer and the joining time the same ownership requirement may have been satisfied.[274]

[273] The test periods stipulated by section 707-135 are already applied pursuant to subsection 707-125(2).
[274] See Chapter 6 (Paragraph 6.77) EM, *Consolidations Act (No.1)*.

### 4.2.3. Modified pattern of distribution test (PDT)

The transfer tests applicable for trust losses mirror the generally applicable recoupment tests (Subdivision 269-C of Schedule 2F ITAA 1936); the test period is merely altered by reference to the trial year. The application of the trial year, a twelve month period ending just after the joining time, for the purpose of the PDT, however, could result in a test "income year" which does not coincide with an actual income year of the joining trust. Such inconsistency could hamper the stipulated comparison of income and / or capital distributions of the last income year (the loss claim year) with the distributions made in six earlier income years.[275] Such outcome is prevented through the operation of subsection 707-130(2), which stipulates that the income year of the joining time and not the trial year has to be applied for the PDT. Consistent with subsection 701-30(8), this income year is deemed to end at the joining time of the relevant non-fixed trust.[276]

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[275] See Chapter 6 (Paragraph 6.87) EM, *Consolidations Act (No.1)*.
[276] See ibid Chapter 6 (Paragraph 6.89).

## 4.3. Recoupment of tax losses under consolidation

Losses transferred to the group are deemed to be incurred by the head company in the income year in which the transfer occurred (subsection 707-140(1)). Accordingly, the ability to carry-forward and utilise losses depends on the satisfaction of the relevant corporate recoupment test, the COT, subject to modified conditions under Subdivision 707-B, or the SBT.[277] With the exception of COT losses transferred from company subsidiaries (section 707-210), the transferred losses are "refreshed" in the hands of the head company through the resetting of the applicable test times (subsection 707-205(2)). The following two sections provide an overview of the main conditions for the utilisation of COT and SBT losses, subject to transfer at the time of consolidation. In accordance with the scope of this thesis, the discussion concentrates on the core recoupment principles, and does not cover the treatment of losses incurred subsequent to consolidation or the transfer of losses from a consolidated head company to a head company which acquires the full ownership in the consolidated group.

[277] These tests are also applicable to losses transferred from wholly-owned trusts at the time of initial consolidation.

#### 4.3.1. Losses transferred as COT losses

For COT losses, the head company "inherits" the ownership history of the loss-transferring subsidiary (subsection 707-210(2)).[278] This means that the COT test time starts not at the joining time, but at the time which was initially applicable for the recoupment of the loss in the hands of the subsidiary member, the test company (subsection 707-210(3)), which is the start of the loss year. According to subsections 707-210(1) and 707-210(3), the test company is the first company that made the loss or a company that was the last to receive the loss through a transfer.[279]

The retaining of the initial testing time is not important, since, as far as COT transferred losses are concerned, the COT conditions must already have been met for the loss transfer at the time of consolidation. The recoupment test period starts practically, therefore, at the loss transfer time. More significantly, the test subject, which is the ownership structure of the subsidiary, is also the same. From this

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[278] According to subsection 707-210(2), the head company of a consolidated group (the 'latest transferee') is able to utilise the respective loss only where the loss company would have met the conditions stated in section 165-12 for the income year, with regard to the circumstances defined in subsection 707-210(4). The requirement for the loss company to meet the ownership conditions stated in section 165-12 ensures that the initial start of the COT test period is retained after consolidation. In the absence of this principle, the transferred COT losses could be utilised faster, or to a greater extent than outside consolidation. Such losses, "refreshed" in the hands of the head company, would be subject to ownership conditions relating to the head company and starting at the time of consolidation. This would eliminate the effect of the "same share same person" test (sections 165-165 and 166-170).
See Chapter 7 (Paragraph 7.4) EM, *Consolidations Act (No.1)*.
See Clarke, above n 262, 10.

[279] For a detailed discussion of the term "test company", see Chapter 7 (Paragraph 7.26 and following) EM, *Consolidations Act (No.1)*.

it follows that the head company is able to use the COT losses only where:

- the subsidiary remains a member of the consolidated group, in which case the head company holds, directly or indirectly, all membership interests in the subsidiary,[280] or
- the subsidiary leaves the group, however, group members are still able to meet the majority requirements in relation to voting power, dividend entitlements and capital distributions.

Importantly, SBT (company) losses are not affected by these rules, since the ownership changes in the loss transferring entity were already recognised when determining that the SBT had to be met at the loss transfer time, the time of consolidation.[281]

Furthermore, for the recoupment of trust losses, only ownership changes occurring in relation to the head company, tested from the time of the transfer, have to be taken into consideration. This rule can be recognised as a direct consequence of the transfer of the trust losses into the hands of the head company. Subsequent to the transfer, the losses are subjected only to COT or SBT requirements. The trust loss recoupment tests are not applicable for a consolidated group, which makes the resetting of the test time inevitable. This

[280] From this it follows that intra-group ownership changes can be ignored for the purpose of the COT. This principle is also stipulated in subsection 707-210(4)(c).
See also Chapter 7 (Paragraph 7.11) EM, *Consolidations Act (No.1)*.
[281] See ibid Chapter 7 (Paragraph 7.15).

favourable treatment may constitute a considerable benefit for groups obtaining trust losses.

Finally, the tax history of the loss making company is not inherited by the head company where, at the time of transfer, the requirements of the COT and SBT were met, but the control test was failed. After all, such losses are classified as SBT losses, since the transfer was only possible pursuant to the satisfaction of the SBT same business conditions (subsection 165-15(2)).[282]

In cases where the COT fails, whether for company or trust losses, the head company can seek to use the loss under the SBT conditions. The SBT test time commences just before the established time of the change in the ownership or at the start of the loss year (165-13(2)), whereas, in relation to company losses, the head company is taken to have failed the test at the time at which the test company, the exiting loss maker, would have failed the test requirements (subsection 707-210(5)).

[282] See ibid Chapter 7 (Paragraph 7.16).

### 4.3.2. Losses transferred as SBT losses

Losses transferred under SBT are not subject to further business testing subsequent to consolidation, unless the head company, which is taken to be the loss making entity (subsection 707-105(1)), does not meet the COT ownership requirements or undertakes to transfer the losses again.[283] The same principle is valid for trust losses transferred on consolidation.

The recoupment conditions for these losses are tested solely in relation to the ownership status and activities of the head company. However, it remains unclear, to what extent changes in the business activities of subsidiary members might be attributed to the business of the head company, in which case they would become relevant for the passing of the SBT.[284] Arguably, the head company is the only loss making group member. As such, 'the business of the head company, as the entity carrying on all business for the group',[285] not the isolated activities of all single group subsidiaries, should be referred to for the purpose of the SBT.

Nevertheless, under this approach it must be specified to what extent and under which circumstances the activities of the subsidiary members could influence the definition of the business carried out by

[283] See ibid Chapter 6 (Paragraph 6.105).
[284] See Clarke, above n 262, 11.
[285] See Keech, above n 268, 180.

the head company. Neither the *Consolidation Reference Manual,*[286] nor the *Explanatory Memorandum* [287] provide guidance into this crucial issue.

Finally, losses transferred to the group which pass one of the relevant recoupment tests cannot be used without reference to the stipulated order of use, which differs fundamentally from the rules applying to non-consolidated entities.

[286] ATO, Consolidation Reference Manual (May 2003).
[287] EM, *Consolidations Act (No.1)*.

### 4.3.3. Order of use

Subdivision 707-A provides a general principle for the use of losses under the consolidation regime. Transferred losses of a particular sort can only be used subsequent to the use of current year deductions and post-consolidation losses of the same sort accrued to the group (subsection 707-305(2)), even though such deductions and losses are incurred in income years following the time of loss transfer.[288] Consistent with this rule, concessionally transferred (COT) losses must not be used prior to the use of non-transferred losses of the same sort (subsection 707-350(2) ITTP).[289] Referring to these provisions, the order of use of losses under consolidation can be determined in a simplified manner as follows:

- group (post-consolidation) losses;
- transferred concessional COT losses; and
- "standard" transferred losses of the same sort.

The maximum potential usable portion of transferred losses amounts to the sum remaining after the assessable income and gains are reduced by current deductions, accrued group losses and concessionally transferred losses.

[288] Chapter 8 (Paragraph 8.6) EM, *Consolidations Act (No.1)*.

[289] For the discussion of the (transitional) conditions determining the concessional transfer and use of such losses see Part B Chapter III 4.4.

However, the annual rate at which the Subdivision 707-A losses can be used is further limited by the “available fraction”, an individually calculated percentage of non-concessional losses which can be used for each income year subsequent to the time of consolidation. The following section provides an insight into the process of determining the available fraction for standard transferred losses.

### 4.3.4. Loss factors

The group's ability to use losses transferred by joining subsidiaries must reflect the rate at which such losses would have been used had consolidation not taken place (subsection 707-305(3)). The loss utilisation is therefore based on an individually calculated allowable / available fraction. This is a percentage of assessable income stipulating the maximum annual rate at which a head company can deduct standard transferred losses. It is determined with regard to the subsidiary's modified market value, presumably representing the ability to generate income or gains in the future (subsection 707-305(4)(b)), as a proportion of the group's modified market value (subsection 707-320(1)) at the time of consolidation. The following formula illustrates the calculation of the available fraction at the time of initial consolidation:

$$\frac{\text{Modified market value of loss entity (section 707-325)}}{\text{Value of joined group (including the loss entity)}}$$

**Formula 5 Available fraction (subsection 707-320(1))**

An available fraction must be calculated for losses of each consolidated group entity, which are transferred at the time of consolidation. Such losses form a "loss bundle" (section 707-315) that

is retained together with the determined fraction until all loss amounts are used (subsection 705-315(3)).[290]

In conclusion, the maximum amount which can be used at a certain time depends on the sort of loss held in a particular loss bundle, this determines the losses' order of use, and the result of the available fraction multiplied by the group's notional taxable income.

**Example 4**: Available fraction

The wholly-owned Subco joins a consolidated group on 1st July 2003 (the date on which the group was established, following notification made by the group's head company).

Subco has AUD 200,000 carry forward losses. Subco's business record at the consolidation time is relatively weak which results in a modified market value of the entity amounting to AUD 1,000,000.

The group's calculated market value is AUD 25,000,000.

The available fraction for the use of the Subco's losses is calculated as follows:

1,000,000 / 25,000,000 = 0,04

Consequently, the maximum annual amount of Subco's carry forward losses that can be used by the group amounts to AUD 8,000 (4% from 200,000).

As this example shows, the available fraction rule constitutes an effective instrument containing loss trafficking from economically weak subsidiary members to groups electing consolidation.

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[290] The fraction is recalculated, however, in the case of events specified by subsection 705-320(2).

The use of transferred losses is determined by the following steps:

- the calculation of the amount of each relevant income category (capital gains, assessable foreign income, exempt film income, film income, other exempt income, other assessable income) less applicable deductions (inclusive of group losses and concessional losses, but not the standard transferred losses);
- the amount in each income category resulting from the previous step is multiplied by the available fraction; and
- the amounts calculated under the second step are the deductible fractions for the relevant categories of standard transferred losses, which can be deducted from the assessable income of the group.

The first two steps are based on the procedure stipulated by subsection 707-310(3). In the third step, the deductible amount of transferred losses is used.[291] The relevant loss bundle is also reduced by this amount.

As discussed above, the calculation of the available fraction is based on the modified market values of the group and the member entities. The market value of a loss entity has to represent its income generating capacity. Consequently, accrued tax attributes such as

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[291] See section 707-340 for the use of transferred losses in relation to exempt income, which has to be reduced to the same extent as the non-exempt income using the available fraction. See Chapter 8 (Paragraph 8.36) EM*, Consolidations Act (No.1)*.

losses and franking credits have to be subtracted from the established market value (subsection 707-325(1)(a)). Moreover, even though the fraction is calculated subsequent to the consolidation time, the loss entity's market value has to be established as if it was a single non-consolidated entity (subsection 707-325(1)(b)). However, the established market value must not account for the value of interests in other group members (subsection 707-325(1)(c)). This reduction prevents a double counting of values held by the consolidated group. Moreover, subsection 707-325(2) prevents a potential inflation of the modified market value of loss entities. According to this provision, certain increases in the established value resulting from capital injections or non-arm's length transactions must reduce the calculated amount of the modified market value.[292]

The market value of the joined group, on the other hand, amounts to the value of the group's head company which comprises the value of all consolidated group members, ignoring the amounts of accrued / transferred losses and franking credits (subsection 707-320(1)). Finally, market values of interests held by the head company or other group members in non-member entities are recognised in the calculation of the market value for the single loss entities and the value of the entire group.

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[292] For detailed comments on the anti-inflation provisions see
Emma Crause, Mark Friezer, 'Pre-consolidation transactions and loss utilisation.' (2003) 14 *Journal of Banking and Finance Law and Practice* 291.

The procedure of calculation of the loss factors explicitly refers to the income generating capacity of a relevant group member. In this way, the rules for the recoupment of losses transferred under consolidation diverge from the previous grouping provisions, which allowed losses to shelter income of other group companies.[293]

Taking this approach, the consolidation regime ensures that 'transferred losses are used up at approximately the same rate they would have been used had the loss entity remained outside the group'.[294] From this it follows that the initial transfer of losses to the group does not constitute an opportunity to use these losses, which were accrued by group members prior to consolidation, under the principles arising from the single entity rule. Only post-consolidation losses can be used by groups without regard to the established loss bundles and available fractions. Consequently, the decision to consolidate should not be driven by the tax treatment of losses accrued at the time of the formation of the group.[295]

Consolidating groups can escape these restrictive loss utilisation principles only through the application of transitional rules where an election to consolidate is made prior to 30th June 2004.

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[293] See Keech, above n 268, 183.
[294] Chapter 8 (Paragraph 8.19) EM, *Consolidations Act (No.1)*.
[295] See ibid.
See also Michael Charles, 'Consolidations For Tax: Overview and Implications' (2003) 15 (4) Australian Insolvency Journal 9, 12.

### 4.4. Transitional loss rules

Corresponding to the introduced option to retain the tax cost of assets, transitional concessions are also available in relation to the transfer and utilisation of (pre-consolidation) losses. The eligibility requirements for these provisions are the same as those governing access to the transitional asset rules.[296]

At the time of the formation of a group, which must not be later than 30th June 2004, the head company must make the decision whether (or not) to apply the transitional loss concessions in relation to loss bundles transferred by a particular or all eligible company members (chosen transitional entities).[297] The utilisation of losses transferred from such chosen transitional entities is substantially freed from the limitations imposed by the available fraction method. This outcome results from the application of the following three major concessions which are available before the end of the transitional period:

- market value donor concession for non-concessional losses (*section 4.4.1.*);
- loss donor concession (*section 4.4.2.*); and
- use of COT (concessional) losses over 3 years (*section 4.4.3.*).

[296] See Part B Chapter III 3.3.
[297] For more details concerning the eligibility conditions see section 5.3 in this Chapter (pages 107 to 109).
Importantly, these concessions are available only for losses transferred from companies. See Chapter 9 (Paragraph 9.10) EM, *Consolidations Act (No.1)*.

An analysis of the current loss concessions is important not only in the context of the choices available during the transitional period. To some extent, these transitional rules can contribute to the understanding of the general loss provisions and underline the relative strictness characterising the non-concessional treatment of losses transferred at the time of consolidation.

#### 4.4.1. Value donor concession – donating market value

In accordance with section 707-325 ITTP 1997,[298] the available fraction calculated for a bundle of losses brought into the group by a company member (the **real loss-maker**) at the time of the formation of the group can be increased through a step-up in the loss-makers' modified market value. Such a step-up is achieved using a 'percentage of the modified market value of a company (the ***value donor***) other than the real loss-maker (…) for the bundle' (subsection 707-325(1)(a) ITTP 1997). In other words, the market value of one loss company is boosted through the transfer / donation of a share of the market value which was established for a second loss company of the group. In the course of this donation, the market value of the value donor is reduced by the relevant market value amount that was assigned to the real loss-maker (subsection 707-325(8) ITTP 1997).

The following conditions must be met in order to apply the value donor concession:

- both the real loss-maker and the value donor belong to the entities joining the group at the time of its initial formation (subsection 707-325(1)(b) ITTP 1997);
- the loss bundle of the real loss-maker contains losses that are not concessional losses to which section 707-350 applies

[298] The transitional loss provisions were introduced within Schedule 2 *Consolidations Act (No.1)*.

(subsection 707-325(1)(d) ITTP 1997), or overall foreign losses (section 160 AFD ITAA 1936);

- the test loss,[299] had it been accrued by the donor company, could be transferred from the donor to the transferee (the head company) under Subdivision 707-A (subsection 707-325(1)(e) ITTP 1997);
- the real loss-maker could have transferred the test loss to the value donor under Subdivision 170-A or 170-B for an income year consisting of the period defined as the trial year or the time when the loss was incurred until the consolidation date, if this time is shorter than the trial year (subsection 707-325(2) and section 707-328 ITTP 1997); and
- the head company chooses 'to increase the available fraction for the bundle' (subsection 707-325(5) ITTP 1997).[300]

The requirement for the reduction of the market value / available fraction calculated for the value donor at the same rate as the market value of the loss-maker is increased, and the condition for the loss-maker to be able to transfer the relevant losses to the donor, ensure that a group using the loss concession does not obtain any undue advantage in terms of an accelerated utilisation of losses, which would

[299] The term "test loss" is not used within consolidation legislation, it is, however, defined by the EM as a 'tax loss or a net capital loss that is not a concessional loss'.
Chapter 9 (Paragraph 9.13) EM, *Consolidations Act (No.1)*.
[300] For a detailed discussion of these criteria see also
See Chapter 9 (Paragraphs 9.12 to 918) EM, *Consolidations Act (No.1)*.

not be available under the previously applicable grouping provisions. The proportion of the modified market value that can be transferred by the donor must be equivalent to the amount of 'income that the value donor could have chosen to have sheltered by the real loss-makers losses',[301] provided that the outphased grouping provisions would apply.[302] This postulate is enforced by the formula for the calculation of the amount of increase in the market value of the real loss-maker (subsection 707-325(3) ITTP 1997).

Finally, groups applying this value donor concession are entitled to loss donations under subsection 707-327(1)(a) ITTP 1997.

[301] Keech, above n 268, 183.
[302] Importantly, the increase in the available fraction has no impact on the utilisation of foreign losses (subsection 707-325(9) ITTP 1997). After all, the foreign losses were not transferable under the previous grouping provisions.
See also Chapter 9 (Paragraph 9.25) EM, *Consolidations Act (No.1)*.

### 4.4.2. Value donor concession – donating losses

Under this concession, the real loss-maker's loss bundle is increased by the value of losses donated by the value donor entity. These losses must qualify for transfer under the previous loss transfer rules (Subdivision 170-A or 170-B) for an income year that is generally the trial year (subsection 707-327(3) ITTP 1997).[303] Moreover, the donated losses must be "movable losses"[304] that are transferred from the value donor (707-327(1)(b) ITTP 1997). Finally, the head company must choose the donation (subsection 707-327(4) ITTP 1997).

As indicated above, the loss donor concession is available only in connection with the donating of market value. In fact, the donation of losses 'is essentially the reverse of donating value'.[305] The increase in the market value is counterbalanced by an increase in the loss bundle of the relevant group member.

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[303] Importantly, the transfer must be possible in relation to the real loss-maker and to all remaining group members, if any, that donated value under the transitional concession (subsection 707-327(2) ITTP 1997). Furthermore, subsection 707-327(1)(d) ITTP 1997 stipulates that 'each company covered by subsection (2) would have been able to transfer the loss [to the head company] under Subdivision 707-A'.
The application of Division 170 is slightly modified for the purpose of the concessional rules. For details see Chapter 9 (Paragraphs 9.44 to 9.54) EM, *Consolidations Act (No.1)*.
[304] Chapter 9 (Paragraph 9.30) EM, *Consolidations Act (No.1)*.
This means that the donated loss 'must be a tax loss or a net capital loss that is not a concessional loss'.
Chapter 9 (Paragraph 9.32) EM, *Consolidations Act (No.1)*.
Moreover, 'a loss that provided a basis for working out an increased available fraction for a bundle of losses under section 707-325 cannot be treated (…) as if it were included in another bundle of losses' (Note to subsection 707-327(6) ITTP 1997). A *test loss* held by a *real loss maker* cannot be donated.
See Chapter 9 (Paragraph 9.33) EM, *Consolidations Act (No.1)*.
[305] Chapter 9 (Paragraph 9.29) EM, *Consolidations Act (No.1)*.

### 4.4.3. Use of COT losses over 3 years

Section 707-350 ITTP 1997 delivers a further major concession relating to the use of losses transferred at the time of consolidation. In accordance with this provision, the group can use certain company losses ("concessional losses") over a 3 year period, regardless of the available fraction that has been established for the loss bundle. This concession can only be used for COT losses (subsection 707-350(1)(c) ITTP 1997) which were made for an income year that ended on or before 21st September 1999 (subsection 707-350(1)(a) ITTP 1997). These losses must not have been previously transferred to a group (subsection 707-350(1)(d) ITTP 1997).[306] Finally, as was already the case with the donor concessions, the group's head company must choose to apply this concession when the group is initially formed (subsection 707-350(1)(e) ITTP 1997).[307]

Where such a choice is made, the relevant COT losses are divided into three equal portions. The maximum amount of the concessional losses that can be used in the first income year following the consolidation event is the calculated portion (subsection 707-350(3)Item 1).

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[306] From this it follows that in the case of a subsequent acquisition of a consolidated group by another consolidated group, the relevant COT losses lose their concessional status.
See also Keech, above n 268, 182.
[307] The actual date of choice is the day on which the head company lodges its income tax return for the first income year in which losses transferred under Subdivision 707-A could be used (subsection 707-350(5) ITTP 1997).

The amounts that can be deducted subsequently are calculated as follows:

- the second years' maximum deduction is the difference between '2 / 3 of the total of the amounts of the losses [COT concessional losses] that were transferred to the transferee [the head company] and the amount of the losses utilised for the [first] income year' (subsection 707-350(3) Item 2 ITTP 1997); and
- the recoupment amount for the third year and any later income year is the 'difference between the total of the amounts of the losses that were transferred to the transferee and the total of the amounts of the losses utilised for earlier income years ending after the initial transfer time' (subsection 707-350(3)Item 3 ITTP 1997).

Importantly, groups intending to apply this transitional concession must consider the stipulated order of loss recoupment. According to the loss rules, concessional losses can be used only after the post-consolidation group losses are deducted from the current assessable income / gains of the group (subsection 707-350(2) ITTP 1997).[308] Finally, the concessional recoupment rates can only be used where the transferred losses meet the obligatory test requirements at the stipulated times.

[308] See Part B Chapter III 4.3.3.

In cases where the transitional rules are not applied or the group is formed after the end of the transitional period, the effects of the loss provisions will have a more severe impact on the availability and use of tax loss deductions.

## 4.5. Effects of loss rules

The consolidation loss rules have positive effects and unpleasant "surprises". Admittedly, losses once successfully transferred to the accounts of a head company are less exposed to legal constraints, for instance in relation to the COT, than was the case under the previous provisions targeting each group member individually. On the other hand, the loss transfer tests, as they have been modified for the purposes of the new legislation, introduce far-reaching changes in the way loss entities have to regard their business activities to preserve existing rights to use accrued loss amounts in the event of future consolidation. Implications relating to the tax loss accessibility at the time of the formation of a group and the subsequent income periods under the consolidation regime demonstrate the impact that the elective loss provisions potentially have on the operation of wholly-owned groups.

Groups opting for the application of these rules should consider carefully which loss rules may negatively affect access to their tax attributes, this area of issues is analysed under *section 4.5.1.* Also discussed are the potentials to improve the use of losses incurred by group members prior to and after consolidation, which result from the implementation of the consolidation regime (*section 4.5.2.*).

#### 4.5.1. Rules negatively affecting access to group losses

On the formation of a consolidated group, unused losses accrued by individual group members are accessible to the head company only if they could also have been used by those entities themselves in the hypothetical case that they had not joined the consolidated group.[309]

The conditions for the transfer of losses to the consolidated group as well as their recoupment and use by the head company therefore resemble tests employed by the carry-forward loss provisions applicable to single entities. The COT and the alternative SBT determine the prime requirements for the accessibility of losses accrued by the consolidated group members until their joining time.[310]

Both tests are equally relevant in the context of loss transfer and their subsequent recoupment under the consolidation regime. From this it follows that consolidating groups characterised by stable ownership should satisfy the COT and be eligible for the transfer of pre-consolidation losses to the head company. On the other hand, the trial period applied under COT, ending immediately after joining time, results in most company acquisitions being tested under the SBT rules.[311] This test, however, may cause severe limitations to the accessibility of losses. The application of SBT rules implies a number

[309] Subsection 707-120(1).
[310] The supplementing tests are the *control test* and the *pattern of distribution test*.
[311] See Baxter, above n 250, 96.

of consequences which, at least to some extent, appear not to have been intended by the legislation.[312]

As the discussion in the following sections demonstrates, the application of the SBT in relation to loss transfers at the time of initial consolidation (*section 4.5.1.1.*) as well as at times following this event (*section 4.5.1.2.*) imposes conditions with a virtually retrospective effect. Compliance with such conditions may be achieved more by chance, rather than as the result of active planning.

Moreover, the statutory stipulated order of recoupment of successfully transferred losses further affects access to deductions available to consolidated groups (*section 4.5.1.3.*).

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[312] See Baxter, above n 250, 96.

#### 4.5.1.1. Loss transfer under SBT on the formation of a group

The coexistence of the COT and the SBT for the operation of non-consolidated entities as well as for the consolidation of such entities as members of wholly-owned groups means there is a high probability that there will be losses not transferable to the head company in the event of consolidation.

Non-consolidated entities will regularly rely on the rules provided by COT allowing them to carry-forward losses into future tax periods, as long as the share ownership or the control of the voting power remains stable. Under these conditions, changes in current business activities will not be regarded as substantial in relation to the use of accrued losses. Only in the case of a shift in the ownership or control of the company, will the entity be bound by SBT rules which impose the obligation to maintain the same business activities from the time that such change occurred until the final year of recoupment.

This logic characterising the loss utilisation prior to the implementation of consolidation is virtually ignored by the provisions governing the initial transfer of losses by an entity that becomes a wholly-owned member of a consolidated group through the acquisition of a substantial stake in its membership interests. At the joining time of such an entity, compliance with the requirements of the modified SBT, regarding losses incurred *after 30 June 1999*, becomes mandatory. This happens since the COT test period ends immediately after the

date of consolidation, which prevents the COT requirements being met. The application of the SBT, however, results in the necessity to establish conformity between the business activities at the end of the *loss year* and those carried out during the *trial year* (section 707-125).[313] Entities joining a consolidated group under the application of SBT may therefore fail to transfer their losses to the group, as, prior to acquisition time, they will not expect to be bound by the rigid requirements of the test which is applicable specifically under consolidation.[314]

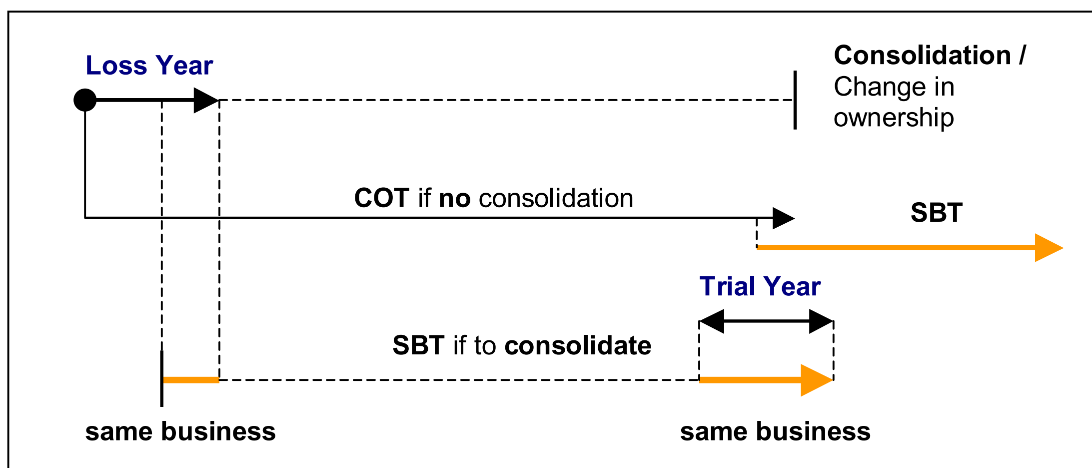


**Figure 9** Loss transfer tests depending on the event of consolidation

The illustration above depicts the conditions for the utilisation of losses following a change in ownership of a loss entity. Whereas the SBT requirements need to be met retroactively by an entity becoming a

[313] The trial year is a 12 months period ending just after the acquisition of the company, which is also the time that the relevant entity joins the tax-consolidated group. See subsection 707-120(2).
[314] See also Keech, above n 268, 179; where the loss transfer rules applicable under tax-consolidation are considered a 'significant extension of the SBT testing period'.

member of a consolidated group, an entity retaining its non-consolidated status relies on the COT rules until the acquisition time, to be bound by SBT only subsequent to the change in ownership.

The transfer of losses incurred *after 30 June 1999* is similarly affected if the ownership or continuity tests were already failed prior to the joining time of the loss entity. In such case, the SBT compares the business carried out just before the income year in which the loss was incurred with the activities in the income year in which the COT was failed, and the trial year. Presumably, the joining entity may have retained the same business activities since the change in ownership or control until the end of the trial year, which is shortly after joining time. The business carried out within both these periods, however, must again be consistent with the business at the end of the loss year. This condition is only valid for the purposes of consolidation and will usually not be considered by non-consolidated entities prior to becoming a wholly-owned member of a consolidating group.

The conditions for loss transfer are different when the losses were incurred *prior to 30 June 1999.* The SBT in relation to such losses requires the continuity of business activities only at the time immediately before the ownership or control tests were failed and during the trial year (subsection 707-120(1)). Such losses should therefore be easily transferable to the head company in the event of the simultaneous acquisition and consolidation of a loss entity, as both

periods considered in connection with the continuity of business coincide. If the failure of COT occurred before the joining time of the loss entity, the transfer of losses would still rely on conditions resembling those which are relevant prior to the application of consolidation measures. The transfer of losses made prior to 30 June 1999 is therefore not affected by requirements that may have not been transparent for the non-consolidated entity prior to its joining time.

### 4.5.1.2. Transfer of SBT losses subsequent to consolidation

Losses transferred to a consolidated group, whether under the SBT or COT rules, are taken to be made by the head company in the income year in which the transfer occurred (subsection 707-105(1)). For SBT losses this could mean that an event triggering the failure of COT on the initial consolidation could be ignored when the losses were transferred to the head company of another consolidated group.[315] This is not the case, however, as section 707-135 makes the passing of the SBT a mandatory condition for a subsequent transfer of SBT losses to a consolidating group.

That measure, employed by the legislation to eliminate a potential advantage available to consolidating companies,[316] may cause a substantial share of SBT losses not being transferable to a consolidating head company in the event of the full acquisition of a consolidated group which carries such losses. Presumably, the head company of the acquired consolidating group would not expect to be restrained by the conditions defined by SBT. On the contrary, the loss transfer rules under the initial consolidation make a head company rely on the applicability of COT for the recoupment of losses

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[315] A tax-consolidated entity may obtain all interests in the head entity of a separate tax-consolidated group to which a SBT loss has been transferred on consolidation. The event will not imply a change in the control of the acquired head company if the previous shareholding already amounted to a controlling stake in the company, e.g. a 85% shareholding. Under these conditions, losses initially transferred under the SBT would be available for a transfer under the control test. No requirements for the continuity of business would have to be met.
[316] See Chapter 6 (Paragraph 6.84) EM, *Consolidations Act (No.1)*.

consolidated in its accounts. Subsequent changes in the business activities may therefore be made without any consideration of their impact on the transferability of SBT losses at a later stage.

#### 4.5.1.3. Delayed recoupment

The stipulated order of use of losses transferred into a consolidated group reverses the procedure previously employed for the recoupment of group losses. As the discussion of the loss recoupment rules illustrates, subsequent to consolidation, the order of use does not refer to the time in which the losses were incurred, but to the relevant category of losses, with the preference for the post-consolidation group losses, followed by transferred concessional losses and standard transferred losses. The recoupment of transferred losses is further delayed through the application of loss factors. Such extension of the period needed for the use of the loss amounts triggers an increasing risk for a breach in the test conditions, which may arise from potential changes in the ownership or business activities of the head company.

### 4.5.2. Rules improving access to group losses

The loss transfer rules introduced in the context of the consolidation regime provide a number of positive effects relating to the accessibility of group losses. One of the most direct changes is the availability of trust losses which, due to the limitation of previous grouping provisions to companies, were quarantined within trusts. Moreover, foreign losses, not transferable under previous grouping provisions, can be transferred to the group's head company at the time of consolidation.

The consolidation rules also improve access to company losses that were not transferable under the (removed) grouping provisions. Losses incurred by majority held, but not wholly-owned subsidiaries were not accessible to the group, even though the head company may subsequently, directly or indirectly, have acquired the full ownership of a loss entity. The consolidation loss rules do not require the transferable losses to be fully accrued to member interests.

Group losses, once they are transferred to the head company, are used in accordance with the COT or, if the first test had subsequently failed, the SBT. The relevant tests are applied solely (COT) or primarily (SBT) in relation to the head company. Movement of interests within the consolidated group as well as changes in business activities of subsidiary members will be largely disregarded for the purpose of the recoupment of accrued losses. The same principles

are applicable for losses incurred subsequent to the implementation of consolidation. Consistent with the single entity rule, losses made by wholly-owned group members are deemed to be incurred by the head company.

## 5. Franking and exempt accounts

The rules for the operation of franking accounts under the consolidation regime are stipulated within Subdivision 709-A. The core principle is expressed within section 709-50 according to which 'only the head company of a consolidated group has an operating franking account'. For the duration of their membership period, franking accounts of subsidiary members remain inactive. This practice is fully consistent with the general tax consolidation principles under which only the head company is directly liable for income taxes and carries the obligation to lodge a single tax return for the entire group (single entity rule). Consequently, even though the relevant franking rules interact directly with the main consolidation principles as well as with the general rules stipulated by the imputation regime (Division 207), Subdivision 709-A introduced an array of provisions imposing specific modifications which must be carefully analysed by groups considering consolidation (*section 5.1.*).[317]

Moreover, the consolidation regime (Subdivision 709-B) also affects the application of the exempting entity and former exempting entity provisions (Division 208 preventing 'franking credit trading schemes'). Numerous adjustments ensure that the consolidation of wholly-owned members, subsidiaries holding franking credits, is not motivated by the

[317] For a comprehensive discussion of the franking rules under consolidation see also Stephen Barkoczy, 'Consolidation and imputation' (2003) 1 *Journal of Australian Taxation* 78.

intention to pass the credits to the head company which would otherwise be prevented from utilising these credits (*section 5.2.*).

Whereas the consolidation legislation implements principles transforming groups into homogenous entities which franking accounts are pooled in the hands of a head company, special rules ensure that the restrictive exempting entities and former exempting entities provisions remain effective in their scope of application.

## 5.1. Franking accounts

The establishment of a single franking account results in the elimination of the debits and credits accrued in the accounts of subsidiary members at the joining time. At the same time, consequential adjustments are made to the account of the group's head company. These measures are discussed within *section 5.1.1.* During the consolidation period, all franking credits and debits arising within the group must be booked in the account of the head company. The operation of this joint franking account is considered within *section 5.1.2*.

### 5.1.1. Establishment of a joint franking account

The very first step directly affecting franking accounts in the consolidation process is the establishment of the current balance at the time of the formation of a group or at the joining time of a subsidiary.[318]

Depending on the actual balances of the subsidiaries' franking accounts at the relevant time, each account must receive either a debit, equalling the established surplus in the account, or a credit, where the account is in deficit, which creates a nil balance in each joining entity's account (subsections 709-60(2)(a) and 709-60(3)(a)).

The head company's franking account, on the other hand, receives a credit which must be equal to the sum of the subsidiaries' eliminated surpluses (subsection 709-60(2)(b)). The group's 'franking credits are pooled in the franking account of the head company'.[319]

However, the Commissioner can determine 'that no credit is to arise in the head company's franking account' (subsection 177EB(5) ITAA 1936), which would otherwise be generated from surpluses accrued by its subsidiary / subsidiaries. This provision constitutes an integrity measure targeting schemes with the prevailing purpose 'of enabling the credit (…) to arise in the head company's franking account'

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[318] See Chapter 10 (Paragraph 10.9) EM, *New Business Tax System (Consolidation) Act (No.1) 2002*.
[319] Ibid.

(subsection 177EB(3)(d) ITAA 1936). The wording of this provision is relatively unspecific and must be interpreted in the practice. Presumably, this integrity rule can be applied only when it can 'objectively be concluded from the relevant circumstances that the scheme was entered into for a more than incidental purpose of enabling the credit to arise in the head company's franking account'.[320] Such a conclusion may be conceivable where a head company or one of its wholly-owned subsidiaries acquires total ownership of a subsidiary which accrued substantial franking credits. However, a final judgement concerning a potential scheme should involve a more comprehensive assessment. For instance the economic conditions, the apparent commercial rationale behind the acquisition of a corporate entity by a consolidated group should be of prime interest in this context.[321]

Finally, subsidiaries whose franking account is in deficit at the time of consolidation are liable for the payment of franking deficit tax (subsection 709-60(3)(b). Consequently, groups intending to implement tax consolidation should adjust their dividend distribution policy and avoid the accrual of any franking deficits for the formation time.[322]

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[320] Barkoczy, above n 317, 110.
[321] See also A C Carey, *Consolidation: The Advisor's Guide, Australian Tax Practice*, (2002) 103-104.
[322] See Deutsch and others, above n 96, 1245.

The main benefit from the application of the consolidation franking rules arises from the fact that the previous grouping provisions (inter-corporate dividend rebate) were removed.[323] Consequently, pooling the group's franking accounts by the head company is the only option to avoid double taxation of group income.

[323] See Part B Chapter II 1.3.

### 5.1.2. Operation of consolidated franking accounts

According to section 709-65, 'the franking account of an entity that is a subsidiary member of a consolidated group does not operate' for the entire period of its membership in the group. The only operating franking account of the group is that of the head company. Within this account, during the membership period, debits and credits generated by the group's subsidiary members and the head company are accounted for (section 709-70). From this it follows that distributions made by subsidiary members to entities outside the group can only be franked by the head company.[324] On the other hand, intra-group dividends are ignored for taxation purposes and do not trigger any changes in the group's joint franking account.[325]

Finally, corresponding to the treatment of losses transferred at the joining time, or such which accrue during the membership period, the head company retains all franking credits in the event of de-consolidation.

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[324] See Chapter 10 (Paragraph 10.19) EM, *New Business Tax System (Consolidation) Act (No.1) 2002*.
An exception to this rule constitutes dividends made by subsidiaries in respect to ESAS shares (section 709-80) and non-share equity interests (section 709-85). In practical terms, no other distributions to entities outside the group are conceivable, since the eligibility criteria for tax consolidation require the subsidiaries to be wholly-owned, disregarding ESAS shareholdings which do not exceed 1% of all ordinary shares issued by the subsidiary and non-equity interests (debt interests). See Part B Chapter I 1.2.2.
[325] See Part B Chapter III 1.1.

## 5.2. Exempting accounts

According to provisions stipulated by Division 208, the general 'gross up and credit' rule (Division 207) does not apply to dividend payments made by entities owned by the so called 'prescribed persons' (non-resident and tax exempt entities), the exempting entities. The relevant rules limit the franking credits available for trading by:

- 'prescribing that franked distributions paid by corporate tax entities, which are effectively owned by non-residents or tax exempt entities, will provide franking benefits to members in limited circumstances only; and
- quarantining the franking surpluses of corporate tax entities which were formerly effectively owned by non-residents or tax exempt entities'.[326]

However, in the absence of specific adjustments, these anti-avoidance measures targeting individual taxable entities may become inoperative in relation to foreign owned MEC-group members implementing tax consolidation and pooling their franking accounts at the joining time. In order to retain the functionality of Division 208 in the consolidation environment, Subdivision 709-B introduced a number of modifications to the general provisions.[327]

[326] Chapter 6 (Paragraph 6.2) Revised EM, *Consolidation, Value Shifting and Demergers Act*.
[327] For a comprehensive discussion of the modifications introduced by Subdivision 709-B see Barkoczy, above n 317, 95-107.

As a general principle, tests determining whether a consolidated group is an exempting / former exempting entity (Division 208) must be applied solely to the group's head company (subsection 709-155(1)). However, according to subsection 709-155(2), 'there are additional rules that can alter the way that Division 208 applies to a consolidated group'.

Where at the time of consolidation the head company is neither an exempting entity nor a former exempting entity, and the joining subsidiary is either an exempting entity or a former exempting entity, the head company becomes a former exempting entity (sections 709-160 and 709-165). That means that the head company must form an exempting account, where the subsidiary's exempting surpluses are transferred.

In cases where the head company is either an exempting entity or former exempting entity and the joining subsidiary member is also either an exempting entity or former exempting entity, the status of the head company remains unchanged (sections 709-170 and subsections 709-175(1) and (2), 709-175(3) and (4)). The status of the head company as well as the application of the general rules are also retained if the head company is a former exempting entity and the subsidiary is neither an exempting entity nor a former exempting entity (subsection 709-175(5)).

These modifications to the anti-avoidance provisions make sense as they ensure that the character of exempting surpluses transferred by subsidiary members at the joining time is not altered in the accounts of a head company which itself is neither an exempting entity nor a former exempting entity. At the same time, groups headed by an exempting entity or a former exempting entity must consider that the franking surpluses transferred at the time of consolidation will be subject to the application of Division 208, even if the joining subsidiary member is neither an exempting entity nor a former exempting entity. Admittedly, this outcome is the only conceivable one under the conditions stipulated by the single entity rule.

## 6. Foreign Tax Credits (FTC)

Consistent with the rules governing the taxation of domestic income, the foreign income of all consolidated group members is assessed as the income generated by the head company. Consequently, at joining time, a subsidiary member transfers its excess foreign tax credits to the head company (subsection 717-15(2)) where they are 'pooled (…) according to class of income and the income year in which they arose'.[328] In the subsequent income periods 'the head company receives any foreign tax credits that arise because the entity pays foreign tax while it is a subsidiary member of the group' (section 717-1). Importantly, the excess credits transferred at the joining time cannot be used in the income year that includes this time, but only in following years (subsection 717-20(5)).

This tax treatment is based on the assumption that the head company, not the relevant subsidiary, is the taxpayer who is personally liable for and pays the foreign tax (subsection 717-10(2)), fulfilling the conditions stipulated in subsection 160AF(1) ITAA 1936. Consequently, corresponding to the loss and franking rules discussed above, the head company can also use the FTCs following the de-consolidation of a subsidiary (subsection 717-30(2)).

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[328] ATO, Consolidation Reference Manual (May 2003), Chapter C6-1, 1.

In conclusion, similar to the situation analysed in connection with franking credits, the FTC rules derive their importance mainly from the fact that the previous grouping concession, which allowed the transfer of excess FTCs, has been removed.

## Part C: Areas interacting with consolidation policies

In addition to the conditions introduced by the tax consolidation regime, groups and their single members are subjected to an array of regulations in the area of corporate governance and accounting. Compliance with these rules is mandatory without any regard for the outcome of the individual tax consolidation decision.

Importantly, the policies expressed in the tax consolidation provisions do not necessarily correspond to the principles determining the formation and operation of groups which are stated in other relevant legal sources. From this it follows that groups eligible for consolidation should carefully consider to what extent the policies pursued by the consolidation legislation and the adjustments made necessary in the process of their implementation are congruent with the obligations sanctioned under the corporations law and the accounting regulations. As the following discussion demonstrates, some of the benefits potentially available under the consolidation rules may be seriously diminished when considered in the light of the corporate governance and accounting requirements.

The main focus within *Chapter I* is set on the lack of compatibility between the tax consolidation and accounting eligibility criteria, which results in increased compliance efforts for groups deciding to implement consolidation.

Concluding from the analysis undertaken, the diverging approaches to the formation of groups are the consequence of the differences in the fundamental policies underlying tax consolidation and financial consolidation.

The tax consolidation eligibility requirements restrict the category of entities qualifying for the grouping benefits to the wholly-owned group members. This procedure opens the way for the full integration of the group's assets in the hands of the head company. The financial consolidation, on the other hand, takes into account the wholly-owned and controlled group members. Its prime aim is to provide transparency to the financial conditions of economic groups.[329] In practice, these evident differences in the eligibility criteria prevent groups from establishing one homogenous reporting system which could be used for tax consolidation as well as financial accounting purposes.

The policies underlying tax consolidation also have a direct impact on the scope and nature of the group's income tax accounting obligations. Due to the central position of the group's head company and the resulting shift in the group's tax liability away from the individual members, the main tax accounting activities concentrate in

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[329] According to AASB 1024, the objective underlying the preparation of consolidated financial accounts is to 'provide relevant and reliable financial information about the related entities as a single reporting entity to reflect that these entities operate as single economic unit'.
AASB 1024, Commentary, Paragraph X.

the hands of the head company. Changes to the accounting practices arising under the identified tax consolidation policies are analysed in the second part of *Chapter I*.

The analysis within the following chapter (*Chapter II*) illustrates how the differences between the tax consolidation policies and corporate governance principles potentially affect the operation of groups. The diverging approaches to the identity of groups and the position of their members may constitute a major obstacle for the efficient use of the advantageous grouping status derived under tax consolidation.

In summary, the analysis undertaken within this part of the thesis focuses on the imbalances characterising the relationship between tax consolidation, corporate governance and accounting policies. A sound understanding of the implications triggered by the evident inconsistencies of the three independent legal sources should constitute one of the main steps in the process towards the initial consolidation decision.

### *Chapter I: Consolidation and accounting*

Groups opting for the implementation of consolidation rules must consider a number of inevitable and elaborate adjustments to the existing accounting systems, which arise in the wake of such a decision. Among the most challenging, is the necessary separation of the accounting data streams for the purposes of financial and tax accounting (*sections 1.* and *2.*).

The diverging eligibility conditions for group membership under tax consolidation and accounting regulations prevent groups from utilising the consolidated financial accounting data for the purposes of tax accounting. Under the conditions set by the consolidation regime, the pre-consolidated accounting data of single group members, not the group's consolidated financial accounts, constitutes the basis for the group's tax accounting. As the following analysis shows, the strict division between the concept of economic group (financial accounting) and wholly-owned group (tax consolidation) has a detrimental impact on the accounting practices of tax consolidating entities.

At the same time, the introduction of novel tax accounting standards, mirroring the principles derived from the tax consolidation legislation, transforms a number of reporting and disclosure obligations so as to make them suitable for the tax consolidation environment (*section 3.*).

In this way, the accounting standards provide the basis for comprehensive reporting on and disclosure of tax consolidation related issues. However, the consolidation of the group's financial accounts and the income tax accounts must be undertaken separately, due to the profound differences in the policies underlying both consolidations.

1. Financial and income tax accounting for consolidated groups

Income tax accounting usually relies on the figures provided by financial accounting for the particular accounting period in question. Financial statements constitute a basis for tax accounting that undergoes a number of adjustments to comply with the requirements set by the tax legislation.[330] However, this common accounting practice cannot be applied for tax consolidation purposes. The consolidation of an economic entity (financial accounting) and the tax consolidation (income tax accounting) do not relate to the same consolidating group. The economic entity comprises all entities[331] owned or controlled by the holding company. This includes not only the wholly-owned subsidiaries of a tax consolidated group but also entities which are controlled due to the ownership of a substantial number of shares, which may be less than 50%.[332]

[330] Of interest are the differences in depreciation rules / rates. For the purpose of financial statements, goodwill can be amortized as a non-current asset over a period of maximal 20 years (AASB 1013, No. 5.2), whereas it does constitute a non-depreciable capital asset in connection with tax accounting (AASB 1020). The second major source of differences between financial accounting and tax accounting is the question of deductibility of expenses.
[331] This may be companies, trusts or partnerships.
See AASB 1024, Commentary, Paragraph III.
[332] According to AASB 1024, Commentary, Paragraph XVIII, control does not have to be exercised as an active dominance. The control requirement is already fulfilled if there is a passive potential to dominate decision making in the subsidiary.
See also Baxter, above n 250, 96.

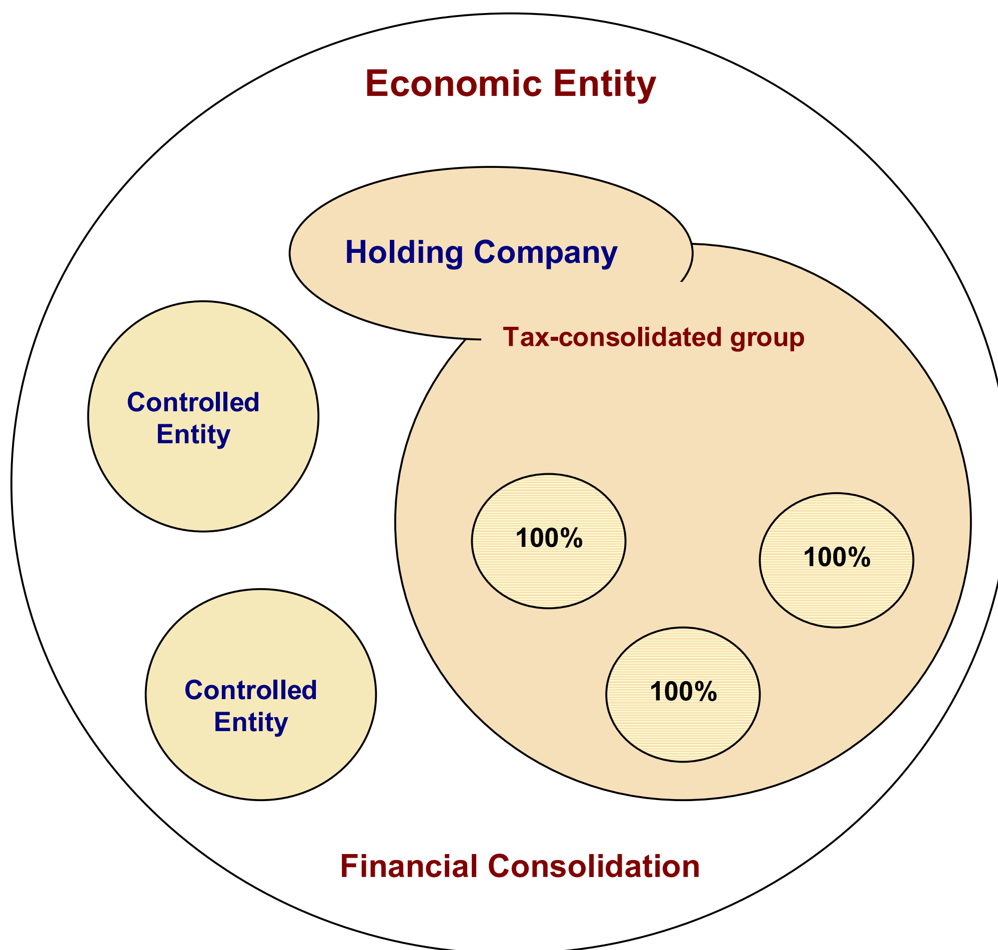


**Figure 10** Corporate group structure - economic entity and tax-group

The consolidation of corporate groups under financial accounting rules (AASB 1024) therefore includes a considerably broader range of entities than is the case for the purpose of tax consolidation. The tax-consolidated group may constitute a sub-group of an economic entity. The consolidated accounts of an economic entity as a single reporting entity however eliminate all intra-group transactions,[333] including those between entities which are not wholly owned. Consequently, the consolidation data obtained through financial accounting cannot be

[333] See AASB 1024, Commentary, Paragraph XXVIII.

used in connection with the tax consolidation of the wholly-owned sub-group.

Moreover, besides the divergences in the composition of the consolidated economic entity and the tax-group, a number of valuation differences may arise in relation to the accounting data. The preparation of financial reports for an economic entity can require adjustments to the carrying amounts of assets and liabilities of subsidiaries, such as *fair value adjustments* relating to the acquisition of an entity. The carrying amounts calculated for the financial statement (economic entity) are potentially different to those used by the head company when determining the tax amounts in relation to the tax-consolidated group. This difference is further deepened through the resetting of tax cost of subsidiaries' assets, the initial step in the implementation of the tax consolidation regime.

Due to this inherent inconsistency in the structure and accounting practices of an economic entity and its tax-consolidating sub-group, the income tax accounting for a tax-consolidated group must rely only on the pre-consolidated accounting data provided by wholly-owned subsidiaries and the group's head company. This results in two independent consolidation accounting processes, the *income tax consolidation of the wholly-owned sub-group* and the *(financial) consolidation of the larger economic entity*. Both accounting streams

are eventually brought together when the relevant tax accounting data is transferred to the financial accounts.

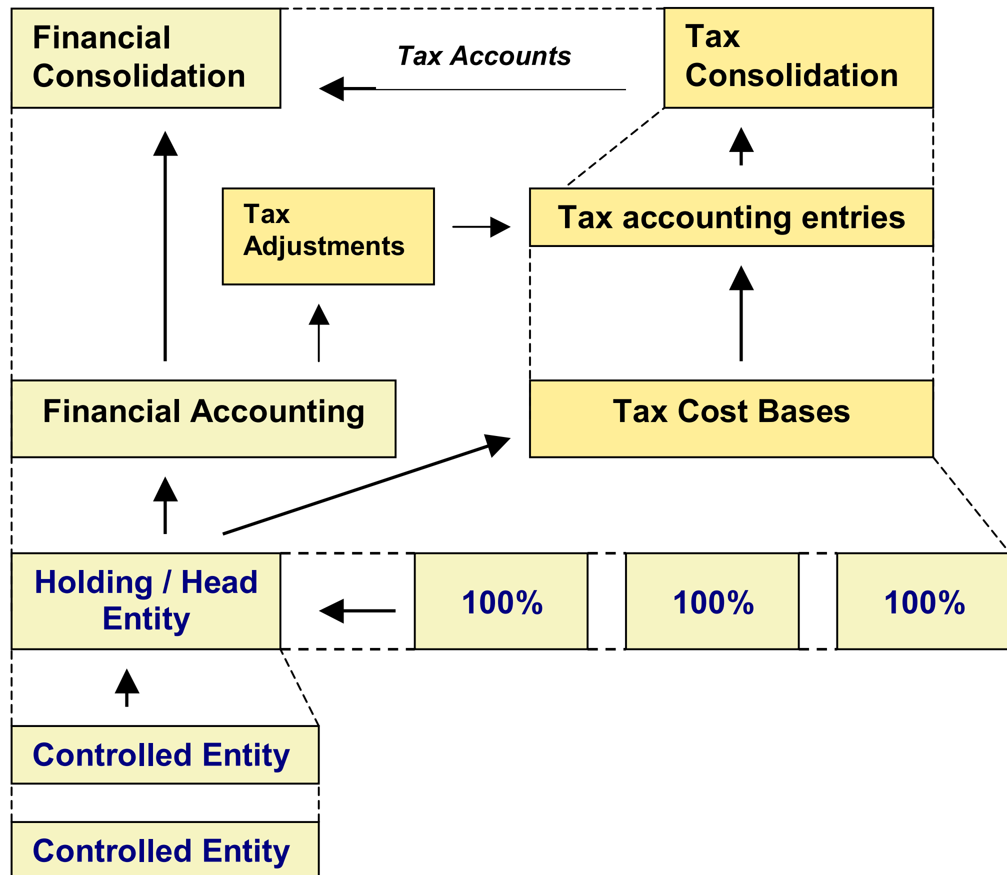


**Figure 11** Financial accounting and tax consolidation for consolidated groups

## 2. Financial and income tax accounting for MEC groups

The inconsistencies between the financial accounting data and the income tax accounting under consolidation also becomes apparent when considered in the context of MEC groups. Concluding from the statutory requirements to the structure and composition of MEC groups, the financial accounting / financial consolidation of economic entities comprising tier-1 companies and their wholly-owned and controlled subsidiaries has to be considered separately from the income tax accounting for MEC group members.

This follows from the fact that MEC groups comprise a number of companies that are first tier subsidiaries of a foreign holding company. By definition, these companies cannot constitute one economic entity, as none of them constitutes a holding company in relation to the remaining tier-1 companies. On the other hand, each of the tier-1 companies may be heading its own economic entity because of the ownership and / or control of a number of Australian resident subsidiaries. Consequently, a MEC group may include an economic entity / entities formed by a sub-group / sub-groups of the MEC group members and entities not eligible for membership in a tax-consolidated MEC group.

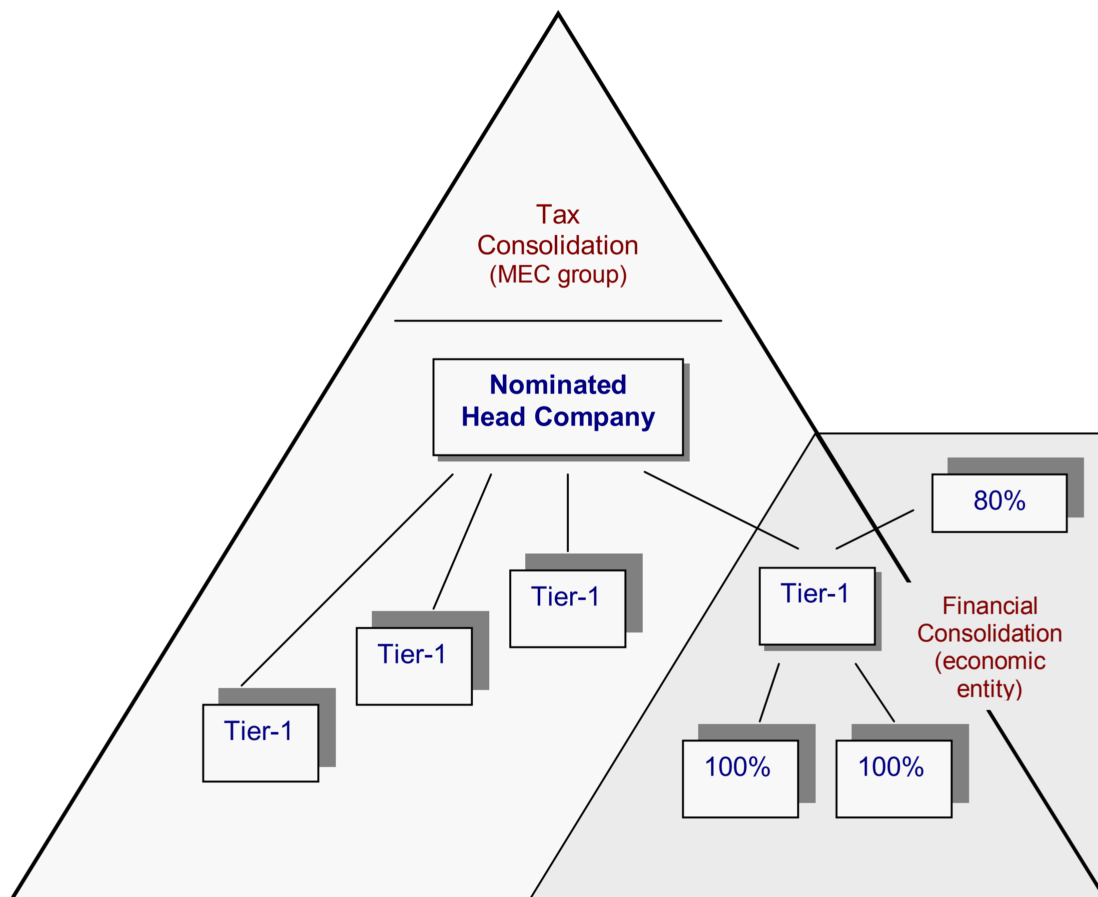


**Figure 12** Financial consolidation and tax consolidation for MEC groups

The relationship between tax accounting and financial accounting becomes even more complex in cases where a nominated MEC provisional head company already undertook financial consolidation prior to the establishment of the MEC group.[334] As this duty remains unimpaired by the membership in a tax-consolidated group, the company will have to carry on with the preparation of financial statements for the economic entity, which do not account for the

[334] This will always be so in the case of a special conversion event initiating the formation of a MEC group.

activities of any other tier-1 company of the MEC group. At the same time, the group's provisional head company also bears the task of collecting and processing data in relation to the MEC group's tax accounting, including all consolidated tier-1 companies and their eligible subsidiaries. Consequently, in contrast to the groups consolidating under Division 703, a MEC group provisional head company may have to manage accounting data originating not only in its controlled and wholly-owned subsidiaries, financial and tax consolidation, but also companies which do not belong to the same economic entity.

Finally, the group accounting may be affected through a change in the identity of the provisional head company of a MEC group (subsection 719-60(3)). According to subsection 719-75(1), the company having the status of a provisional head company at the end of the income year is held to be the group's head company for the entire duration of that year.[335] The previously installed group accounting system becomes obsolete in the event of such a change. The new nominated provisional head company has to ensure, however, that the tax-consolidated data will be generated correctly for the group's annual income tax return. This can only be achieved where the relatively flexible consolidation rules will be matched by an adaptable approach to the existing accounting tools.

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[335] In the case of a consolidated group such a change is not conceivable, since the group de-consolidates if the head entity is not eligible anymore.

## 3. Income tax accounting under tax consolidation

Income tax accounting in Australia is currently based on two pairs of Accounting Standards. They are the *AASB 1020* and *AAS 3 "Accounting for Income Tax (Tax-effect Accounting)"*, issued in 1989, and the *AASB 1020 and AAS 3 "Income Taxes"*, issued in 1999. The application of the elective 1999 standard will be mandatory for reporting periods beginning on or after 1st of January 2005, the date from which the 1989 standard loses its relevance. The tax consolidation regime has a number of implications in relation to income tax accounting, prior and subsequent to the decision to implement the consolidation regime as well as at the time of its initial application.

The following analysis into the income tax accounting related implications arising for tax consolidated groups identifies the specific record keeping and reporting obligations imposed on head companies (*section 3.1.*) and their wholly-owned subsidiaries (*section 3.2.*). Moreover, the area of disclosure requirements that are relevant to all consolidated group members is considered within *section 3.3*. Finally, *section 3.4.* identifies the need for the recognition of deferred tax balances arising from the application of the elective consolidation provisions, even though, at the time when the financial report is prepared, a group may not yet have made its decision to consolidate public.

The income tax accounting regulations have been adjusted so as to allow groups to reflect the changes into the tax liability which are triggered by the implementation and subsequent application of the consolidation provisions. In this way, tax consolidation policies reshaped the scope of accounting obligations.

### 3.1. Head company

In accordance with the single entity rule, the head company of a consolidated group is the group's only taxable entity. It carries the obligation to lodge a single tax return for the group and is liable for all tax amounts arising from its own transactions and relating to transactions, events and balances of the wholly-owned subsidiaries.[336] Consequently, all income tax accounting entries relating to the group's current and deferred tax amounts form part of the head company's accounts.

This predominant status of the head company is particularly relevant for the determination of *deferred tax amounts*. The tax group's *permanent* and *timing differences* under the 1989 Standards and the *temporary differences* under the 1999 Standards, the 'differences between accounting and tax treatments or amounts within an entity',[337] are recognised by the head company by identifying the wholly-owned subsidiary's transactions, events and balances as its own. Under this premise, the permanent and the timing or temporary differences amount to the difference between the head company's taxable income or loss, including the tax effects of the events and transactions triggered by the wholly-owned group members, and the pre-tax accounting profit or loss of the consolidated group.

[336] Excluding the intra-group transactions which are ignored for tax purposes.
[337] See AASB, Urgent Issues Group, Abstract 52, Discussion, No. 30.

At the time of the initial formation of a consolidated group, the head company also recognises pre-existing deferred tax balances relating to its wholly-owned subsidiaries, giving rise to an income tax expense or revenue amount.[338] The subsidiaries derecognise the same deferred tax amounts when becoming members of the consolidated group. Deferred tax assets are recognised by the head company for the group's tax losses where there is a sufficient probability[339] that these losses will be recovered under the tax consolidation regime.[340] The financial statements issued by the head company display the deferred tax amounts, providing the necessary transparency for future tax obligations and benefits of the wholly-owned group.

[338] Depending on the recognition of deferred tax liabilities or tax assets (carried forward tax losses).
[339] The 1989 Standards use the expression 'beyond reasonable doubt', whereas the 1999 Standards employ the term 'probable'.
[340] See AASB, Urgent Issues Group, Abstract 52, Discussion, No. 26.

### 3.2. Wholly-owned subsidiaries

Under general tax consolidation rules, the subsidiary members of a wholly-owned group do not account for any current or deferred tax amounts, as they do not carry any immediate responsibility for the tax effects of their own transactions or the group's activities. However, provided that there is sufficient probability for a default of the head company on its obligations, wholly-owned subsidiaries have to recognise outstanding income tax amounts which may be realised under the joint and several liability imposed by the tax consolidation regime.[341]

At the same time, the potential income tax liability of group members and its tax accounting implications can also be pre-determined by means of a tax sharing agreement which allocates the financial responsibilities between the entities, should the head company default on its tax payment obligations. According to the consensus formulated by the AASB, 'expenses and revenues arising under a tax sharing agreement must be recognised by an entity as a component of income tax expense or income tax revenue'.[342] However, a tax sharing agreement gives rise to income tax accounting entries only in the case of an imminent or actual default of the head company.[343]

[341] AASB, Urgent Issues Group, Abstract 52, Consensus, No. 12.
[342] Ibid, Consensus, No. 11.
[343] At the same time, 'assets and liabilities arising under a tax sharing agreement must be recognised by an entity as tax-related amounts receivable from or payable to other entities in the group, rather than as tax assets and tax liabilities'.
Ibid Consensus, No. 11.

### 3.3. Disclosures

Financial statements issued by group members implementing consolidation must provide information about the current relevance and the general impact of the tax consolidation system upon an entity. Of particular interest in this context is the disclosure of potential pre-determined tax liabilities resulting from tax sharing agreements and tax liabilities which are not assessable, which, however, may arise in connection with the joint and several tax liability carried by all group members (contingent liability; AASB 1044). In relation to a tax sharing agreement, the entities have to report about the ‘significant terms and conditions that may affect the amount, timing and certainty of future cash flows’.[344] The separate legal and economic status of each single member of a consolidated group is reinforced by this requirement to assess and disclose the individual obligations in connection with the group’s tax liability.

[344] AASB, Urgent Issues Group, Abstract 52, Consensus, No. 14.

### 3.4. Pre-consolidation deferred tax balances

The elective components of the consolidation system can become relevant for an eligible group in relation to its income tax accounting (deferred tax amounts) prior even to making the irrevocable decision in favour of the implementation of the rules. According to the consensus established by the AASB, the elective tax consolidation rules have to be applied under the 1989 Standards 'unless it is assured beyond reasonable doubt (or virtually certain, when tax losses are involved) that the tax consolidation system will not be adopted'. On the other hand, the 1999 Standards are considered to require full application of elective consolidation provisions in the context of deferred tax balances when the implementation of the consolidation regime is probable.[345] In both cases the AASB employs the general recognition criteria for deferred taxes, triggering consolidation related accounting entries prior to the actual establishment of a consolidated group.

This approach is comprehensible regarding the potential time discrepancies between the preparation of financial reports and the formal notification sealing an intention to apply elective tax consolidation rules, the date at which the income tax return for the income year is lodged (subsection 703-50(b)). From this it follows, however, that the determination of deferred tax balances requires the

[345] See AASB, Urgent Issues Group, Abstract 39, Discussion, No. 19.

consideration of eligible groups as consolidated, disregarding all intra-group transactions, prior to lodgement of the first consolidated income tax statement. The income tax accounting anticipates the impact of tax consolidation rules on the financial statements of an eligible group already before the formal choice is made.

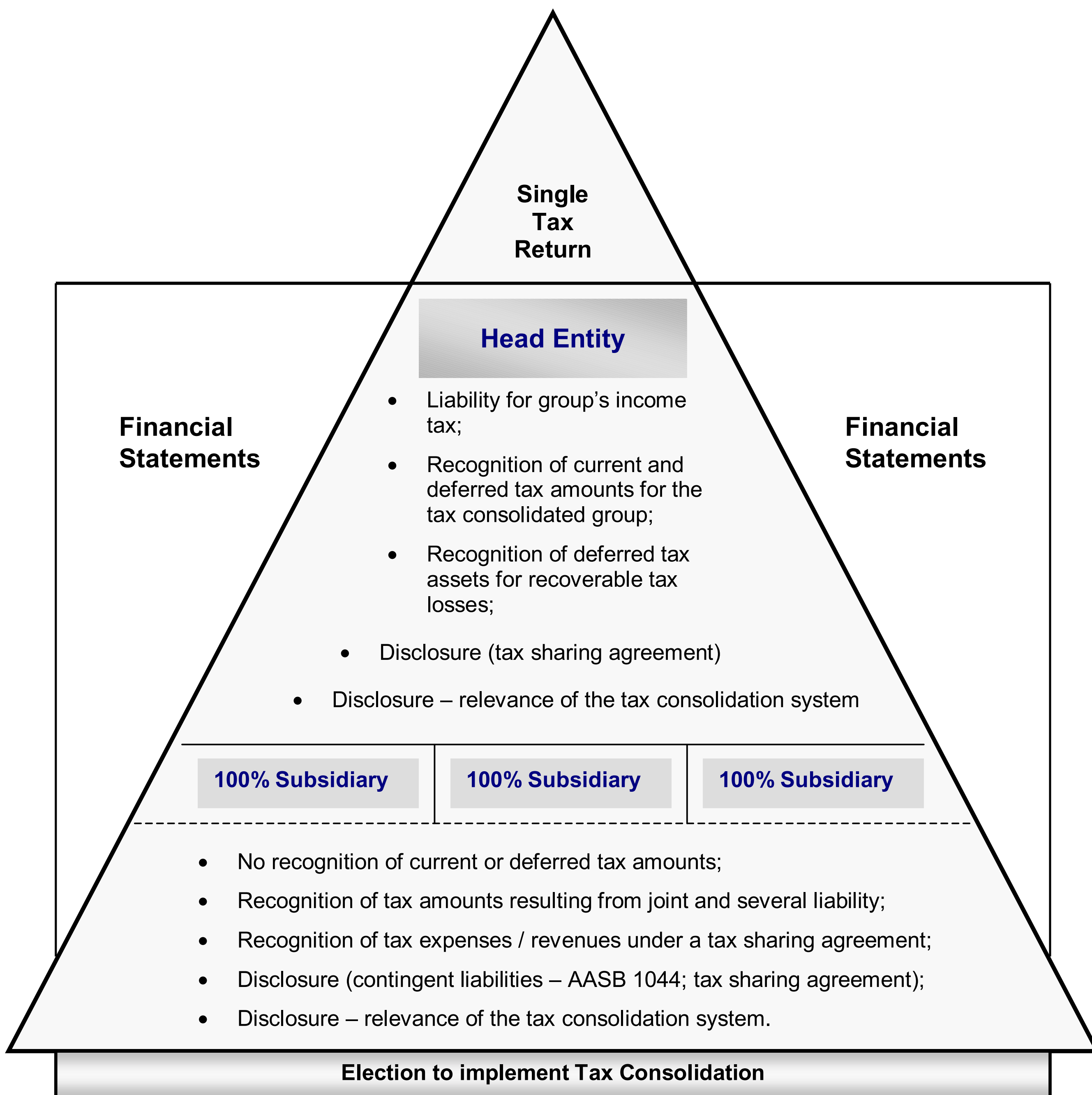


**Figure 13** Income tax accounting under tax consolidation

## 4. Concluding comments

The establishment of a tax consolidated group results in a strong concentration of the tax accounting competencies in the hands of the relevant head company. The head companies, however, are regularly unable to utilise the group's consolidated financial accounting data for the purposes of tax accounting. Since the eligibility conditions for the membership in a consolidated group disqualify all not wholly-owned entities, the consolidated accounting data of economic groups, which include controlled entities, is of no use for the calculation of the group's tax liability and the deferred tax amounts.[346]

The rules governing the formation of MEC groups produce the same undesirable result. MEC groups can be assembled by two or more economic groups, each headed by a separate head company. One of these head companies is nominated as the head company of the MEC group and carries the responsibility for the consolidation of the group's tax accounting data. Consequently, the tax accounting entries within MEC groups are derived from a number of separate economic groups and must be finally processed by the provisional head company. Under these circumstances, the head company of the tax consolidated group is not the head company of one homogenous economic group comprising all tax consolidated entities.

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[346] A different outcome is only conceivable in the case of a consolidated group consisting of an economic group which is assembled by wholly-owned entities.

As the findings identified and analysed in this chapter demonstrate, the evident lack of congruency between the consolidation under the financial accounting regulations and the tax consolidation originates from differences in the approaches to the identity of groups and the definition of entities having access to consolidation. In summary, these differences are mainly triggered through the following two aspects:

- diverging policies (transparency in the financial conditions of economic groups, including wholly-owned and controlled entities, versus aggregation of the tax income and tax attributes in the hands of companies heading wholly-owned groups), and
- technical differences (mere integration of financial accounting data versus full integration of assets in the accounts of a head company).

Importantly, the differences between the policies underlying the formation and operation of groups should be considered directly in connection with the technical differences arising in the same context.

Tax consolidation of wholly-owned groups is based on the condition that the group's head company obtains the hypothetical ownership of assets held by joining entities. The integration of the group's assets is practicable because of the strict wholly-owned criterion.[347] The

[347] See also Part B Chapter I 4.

allocation of the asset values enables the head company to aggregate the group's tax income in its accounts.

Such an asset "transfer" is not relevant for the purposes of financial accounting. The financial status of an economic group can be identified and reported on without any regard to the ownership of the group assets. In contrast to tax consolidation where no individual income statements are used, financial consolidation is based on the individual accounts delivered by the wholly-owned and controlled group members. From this it follows that consolidated accounts must be prepared in addition to individual accounts.[348] This consolidation procedure makes the integration of assets as well as the wholly-owned criterion redundant.

[348] See AASB 1024 , Commentary, Paragraph XXVII.

### *Chapter II: Consolidation and corporate governance*

The relationship between the consolidation provisions and the corporate governance rules demonstrates impressively to what extent some of the rules stipulated by other legal sources can affect the effectiveness of the policies pursued by the consolidation regime. The approach to the operation of corporate groups, which evolved to a framework of specific corporate governance principles, constitutes a virtual opposite to the rules applied under tax consolidation.[349]

The legal nature of this looming tension and its practical implications for the initial tax consolidation decision are discussed within *section 1*. *Section 2* shows the limited scope for a resolution of the potential conflict of policies.

[349] Consequently, 'tax is becoming a parallel universe to corporations law'. John Currie, 'Tax consolidation: the new nightmare.' (2003) 77 (9) *Law Institute Journal* 48, 51.

1. Diverging approaches to group identity

Based on the single entity rule, the process of consolidation of eligible entities transforms a corporate group into one homogenous taxable subject. The lifting of existing legal structures in relation to taxation issues fosters the head company's ability to reassess the most effective distribution of the group's resources, following the identified economic and legal ratios.[350]

Consequently, rationalisation and re-tailoring of the group's structures, both relying on the opportunity to transfer assets and exchange goods and services between consolidated entities without triggering any tax implications, should constitute one of the major indirect results arising from consolidation efforts. In this way, the consolidation legislation supports the notion of a corporate group as a single economic body primarily pursuing the interests of its ultimate shareholders.

This view corresponds strongly with the principles already applied by the accounting standards in connection with financial statements for corporate groups. AASB No. 1024 regards a group of entities comprising the parent entity and each of its subsidiaries as a single 'economic entity'.[351]

[350] For example, the reliance on the limited liability of single group members belongs to the most important legal considerations helping to limit or distribute economic risks related to business activities undertaken by the group.
[351] AASB 1024, No. 7.

Importantly, in contrast to the tax consolidation rules and the accounting standards, the Australian corporations law still remains heavily orientated towards the *single entity approach*, including its strict emphasis on corporate autonomy.[352] Judicial practice applies this principle regularly in the context of group relationships, primarily in view of the protection of the interests of single group members.

According to case law, the "corporate veil" of an individual group entity can be lifted in favour of the economic prospects of a corporate conglomerate only under exceptional circumstances.[353] Pursuant to the single entity concept, a decision made in view of the interests of the group, having no connection to the prime interests of the group member affected, still constitutes an evident breach of directors' duties.

However, under conditions defined in the decision to *Equiticorp Finance Ltd. (in liq.) v. BNZ* by the New South Wales Court of Appeal, no legal sanctions against the directors may result from that 'wrong doing'.[354] According to the relevant decision, this will be the

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[352] See Companies & Securities Advisory Committee, Corporate Groups Final Report, May 2000 at 16.
See section 181 *Corporations Act 2001*.
[353] *Charterbridge Corp. Ltd v Lloyds Bank* [1970] Ch 62.
*Equiticorp Finance Ltd (in liq.) v BNZ* (1993) 11 ACLC 952.
*Linton v Telnet Pty Ltd* (1999) 17 ACLC 619.
[354] Justices Clarke and Cripps found that '…where the directors have failed to consider the interests of the company they should be found to have committed a breach of duty. If, however, the transaction was, objectively viewed in the interests of the company, then no consequences would flow from the breach.'
*Equiticorp*, above n 353, 1019.

case if the objective effects of the action can also be considered beneficial for the affected single group member.

A group relationship where 'the welfare of the group (is) intimately tied up with the welfare of the individual companies'[355] indicates the necessary connection between the collective and individual interests of the corporate group members. This correlation is based on the assumption that a company contributing to the support of other group members might protect the creditability of the entire group, which finally solidifies the economic basis for future well-being of the particular company itself.

Nevertheless, the use of financial and structural assets within corporate groups under the policies introduced by the tax consolidation legislation remains confined by the legal postulate not to disregard the interests of individual group members. The evident divergence between the concept regarding corporate groups as a number of single legal entities (corporations law) and the notion of one economic group comprising all group members (tax law and

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At the same time it is important to remember that the decision in *Equiticorp* case, introducing a notion of derivative benefits which may arise for individual entities from decisions pursuing the group's interests, constitutes a very progressive interpretation of the single entity approach.
An example for a far more strict application of the single entity approach is the conservative judgement in Walker v. Wimborne. Dealing with the relationship of corporate interests and directors' duties Justice Mason recognised that '…the payment of money by company A to company B to enable company B to carry on its business may have derivative benefits for company A as a shareholder in company B if that company is enabled to trade profitably or realize its assets to advantage. Even so, the transaction is one which must be viewed from the standpoint of company A and judged according to the criterion of the interests of that company.'
Walker v. Wimborne (1976) 137 CLR 1 at 6.

[355] Justices Clarke and Cripps, *Equiticorp,* above n 353.

accounting standards) potentially disrupts the establishment of a sustainable relationship between rational structuring and use of the groups resources and proper corporate governance.[356]

[356] This consideration is not applicable to non-corporate group members as trusts and partnerships.

2. Section 187 Corporations Act 2001

The conflicting approaches to the identity of corporate groups may be reconciled under the application of section 187 *Corporations Act 2001*. This provision allows directors of wholly-owned subsidiaries to act in the interest of the holding company.[357] As long as the considered restructuring measures undertaken subsequent to tax consolidation regard the economic relations between the head company and its subsidiaries, the interests of the group may prevail over the interests of the subsidiary members.

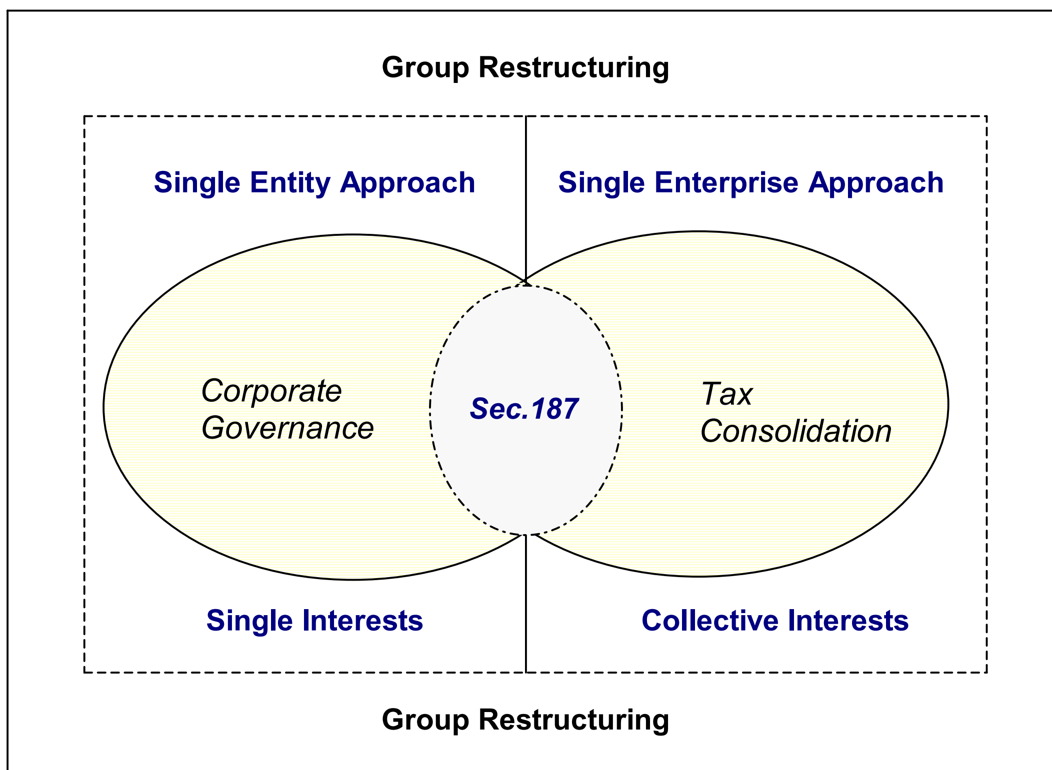


**Figure 14** Group restructuring – Corporate Law & Tax Law

[357] The further statutory requirements are:
- an explicit authorisation provided by the constitution of the subsidiary; and
- the subsidiary is not insolvent at the time of the act and becomes not insolvent as a consequence of the act.

It remains questionable however whether changes introduced in favour of a subsidiary member of the same consolidated group will be considered to be covered by the legal sense of section 187 *Corporations Act 2001*. The contentious issue in this context is the question, whether and under which circumstances the interests of a wholly-owned subsidiary may be regarded as the interests of the group, which can finally be characterised as the interests of the holding company.[358] Since the Australian corporations law lacks any explicit recognition of group's interests in the context of related entities, such a connection appears non-existent.[359] Moreover, considering the fact that in many cases the head company acts as a mere legal structure without any major operative functions relating to the business activities carried out by the subsidiary members, the application of section 187 may only become a theoretical option in the context of consolidated groups.

In addition, MEC groups lack the existence of a domestic holding company.[360] In the case of the MEC groups, the identity of the head company of the consolidating tax group and the identity of the holding

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[358] Important in this context is the fact that the holding company does not necessarily also have to be the group's head entity. In fact, it can be a wholly-owned subsidiary of the head entity, itself holding all interests in one or more entities.

[359] The corporations law has a rather restrictive approach to the operation of related entities, emphasising the need for protection of the individual interests of single entities and their members.
See H A J Ford, R P Austin, I M Ramsay, *Ford's Principles of Corporations Law*, (10th ed, 2001) 129.

[360] The term "holding company" refers to the head entity of the group. It is conceivable however that some of the group's wholly-owned subsidiaries themselves, own all interests in other entities. This fact can provide some of the domestic subsidiaries with the status of a holding company in the sense of corporations law.

company of the corporate group do not coincide. Far-reaching restructuring measures made conceivable by the tax consolidation rules can therefore infringe on the core principles underlying corporations law.

## 3. Concluding comments

Despite the limits set by the *single entity approach*, it remains legitimate and reasonable to set up new subsidiaries[361] or to redefine the business activities of existing group entities in order to find a group structure, which is considered the most effective and efficient in economic and legal terms. At the same time, the group members must still be regarded as individual "profit centres" maximising their revenues through the utilisation of the group's resources assigned to each of them in their capacity as distinct legal persons.[362]

Considered from the policy perspective, the approaches pursued by corporate governance and tax consolidation cannot be easily reconciled. The principles derived from corporations law function as legal guards of the individual interests of single group members, whereas the tax consolidation regime opens new opportunities for a group-orientated use of the group's resources.

Such an incompatibility between corporate governance and tax consolidation principles can only be overcome where the corporations law undergoes major adjustments. Primarily, changes would be necessary in order to establish corporate governance rules explicitly recognising the validity of group's interests, which, at the same time,

[361] This can happen by means of outsourcing parts of the existing business structure into a newly established legal entity.
[362] For example, it may be reasonable to establish an entity holding the immovable (real estates and building facilities) of the group, which can be subject to lease agreements with group members using the facilities in course of their business activities.

would be constrained by provisions protecting the single group entities against potential abuse of power.

As the discussion in the following part of this thesis (Part D) shows, provided that the specific mechanisms are implemented, the corporations law may both:

- fulfil its main role guarding the interests of individual group members as well as the interests of their creditors, and
- enable groups to embrace the opportunities arising in the context of a tax-consolidation decision.

Admittedly, applying policies and principles which evolved under a foreign legislation for the purpose of the domestic legal system is very difficult, if not impossible. However, the analysis of an alternative approach to the subject matter should broaden the perspective for the discussions of the practicability of policies, principles and rules currently affecting the group's initial tax-consolidation decision.

## Part D: Comparative view - consolidation under German law

In order to gain a comparative perspective for the analysis into the policies underlying the Australian consolidation regime, this part of the thesis provides an insight into the German approach to consolidation. The main focus lies on the identification of the parallels and differences between the principles governing the Australian and German consolidation rules. Some brief comments with regard to the German provisions were already made in earlier parts of this thesis. The following chapters provide a deeper understanding of a consolidation system enforcing the model of economic groups.

Corresponding to the conditions set by the Australian law, groups choosing to consolidate under the German law must comply with a complex consolidation framework comprising tax legislation, corporations law and accounting regulations. The following discussion concentrates on the policies underlying German tax consolidation rules (*Chapter I*). Frequent references to the Australian consolidation principles illustrate the characteristic parallels and divergences which are detectible between the domestic and the foreign approach to the main consolidation issues. The comparative observations are completed with an analysis of the relevant corporate governance (*Chapter II*) and accounting provisions (*Chapter III*).

In contrast to the Australian regulations, the German approach to consolidation of groups relies primarily on the economic links existing between subsidiary members and the head entity. This policy ensures a strong coherence between the requirements imposed by the taxation, corporate governance and accounting regulations. As the analysis in previous parts of this thesis demonstrates, such a degree of correlation between the main sources of consolidation regulations is not accomplished under Australian provisions. Recognizing the inconsistencies arising from the Australian consolidation concepts, it should therefore be of interest to understand the policies and principles which shape the alternative German consolidation framework.

### *Chapter I: Consolidation policies*

Starting with an introduction into German business taxation rules (*section 1.*) this chapter illustrates the main features of the tax consolidation concept in Germany. The following discussion is structured in accordance with the composition of the German business taxation regime which makes a distinction between the consolidations under:

- the *Corporation Income Tax Act* (*section 2.*), and
- the *Trade Tax Act* (*section 3.*).

Importantly, there are no uniform tax consolidation rules which would be applicable under both tax acts.

The rules stated by the more significant tax-consolidation regime under the *Corporation Income Tax Act*[363] are highly compatible with German accounting and corporate governance regulations. The consistent application of the *economic group approach* needs to be closely considered as a workable alternative to the policies implemented under the Australian tax-consolidation system.

[363] The *Corporation Income Tax Act* is the major legal source for the taxation of business income in Germany.

## 1. Taxation of business entities in Germany

The income taxation of business entities in Germany is based on two parallel applicable taxation regimes. On one hand, business income is subject to the *Corporation Income Tax* (Koerperschaftssteuer). The corporate tax rate is at 25% of the business income generated by taxable entities (subsection 23 (1) *Corporation Income Tax Act*). Importantly, according to subsection 8(1) *Corporation Income Tax Act*, the calculation of business income under the Corporation Income Tax requires the application of the general income tax provisions stated in the *Income Tax Act* (Einkommenssteuergesetz).

The second source of business income taxation is the *Trade Tax Act*. The business income taxable under the *Corporation Income Tax Act* is adjusted in accordance with the rules stipulated by the *Trade Tax Act* and constitutes the income used for the assessment of the Trade Tax liability. The Trade Tax is a regional tax and its amount depends on the place of business of the business entity. According to subsection 16(2) *Trade Tax Act*, each commune is entitled to determine the relevant tax percentage orientated on a basis of 1 to 5% of the taxable business income (subsection 11(2) *Trade Tax Act*).[364] As far as a commune does not exercise its right to choose a tax percentage, the binding percentage is 200% (subsection 16(4) *Trade Tax Act*).

[364] The percentage of business income which is used for the calculation of the Trade Tax liability depends on the amount of the calculated business income.

From this it follows that, considering the maximum of 5% of the business income being subjected to this percentage, the maximum tax imposed by the *Trade Tax Act* in the absence of communal regulations can amount to 10% of the adjusted taxable business income (200% multiplied by 5%, multiplied by the business income).

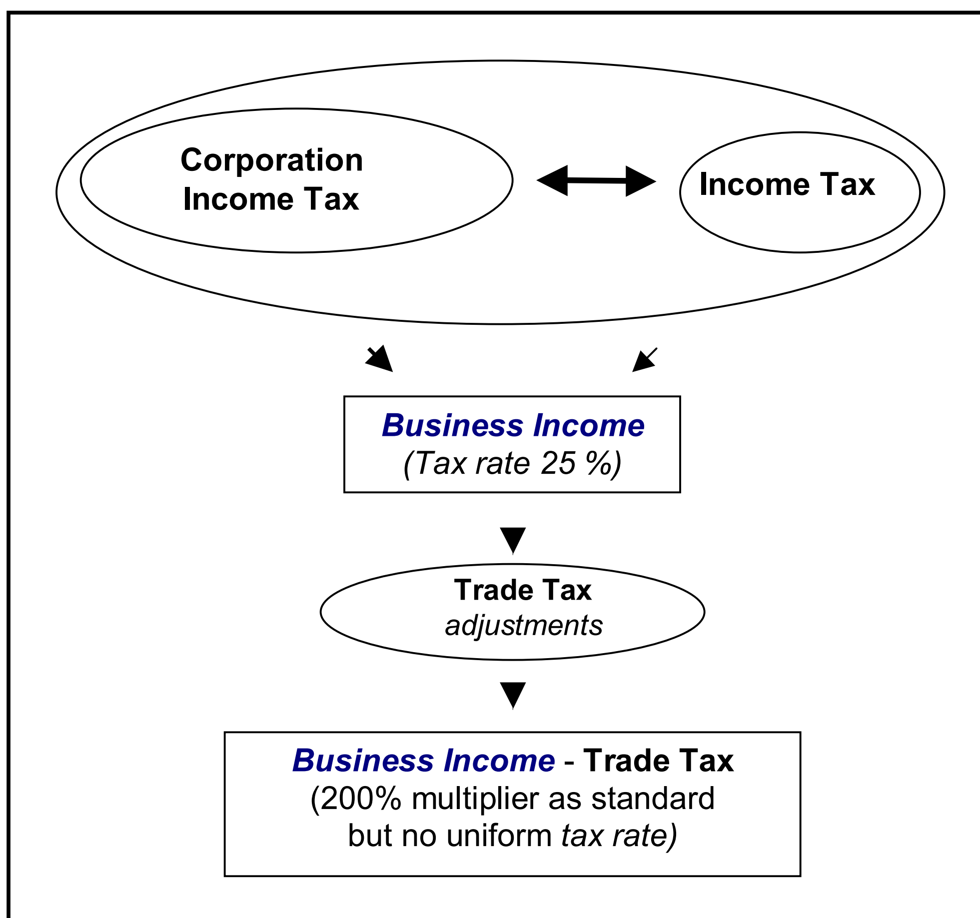


**Figure 15** Taxation of business income in Germany

The consolidation rules under the *Trade Tax Act* are based on the provisions stated in the *Corporation Income Tax Act*. The general view on tax consolidation is that the controlled and wholly-owned group

members, although separate legal entities, constitute mere sections of the economic entity lead by the head entity.[365]

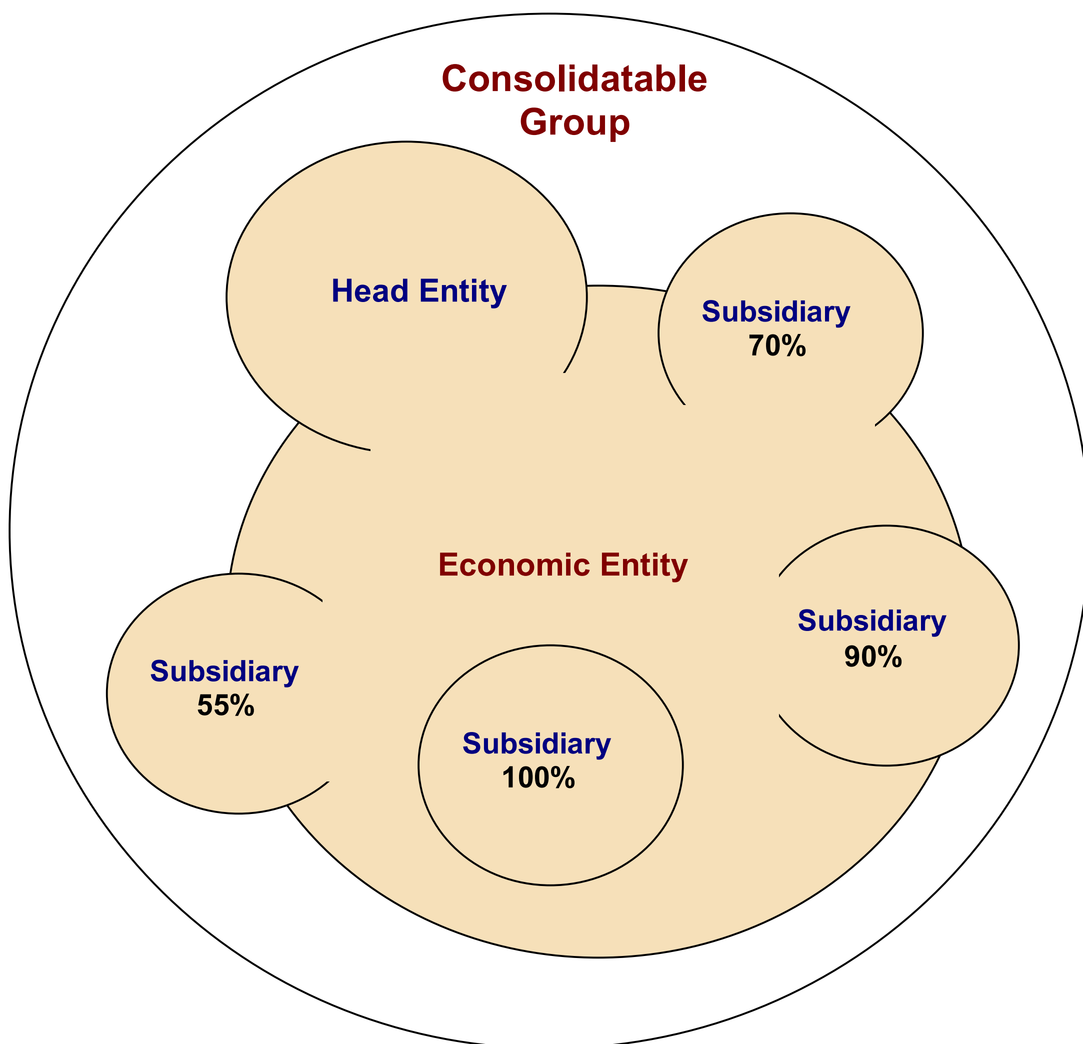


**Figure 16** Economic entity under German tax consolidation rules

As the following discussion of the German tax-consolidation rules illustrates, the *economic entity approach* enables groups to consolidate the group's tax income / loss without integrating the joining members' accounts in the hands of the head company.

[365] The term "head company" is not used in the context of the German consolidation rules, since groups can be headed by non-incorporated entities and individuals.

## 2. Consolidation under the Corporation Income Tax Act

The main eligibility conditions for consolidation under the Corporation Income Tax are stated within section 14 of the *Corporation Income Tax Act* and refer to:

- the legal form of the head entity and the subsidiary members;
- the residency of the group entities;
- the controlling stake requirement; and
- the profit transfer agreement.

According to subsection 14(1) *Corporation Income Tax Act*, joint-stock companies, German resident entities, are eligible for the status of subsidiary members in a consolidated group.[366] Furthermore, under the conditions specified in section 17 *Corporation Income Tax Act*,[367] limited companies can also join tax-consolidated groups as subsidiary members.

The position of head company is available to individuals, who must be liable to tax, or partnerships and companies that are not exempt entities (subsection 14(1)No.2 *Corporation Income Tax Act*).[368]

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[366] Besides joint-stock companies, entities formed as limited partnerships on joint stocks (Kommanditgesellschaft auf Aktien) are also eligible to become a group's head company. The legal nature of these entities mirrors the identity of joint-stock companies. The major difference between both legal forms is the fact that at least one of the share holders of the limited partnership on joint stocks must carry unlimited liability for the partnership's obligations (section 278 *Joint Stock Company Act* (Aktiengesetz)).
[367] The stipulated conditions commit consolidated limited companies and their head companies to comply with relevant provisions stated in the *Joint Stock Company Act*.
[368] However, partnerships can head a group only if carrying on a business.

In order to form a consolidated group, the group's head company, a German resident entity, must hold throughout the relevant income year, directly or indirectly, a **majority of voting rights** in the eligible subsidiaries (subsection 14(1) *Corporation Income Tax Act*). This condition constitutes a significant difference to the wholly-owned criterion stipulated by the Australian consolidation regime. Under German rules, the mere control over a subsidiary is sufficient for the establishment of a consolidated group. Accordingly, consolidation under the *Corporation Income Tax Act* occurs with major regard to economic / financial links within corporate groups (*economic group approach*).[369] Such an orientation on the economic realities makes the tax-consolidation provisions very much consistent with the policies pursued by the accounting regulations.

The second main eligibility condition is the existence of a **profit transfer agreement** (paragraph 291 (1) *Joint Stock Company Act*) between the head company and all subsidiary members. Such an agreement must have a minimum duration of five years (subsection 14(3) *Corporation Income Tax Act*).[370] This condition ensures that the control over the subsidiaries, based on the majority of voting rights, must be actively utilised in order to form an economic group and make it eligible for tax consolidation.

[369] See also K Tipke, J Lang, *Steuerrecht*, (17th ed, 2002) 474.
[370] Essential in this context is the requirement for recurrent payments to minority shareholders (paragraph 304 AktG).

The requirement of a so called 'financial and organizational integration' going beyond the scope of a profit transfer agreement, which constituted a major threshold for entities intending to consolidate in the past, was removed during the course of the last major tax reform.[371]

In contrast to the Australian approach, the income of the consolidated entities must be determined on the level of the subsidiary member. In a second step, the profit / loss is passed to the head entity where the group income or loss is calculated. The main advantage for groups consolidating under these conditions is that the profits generated by eligible group members can be set off against losses accrued within the group as the head company aggregates them.[372]

These tax-consolidation principles differ considerably to their Australian equivalents. In the absence of the wholly-owned requirement, the subsidiary members retain a stronger organizational and structural independence compared to entities which are eligible to consolidate under the Australian provisions. The German rules rely primarily on the concept of factual economic links. Such links are already established through a majority of voting rights in the hands of a group's head company, rather than the "unity of resources" required by Australian consolidation regime. Under these circumstances,

[371] See *Tax Reduction Act* - 'StSenkG' dated 23 October 2000 (Federal Law Gazette I, p. 1433 (KStG/2000)).
[372] Bundesfinanzministerium, Bericht zur Fortentwicklung des Unternehmenssteuerrechts, Pressemitteilung (Press Release) 19.04.01 at 40.

corporate groups consolidating under the *Corporation Income Tax Act* do not have to undergo the complex process of the allocation of group assets. To the contrary, the explicit aim of the policies underlying the German approach to tax consolidation is the avoidance of potential mergers within groups triggered by tax-related considerations.[373] The Australian provisions, on the other hand, stipulate the deemed disposal of interests held in subsidiary members and the acquisition of group's assets by the relevant head company.

Importantly, these German tax-consolidation provisions can be applied in a flexible manner, since the 'once in, always in' or the 'one in, all in' principles are not enforced. Consolidation can be elected for all or some of the group members fulfilling the eligibility criteria. This choice must be made separately for every ending income year and has no implications for subsequent income periods. In this regard, the German consolidation provisions resemble the application of removed Australian grouping rules. However, the man difference between the current German and the former Australian approach to taxation of groups is that under German provisions the group income is aggregated in the accounts of the head entity, whereas the removed grouping provisions retained the separate taxation of group members and allowed only some of the tax attributes, such as tax losses, to be considered in the group context.

[373] See Tipke and Lang, above n 360, 473.

Since there is no obligation to allocate the group assets in the accounts of the head entity, Corporation Income Tax consolidation rules do not apply any principle equivalent to the 'single entity rule'. Intra group transactions are not ignored but have a neutral impact on the group's taxable income, as the gains of some group members mirror the costs incurred by other members of the same tax-consolidated group.

Members of economic groups applying the relevant consolidation provisions are, in contrast to Australian wholly-owned groups electing to consolidate, obliged to assess their taxable income or tax loss individually. The consolidated group income is derived from the sum of the individual income statements and the resulting transfer of profits or losses accrued by the group members.

In summary, Corporation Income Tax consolidation provisions are built upon numerous principles which resemble those used in both the removed and the current Australian grouping regulations. At the same time, a group can be consolidated on the basis of economic links which are established already through majority of voting power and the installation of a profit transfer agreement. The consideration of corporate groups as economic entities makes the elaborate process of integration of the group's accounts, which constitutes a main obligation under the Australian *wholly-owned approach*, redundant.

3. Consolidation under the Trade Tax Act

The main eligibility conditions for consolidation under the *Trade Tax Act* are derived from the *Company Income Tax Act*. The legal identity of entities eligible for the status as head entity or subsidiary member in a group consolidating for Trade Tax is therefore stipulated in section 14 *Corporation Income Tax Act* (subsection 2(2) *Trade Tax Act*).[374]

At the same time, in order to become eligible for consolidation under the *Trade tax Act*, groups must have established economic links which go beyond the requirements made under the *Corporation Income Tax Act*. In contrast to the conditions discussed above, the majority of voting rights held by the head entity must be constituted by a direct investment. Moreover, the consolidated subsidiary must constitute an integrated part of the business structure of the group and comply with directives formulated by the head entity. [375]

The profits / losses accrued by the subsidiary members are considered to be a part of the assessable Trade Tax income of the head entity. This means that no profit transfer agreements are required for consolidation under the *Trade Tax Act*. This concept has strong similarities to the Australian approach to consolidation where the group's income is generated by the head company alone.

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[374] See also H Broenner, *Die Besteuerung von Gesellschaften, des Gesellschafterwechsels und der Umwandlungen*, (17th ed, 1999) 1475.
[375] Bundesfinanzministerium, Bericht zur Fortentwicklung des Unternehmenssteuerrechts, Pressemitteilung 19.04.01 at 40 and 41.

However, in contrast to Australian provisions, the Trade Tax consolidation regime does not affect the obligation of the subsidiary members to assess the annual income or loss individually. This condition is consistent with the rules governing consolidation under the *Corporation Income Tax Act*. According to the general rules, the Trade Tax income or loss of every single group member must be derived from its business income or loss calculated under the *Corporation Income Tax Act*. The adjustments required for the calculation of the Trade Tax income / loss are practicable only at the level of the individual entity, not the consolidated group. From this it follows that, despite the stronger integration of groups consolidating under the *Trade Tax Act*, all members, not the head entity alone, must comply with the obligations imposed by the act. The head entity is, nevertheless, the only Trade Tax liable group member.

### *Chapter II: Consolidation and accounting*

Under the German *Code of Commercial Law*, conditions governing the obligation to consolidate group's financial accounts mirror the entry requirements applied for tax consolidation. According to section 290 *Code of Commercial Law*, a domestic head company holding a majority of voting rights in subsidiary companies (*economic group approach*) must prepare consolidated annual accounts for the group. This principle stipulating a yearly consolidation of financial accounts is equivalent to the financial accounting regulations set by AASB 1024.[376]

However, in contrast to the Australian consolidation practice, the tax consolidation data is derived directly from (adjusted) financial accounts.[377] This fact is primarily due to the following two factors:

- application of the *economic group approach* (potential tax consolidated (corporate) group equals the group implementing financial consolidation); and
- retaining of asset values (no allocation of the restated asset values in the accounts of the head entity).

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[376] See Part C Chapter I 1.

[377] Importantly, in contrast to the conditions under the Australian tax accounting regulations, German business entities are obliged to prepare a separate tax balance sheet reflecting the financial situation of the entity in accordance with tax rules which may be different to the accounting provisions (e.g. longer depreciation periods). This tax balance, not the separate financial statement, is the basis for the calculation of the annual taxable income of the entity. However, in accounting practice, the tax balance is derived from the annual financial statement. The financial statement undergoes a number of adjustments necessary to comply with the specific tax rules.

The main policy underlying both financial and tax consolidation is the application of the *economic group approach*. At the same time, under the *Corporation Income Tax Act* the consolidated entities retain their individual status within the group and the obligation to calculate their assessable income at the end of each income period.

Under these conditions, tax consolidation does not trigger any substantial adjustments to the existing reporting and accounting procedures. Consequently, corporate groups consider tax consolidation as a measure closely related to the steps undertaken in the context of financial accounting regulations.

### *Chapter III: Consolidation and corporate governance*

German corporations law defines a number of classes of corporate groups which, in contrast to the common law principles (*single entity approach*), are regarded as single enterprises (*single enterprise approach*).[378] Section 15 *Joint Stock Company Act* stipulates the main principles for the formation and operation of groups. According to this provision, the following relationships can be established between joint stock companies on the basis of shareholding and contractual agreements:

- majority shareholding (section 16 *Joint Stock Company Act*);
- controlling and controlled entities (sections 17 and 16 *Joint Stock Company Act*);
- corporate groups (sections 18 and 17 *Joint Stock Company Act*);
- companies with mutual shareholdings (section 19 *Joint Stock Company Act*); and
- control-agreements (sections 291 and 292 *Joint Stock Company Act*).

[378] For an general overview of the German group enterprise law see also D. Sugarman, G. Teubner, *Regulating Corporate Groups in Europe*, 339-341.

The Limited Liability Company Act does not provide any specific rules in relation to corporate groups. However, the rules stipulated by the Joint Stock Company Act can also be applied to groups formed by limited liability companies.[379]

This chapter focuses on provisions implementing the *single enterprise approach* and the *economic group approach* under the German corporations law. Of particular interest are rules which establish a balance between powers assigned to head companies and the protection of interests of subsidiary members / minority shareholders having no direct influence on the business activities of a group. As the following analysis shows, a definition of groups as homogeneous business entities does not necessarily compromise the statutory postulate to guard the fundamental interests of single group members.

Considering rules affecting wholly-owned and controlled groups which are eligible for tax consolidation, the category of the so called '*subordinated groups*' has the greatest relevance.[380] According to subsection 18(1) *Joint Stock Company Act*, a subordinated group is formed where a head company and one or more controlled entities are operated under the direction of the head company.

[379] Eisenhardt U, *Gesellschaftsrecht*, 9th ed., C.H. Beck, Muenchen, 2000, at 491
[380] Subsection *18(2) Joint Stock Company Act* also names a second category of groups, the '*horizontal groups*'. According to this provision, a number of independent companies can establish a joint leadership and form a corporate group. Such groups, however, are not based on a majority shareholding and are not eligible for tax consolidation. They are therefore not considered in the following analysis.

Such a constellation can arise under the following three alternatives:

- factual position of dominant influence exercised by the head company over its subsidiaries (*de-facto group*);
- ‘integration’ of two or more companies (*integrated group*); and
- contractual control-relationship (*contractual group*).

The conditions for the formation of such groups are discussed in the following sections. As further analysis shows, some of these different categories of groups implement the single enterprise approach providing the head company with the power to pursue the group’s interests which may not always be the interests of some of the single group members.

1. Contractual groups (subsection 18(1) 1st alternative)

Contractual groups are created through the conclusion of an agreement in which the subsidiary members assign to the head company[381] the right to conduct the activities of the entire group (subsection 18(1) in connection with section 291 *Joint Stock Company Act*), contract of dominance.[382] Pursuant to such an agreement, the head company obtains the right to directly supervise the subsidiary's directors (subsection 308(1) *Joint Stock Company Act*). Importantly, this includes the right to give orders potentially clashing with the interests of a subsidiary member, as far as these are assessed as advantageous for the head company and / or other group members (subsection 308(1) *Joint Stock Company Act*).[383]

Insofar, the German provisions concentrating on the group's interests have a similar effect as section 187 *Corporations Act 2001*. However, in contrast to the Australian law, there is no requirement for the full

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[381] A company becomes a 'head company of a subsidiary company if it obtains a direct or indirect "dominant influence" over the subsidiary' (subsection 17 (1) *Joint Stock Company Act*). This influence can be established through a majority shareholding (subsection 17 (2) *Joint Stock Company Act*).
[382] According to subsection 293(3) *Joint Stock Company Act*, the agreement must be in writing. Furthermore, the agreement is subject to the approval by shareholders of the subsidiary. A majority of at least 75 % of the votes in a general meeting is required (subsection 293(1) *Joint Stock Company Act*).
[383] In most cases, contractual groups are also subject to a profit transfer agreement making them eligible for consolidation under the Corporation Income Tax Act.
See Part D Chapter I 2.
Importantly, minority shareholders affected by such an agreement should be entitled to compensation which amounts to an 'adequate proportion' of profits made by the subsidiary member (section 304 *Joint Stock Company Act*).

ownership of a subsidiary. The economic group approach prevails also under corporate governance regulations.

At the same time, an effective limitation of the powers executed by the head company is stipulated by subsection 302(1) *Joint Stock Company Act*. According to this provision, the head company must compensate the financial losses suffered by subsidiary members. Consequently, the economic condition of subsidiary members is permanently tied up with the financial results of the group's holding company and *vice versa*. This mutual responsibility is compatible with the single enterprise approach disregarding the legal / economic independence of single group members.

2. Integrated groups (subsection 18(1) 2nd alternative)

A group can also be established in the process of the absorption / integration of subsidiary members through the head company (subsection 18(1) in connection with sections 319 and 320 *Joint Stock Company Act*). Such absorption takes place in cases where the head company obtained at least 95% of the issued shares of the controlled subsidiaries and 75% of the shareholders of the head company approved the formation of the group in the course of a general meeting. Under these circumstances, the head company has the obligation to acquire the remaining stock of shares (section 320a *Joint Stock Company Act*).[384] The controlled group members become wholly-owned subsidiaries.

In an economic sense, the formation of an integrated group resembles a legal merger between the group entities.[385] Nevertheless, the absorbed subsidiaries retain their separate legal identity for the entire duration of group membership.

According to subsection 323(1) *Joint Stock Company Act*, the head company of an integrated group has the right to give direct orders to subsidiary members. In contrast to the conditions governing the

[384] Importantly, the minority shareholders are entitled to adequate compensation (subsection 320b(1) *Joint Stock Company Act*).
[385] J Kuhlmann, E Ahnis, *Konzernrecht*, (2001) 13.

operation of contractual groups, however, these orders do not necessarily have to be made in the apparent interest of the group.

At the same time, the holding company becomes jointly and severally liable for all debts incurred by its subsidiaries after the integration is completed (s 322 (1) *Joint Stock Company Act*). This provision practically prevents any actions to the detriment of a subsidiary member, which were not equally counterbalanced by benefits arising in the context of the group.

3. *De-facto* groups (subsection 18(1) 3rd alternative)

In the absence of a contract of dominance or the absorption of controlled subsidiaries, a subordinated group can be established on the grounds of a factual capability of the head company to exercise a dominant influence over its subsidiaries.[386] Such an influence is assumed if a head company obtains a majority shareholding in a subsidiary company (subsection 18(1) in connection with subsection 17(2) *Joint Stock Company Act*).

At the same time, *de-facto* group subsidiary members undergo no formal integration into the group and retain their individual entity status. Consequently, in contrast to the operation of integrated groups and contractual groups, head companies of *de-facto* groups must pay attention to the individual interests of subsidiary members (subsection 311(1) *Joint Stock Company Act*).

Under these conditions, head companies must compensate subsidiary members for any losses resulting from directions which were detrimental to their interests (section 311 *Joint Stock Company Act*).[387]

[386] This rule has a strong similarity to section 50 AA *Corporations Act 2001*.
[387] Importantly, corresponding to the common law principles, the German legislator initially intended to ban the exercise of any non-contractual group relationships and bind any potential abuse on strict liability. This policy would have been very similar to the single entity approach. The economic reality, however, forced the German legislator to accept the necessity for the establishment of rules relating stronger to corporate practice.
See Sugarman and Teubner, above n 378, 344.

## Part E: Conclusion

The Australian approach to tax consolidation rests upon a framework of rules making direct or indirect use of the wholly-owned criterion. The accounting provisions, on the other hand, apply the economic group approach, regarding controlled entities as group members. These diverging policies result in a parallel definition of corporate groups as:

- economic entities (accounting regulations), comprising all controlled and related companies (*economic group approach*), and
- tax-consolidated (wholly-owned) groups (*wholly-owned approach*).

Both these categories of groups are governed by the *single enterprise approach* which transforms them into homogeneous legal entities in relation to income taxation and / or accounting regulations. However, due to diverging eligibility requirements, the composition of such groups, even though they may be headed by the same company, can differ considerably.

With regard to core policies which may be relevant in the process of the initial tax consolidation decision, groups must also consider that, in contrast to the tax and accounting rules, the company law does not recognise any form of consolidated group identity. To the contrary, corporate governance provisions still employ the *single entity*

*approach* strictly enforcing the recognition of the individual interests of each single group member. This policy is pursued irrespective of a decision in favour or against tax consolidation, or the requirement for the consolidation of financial accounts.

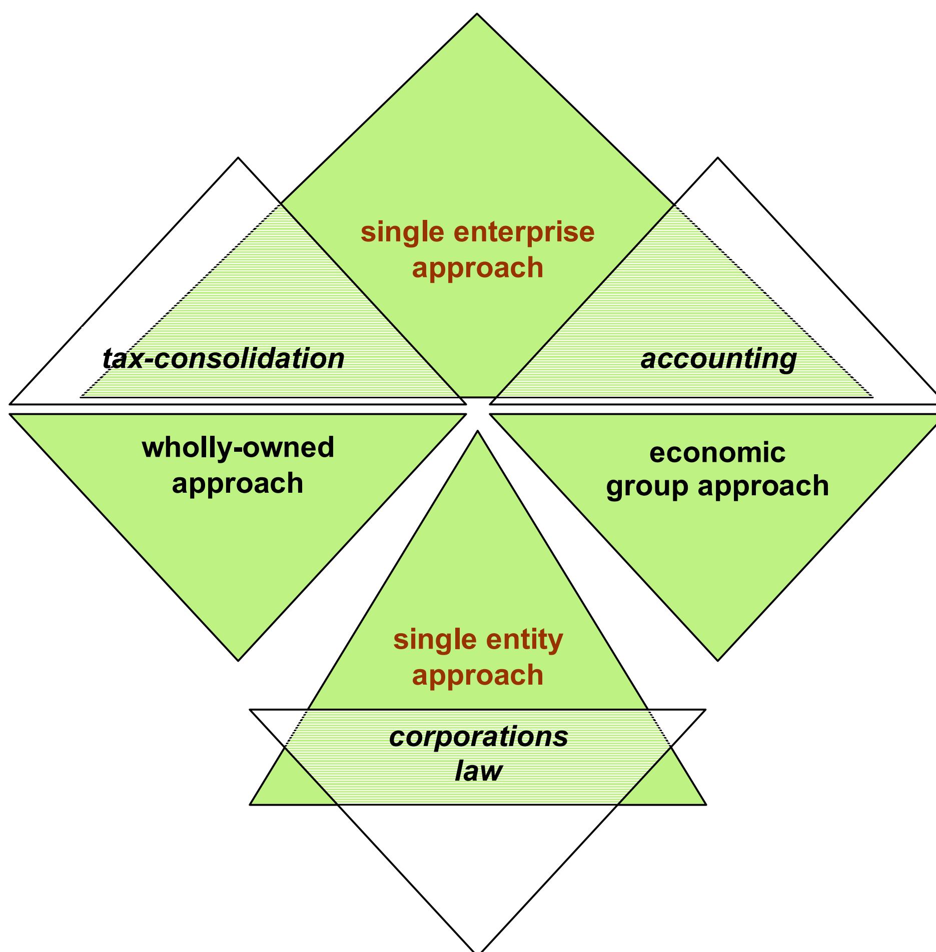


**Figure 17** Australian consolidation policies

The upholding of the wholly-owned requirement clashes with one of the core policies underlying consolidation legislation. The definition of consolidated groups as single enterprises (subsection 701-1(1)) for the purpose of income taxation can be of limited effect only, since

controlled entities are disqualified from participation. The exclusion of controlled entities triggers the disregarding of group relationships whose economic character may often be not different to the operation of wholly-owned group members.

Within the Australian legal system, these group relationships are recognised only under the accounting regulations where both the *single enterprise approach* and the *economic group approach* are implemented. As examples from foreign jurisdictions illustrate, a wider application of the relevant policies is practicable.

German tax legislation makes controlled entities eligible for membership in consolidated groups (*economic group approach*). The evident need for the protection of minority shareholders and of the interests of the controlled entity itself is delivered through a framework of statutory sanctioned mechanisms. These provisions, however, do not affect the consistent application of the *single enterprise approach*. Disregarding the single members' interests triggers only the obligation of the head company to compensate any loss suffered by the subsidiaries in the course of decisions made to their detriment.

In conclusion, the interests of the group, e.g. in the context of the most effective tax planning, prevail over those of the single members. However, potential abuse of this power is limited through the threat of compensation claims which can be made by subsidiary members and their minority shareholders.

Moreover, consistently with principles governing tax and corporations law, German accounting regulations are based on the policy pursuing the consolidation of economic groups. Wholly-owned and controlled subsidiaries are considered members of a “single enterprise” whose financial position must be disclosed in the head company’s consolidated group accounts.

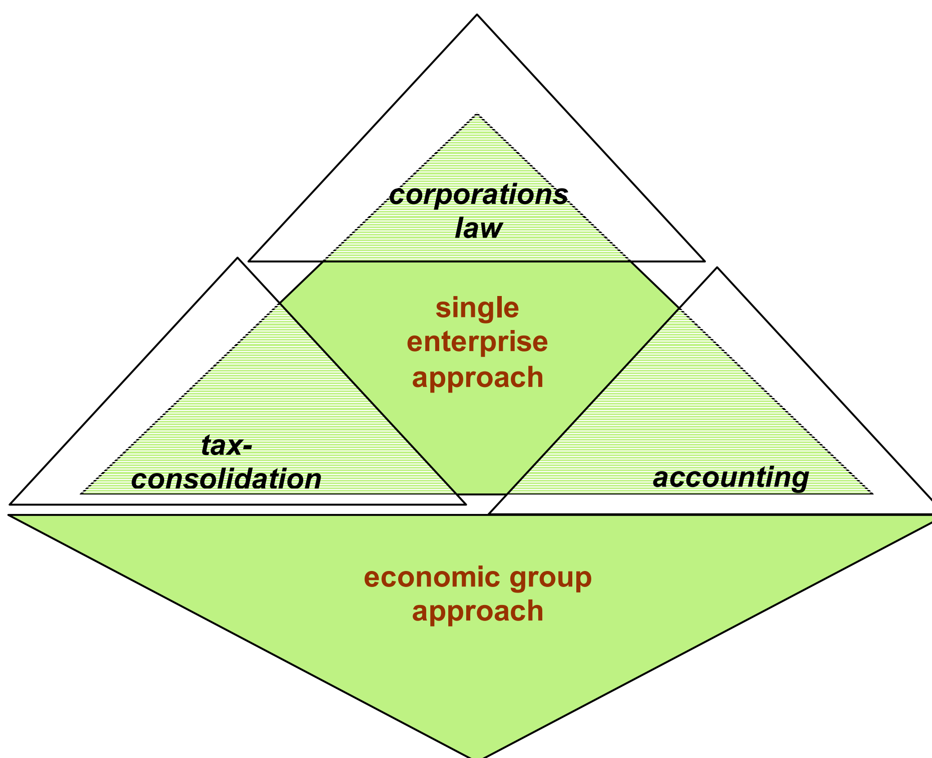


**Figure 18** German consolidation policies

Such a degree of correlation between the policies underlying accounting regulations and taxation / corporate governance provisions, jointly representing the same economic reality of groups, is not achieved under Australian consolidation legislation.

On the contrary, the single entity rule (group members are regarded as a part of the head company) stipulates the integration of the group's assets, liabilities and tax attributes (losses and franking credits) without having any impact on the separate corporate entity status of consolidated group members. Furthermore, the wholly-owned eligibility requirement, the key instrument for the integration of all eligible group members, stands in direct contrast to the policies underlying the mandatory accounting regulations.

Admittedly, this evident lack of consistency between the approaches to the composition and operation of groups under tax legislation and accounting principles was already detectible with regards to the former grouping provisions. The introduction of the new consolidation regime made the existing differences more apparent. Under the current rules, tax consolidation of wholly-owned groups and financial consolidation of economic groups must be regarded as two separate consolidation processes.

The necessity for a thorough assessment of these indirect and direct implications arising from the initial tax consolidation decision results from the statutory imposed definiteness of the steps undertaken towards consolidation. Diverging from conditions stipulated under the removed grouping rules, head companies deciding to apply the elective elements of the new legislation must make an irrevocable choice for the permanent consolidation of all eligible group members.

The flexibility of making an individual decision for a particular income year, whether to apply the elective grouping rules or to maintain the separate entity status is replaced by the “one in all in” and “once in, always in” principles. In view of the resulting permanent exposure to the consolidation provisions, groups have only limited means to adjust their tax planning to potential changes in the relevant legislation.

The irrevocable integration of all eligible (wholly-owned) group members to a single enterprise (*single entity approach*) is manifested by the liability regime imposing the group’s tax liability primarily on the head company. However, even though the head company is the *prima facie* income tax liable group member, all consolidated subsidiary members are subjected to a joint and several (contingent) liability for the unsettled group obligations.

Importantly, this liability cannot be avoided in the course of payments made with regard to a tax funding arrangement. Such contributions may even constitute a double tax expense in cases where the contingent liability arises.

The only valid option to escape the group tax obligations is accessible under the rules governing TSA. The effectiveness of this instrument, however, depends on compliance with an array of complex, and in some instances obscure, conditions.

Moreover, since the execution of the TSA depends on the submission of the document by the group's head company at the required time and in the prescribed form, entities leaving a group under such an agreement may still become liable for income tax obligations accrued before the time of de-consolidation. This fact may have detrimental effects on a market valuation of group entities which is conducted subsequent to consolidation. Head companies intending to restructure and dispose of wholly-owned subsidiaries should therefore complete the relevant steps prior to the formation of the consolidated group.

The concentration of the group's liabilities in the accounts of the head company rests upon the stipulated elimination of membership interest and the parallel integration of assets. At the time of consolidation, the group's current asset values are aligned with the cost base of membership interests held in the joining group members. In other words, the value of interests held in each joining group entity is replaced by a restated tax cost of the entity's assets. The joining group members' liabilities and assets are absorbed by the group's head company.

Importantly, with regards to the resetting of the joining time tax cost of assets, the consolidation process has some substantial challenges. On one hand, any potential increase in the tax cost of group assets is limited through the requirement for the reset value attributable to each consolidated asset not to exceed its current market / termination

value. On the other hand, the recognition of the goodwill value at the joining time may contribute to a considerable decline in the post-consolidation tax cost of the depreciating assets. This risk, which is inherent to groups comprising long established and owned entities, can only be avoided through the use of transitional rules.

The application of these concessions, providing the retention of the pre-consolidation asset tax cost, occurs in cases where the resetting process results in an overall decrease in asset tax cost and / or a shift from depreciating assets to non-depreciating assets. Such a decision can be made separately in relation to each joining group member.

Transitional concessions are also available for the use of group losses which are transferred to the group's head company at the joining time. The availability and transfer of such losses, however, depends on the passing of either the COT or the SBT, which have been modified for the purpose of the tax consolidation regime. Importantly, the COT test period ends just after the time of consolidation. From this it follows that entities which were acquired immediately prior to the consolidation event are able to transfer their losses only under the SBT. However, under the stipulated loss transfer rules, the same business condition must be met retrospectively from the end of the loss year on.

Consequently, groups opting for tax consolidation may refrain from acquiring a 100% stake in loss entities controlled through the ownership of less than 50% voting power. Losses accrued by such

group members cannot be transferred at the time of consolidation and are therefore lost for the joining subsidiary and the group's head company.

Importantly, in relation to groups consolidating after the end of the transitional period, the stipulated order of use, group losses before transferred losses, delays the recoupment date of losses transferred at the joining time, making compliance with the SBT and / or COT more difficult. This detrimental effect is lessened by the fact that the relevant tests are applicable solely (COT) or primarily (SBT) in relation to the head company.

Furthermore, in the wake of the removal of the previous grouping provisions, the pooling of foreign tax credits and franking accounts and the principle of ignoring intra-group transactions undertaken subsequently to consolidation are the main means for preventing double taxation of group income. However, adjustments to the exempting entity and former exempting entity provisions ensure that the consolidation regime is not considered as a tool for the avoidance of restrictions imposed by Division 208.

Finally, one of the main benefits arising from consolidation is the opportunity to escape the application of the modified anti-avoidance and integrity measures. These restrictive provisions were introduced simultaneously with the elective elements of the consolidation regime.

In conclusion, the consolidation legislation defines a complex system for the taxation of group entities, which, despite some inconsistencies, should provide a far more appropriate treatment of wholly-owned groups than was the case under the “patch-work” of the removed grouping concessions. Groups understanding the policies, principles and rules which shape the consolidation framework should be able to employ strategies allowing them to minimize potential negative impact on liabilities, assets, losses and franking accounts. Admittedly, this task will soon become more challenging, once the transitional concessions cease to apply.

Beyond the direct impact of the tax consolidation provisions, in making an irreversible decision for the implementation of the elective consolidation provisions, a head company must also understand and thoroughly assess a number of critical issues arising in the context of inconsistencies between consolidation rules imposed by tax legislation, corporations law and accounting regulations.

Due to diverging eligibility criteria, groups face serious compliance efforts arising from the separation of the tax consolidation and the financial consolidation data streams. Moreover, the fundamental differences in the definition of the legal identity of groups under tax consolidation and corporate governance principles limit the potential for efficient tax planning based on the consolidated group’s interests.

Consequently, to a considerable degree, benefits potentially resulting from the implementation of the consolidation regime are affected by policies and principles sanctioned by rules stipulated outside the tax legislation.

As the discussion of the German consolidation framework has demonstrated, a strong congruence between tax rules, corporate governance principles and accounting provisions can constitute a core criterion for the establishment of a consolidation system.

However, in contrast to the Australian eligibility criteria, this foreign approach is accessible only for head entities and their corporate subsidiary members. The question whether and to what extent the relevant policies and principles could be also adapted within a consolidation environment integrating subsidiary members in the legal form of partnerships and trusts is disputable and requires further comparative research.

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