Greenwoods & Freehills guide to

Tax consolidation for corporate groups in Australia

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Contents

Tax consolidation for corporate groups in Australia 5

- The consolidation regime — a summary 5
- Application 6
- Group membership requirements 6
- Groups with single foreign parent company but no common Australian holding company 8
- Group taxed as single taxpayer 9
- Tax cost setting of assets 10
- Allocation of allocable cost amount of subsidiary's assets 12
- Leaving the group: pushing up asset tax costs 16
- Losses 16
- Imputation rules 21
- International taxation of consolidated groups 23
- Joint and several liability and tax sharing agreements 25
- Company tax instalments 26
- Losses and value shifting 26
- Further amendments and unresolved issues 27

Where to look for further information 28

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Tax consolidation for corporate groups in Australia

The consolidation regime — a summary

In 1998 the Australian Government announced a major tax reform which included the tax consolidation of 100 % owned company groups. The Ralph committee was appointed to investigate the proposal and develop details on this and many other tax reform issues. The proposals were then implemented in stages from 1999 onwards, with consolidation being the highlight of 2002.

The system is founded on six basic principles:

- consolidation is optional but if a group decides to consolidate, all of its wholly owned Australian resident group entities must consolidate
- consolidated groups of wholly owned Australian entities with a single common head company are to be treated as a single entity
- repeal of the existing grouping provisions
- losses and imputation attributes of entities entering a consolidated group should generally be able to be brought into the consolidated group
- losses and imputation attributes remain with the consolidated group on an entity's exit from the group
- the tax cost of assets in the consolidated group should be established by the asset model, that is, the cost of equity held by the head company should be pushed down to the assets held by subsidiaries on entering consolidation and the cost of assets of subsidiaries should be pushed up to equity in a subsidiary on exit from consolidation.

The major pieces of legislation implementing the consolidation regime in Australia are now law. An indication of the complexity of the new regime can be gleaned from the fact that no fewer than 12 Acts have been passed to implement the regime amounting to about 500 pages of legislation.

Further refinements are in the pipeline, including one measure announced in the 2005 Budget, however, these should not alter the thrust of what we have currently.

Given that the substance of the tax consolidation regime is now in place, this booklet is intended to provide a broad outline of the rules as they currently stand.

Application

The tax consolidation regime may apply to wholly-owned groups of entities from 1 July 2002, at the election of the taxpayer. The normal Australian income year runs from 1 July to 30 June, rather than 1 January to 31 December as is common in the northern hemisphere. Many foreign owned groups in Australia are allowed to use the tax balance date of their parent and thus end up with income years commencing 1 January (or 1 April for UK parent companies). This is called a substituted accounting period.

Transitional rules allowed groups to defer entry until as late as 30 June 2004 and still gain access to certain transitional concessions.

While entering the consolidation regime is not mandatory, the previous grouping provisions (which allowed, for example, loss transfers, CGT roll-overs, and excess foreign tax credit transfers) ended for most corporate groups on 30 June 2003 (this date varying for those groups with substituted accounting periods). As a result, corporate groups are required to consolidate if they want any form of 'single entity' treatment.

There is an exception for foreign bank branches and consolidated groups. A foreign bank branch and the head company of a consolidated group can still transfer losses between them, provided that both still meet the existing loss-transfer rules, including 100 % common ownership. This benefit is also being extended to branches of other non-resident financial institutions such as investment banks and securities companies.

The choice to consolidate must be made before the due date for lodgement of the tax return for the income year in which the consolidated group is formed.

Group membership requirements

For a consolidated group to exist, there must be a **head company** and **at least one subsidiary member**. There are slightly different requirements for groups of companies that have the same foreign ultimate holding company (see below).

To be a head company, a company must be:

- an Australian resident company that has some income taxed at the general company tax rate, and
- not wholly-owned by any other Australian resident company.

A head company can also be a corporate unit trust or a public trading trust that is taxed like a company but still subject to a number of tax rules relating to trusts (these kinds of trusts are used in Australia in infrastructure developments). It should be noted that if a corporate unit trust or a public trading trust elects to be the head company of a consolidated group, they are, from the date that the election takes effect, taxed like a company for all purposes of the Australian income tax legislation and are no longer partially subject to trust tax rules.

To be a subsidiary member, the entity must:

- be a company, trust or partnership
- be 100 % beneficially owned, either directly or indirectly, by the head company and/or another subsidiary member of the head company's group, and
- meet certain Australian residence requirements.

Special rules exclude certain exempt entities like charities from membership of a consolidated group.

If a head company chooses to consolidate, all its subsidiaries must form part of the group (the 'one in, all in' principle).

The 100 % ownership test is applied to shares in companies which are not treated as debt for tax purposes under Australia's debt/equity rules. Options and convertible bonds are disregarded (that is, can be owned by third parties) as are shares issued under employee share schemes in limited cases. Similar rules are applied to trusts and partnerships (except that there is no exception for employee interests).

In the transitional phase it is possible in certain circumstances for companies to form consolidated groups even though ownership is traced through a non-resident entity. Often cross border mergers in the past would leave an Australian parent company with a 100 % foreign subsidiary which in turn had a 100 % Australian subsidiary. The transitional measures allowed the two Australian companies in

this example to form a consolidated group. After 1 July 2004 however, it is not possible to take advantage of this concession. Accordingly, cross border mergers now have to be organised so that the Australian subsidiary of the foreign company in this example becomes a subsidiary only of Australian resident entities, that is, the shares in the Australian subsidiary have to be transferred by one means or another from the foreign company to Australian resident companies.

Groups with single foreign parent company but no common Australian holding company

Consolidation is permissible between resident subsidiaries of a foreign parent, notwithstanding the absence of a single head company resident in Australia. This is done by way of a Multiple Entry Consolidated (MEC) group. An MEC group is treated in the same way as a consolidated group (ie all the members of the group are treated as parts of the head company for Australian tax purposes).

An MEC group can be formed between two or more Australian resident companies that are directly owned (either wholly or partly) by foreign resident entities (referred to as 'tier-1 companies'), provided the Australian resident entities are both ultimately 100 % owned by the same foreign resident company. It is possible to have foreign entities interposed between the single foreign parent and the tier-1 companies.

Where these requirements are met, the two or more tier-1 companies may elect to form an MEC group. If they do, every Australian resident company, trust or partnership that is 100 % owned (either directly or indirectly) by each of the tier-1 companies must join that MEC group.

However, the 'one in, all in' rule is modified for MEC groups. If there are two or more tier-1 companies of a common foreign resident parent, each of the tier-1 companies can elect not to join the MEC group. The effect of this is that all of the 100 % owned Australian resident entities in that tier-1 company's 'silo' cannot be members of the MEC group. This modification is best explained by an example:

F1 Co is a foreign resident company that owns all of the shares in another foreign resident company, F2 Co. F2 Co in turn owns all the shares in A1 Co, A2 Co and A3 Co (who are all Australian-resident companies). Each of A1 Co, A2 Co and A3 Co are able to be part of an MEC group as they are

each 100 % owned by the same ultimate foreign resident company, F1 Co. The three tier-1 companies have the following options:

- all three (and thus, each of their 100 %-owned Australian-resident companies, trusts and partnerships) can choose to form a MEC group
- any two (for example, A1 Co and A2 Co, and thus, each of their 100 % owned Australian resident companies, trusts and partnerships) can choose to form an MEC group, and the other (in this case A3 Co, and thus, each of its 100 % owned Australian resident companies, trusts and partnerships) can either form its own consolidated group or not form a consolidated group or MEC group, or
- all three can (and thus, each of their 100 % owned Australian resident companies, trusts and partnerships) choose to form their own separate consolidated group, or elect to not form a consolidated or MEC group.

An eligible tier-1 company, none of whose membership interests are owned by other members of the MEC group, may be appointed as the provisional head company of the group. This provisional head company is treated as the 'head company' of the MEC group.

Aspects of the consolidation regime covered below relating to the single entity principle, cost setting rules and pooling of imputation and loss attributes apply to MEC groups albeit in a modified manner. These modifications reflect the different nature of an MEC group, namely, that the group has two or more companies that are collectively akin to a head company of a consolidated group.

Group taxed as single taxpayer

Essentially, the consolidation regime allows wholly-owned groups of entities to be treated as one single taxpayer—the 'single entity' principle. The head company will complete a single tax return, and any transactions between members of the group will be ignored for tax purposes. Intra-group shareholdings and loans will also be ignored for tax purposes. Further, the assets and available tax losses of subsidiary members of the group automatically become those of the head company (these notional transfers are subject to special rules which are discussed below).

Unlike other countries, the rules do not provide for separate calculation of income for each company in the group and then a process of elimination of intra-group transactions. Rather, the assets and liabilities of all the companies are simply attributed to the head company. This method of calculation has thrown up many practical problems and the Australian Taxation Office (ATO) has issued many public rulings on how the calculation is done, with many more expected.

Tax cost setting of assets

Because the head company is treated under the single entity principle as automatically becoming the owner of the assets of its subsidiaries, the tax cost of the assets in the head company's hands must be ascertained so that it can account for the tax consequences of such ownership including gains and losses on subsequent sale of the assets. Rather than keeping the cost that they have in the hands of the subsidiary, the cost of assets is 'reset' by attributing the cost for the head company of the shares in the subsidiary to the assets of the subsidiary (which is commonly referred to as a 'push down' of the cost). This seems to be a unique feature of the Australian regime. The tax costs of assets of the head company, are, however, not reset based on the cost of equity in the head company.

Calculation method

The method of setting the cost of the assets of subsidiaries in the head company's hands involves adding the liabilities of subsidiaries to the head company's cost of equity in the subsidiaries and then making adjustments for certain profits and losses of subsidiaries as well as cases where assets have previously been transferred among group companies without being taxed under a tax free rollover. This total tax cost (referred to as the 'allocable cost amount') of the subsidiary's equity is then allocated among the assets mainly based on their market values. The tax cost of the assets is reset at the time the subsidiary member (referred to as the 'joining entity') joins a consolidated group (which includes the initial formation of a consolidated group) and is referred to as the 'joining time'.

The method of calculating the allocable cost amount of the assets of a subsidiary member differs depending on what type of entity the subsidiary member is (company, trust or partnership). The company and trust rules are similar, and are set out below. In Australia, a partner is treated as owning a pro rata share of the partnership's assets, and equity

in the partnership is ignored for tax purposes. Accordingly there is no push down for the cost of equity in a partnership.

Generally in making adjustments for pre-consolidation retained earnings of the subsidiary, the calculation allows only taxed retained profits that accrued to the group to be added to the allocable cost amount. However, as a transitional concession, a joining entity was allowed to add untaxed retained profits that accrued to the group, provided that the consolidated group was formed on or before 1 July 2003, or on the first day of its substituted accounting period that commenced after 30 June 2003 and before 1 July 2004.

For losses, the calculation distinguishes between tax losses which accrued to the group and those which arose prior to the head company acquiring the subsidiary member. Unutilised tax losses of the joining entity that are brought into the consolidated group that accrued to the joining entity while it was directly or indirectly owned by the head company are subtracted in full from the joining entity's allocable cost amount. In contrast, the amount subtracted for tax losses that accrued to the joining entity when it was not owned by the head company (pre-acquisition losses) is the tax-effected benefit of those losses, that is, 30 % which is the corporate tax rate in Australia. It is assumed that the head company will benefit from the loss when it is used to reduce future income under the rules for losses discussed below, and there would be a double benefit if the tax cost of the equity were not adjusted for this amount. The head company can elect to forgo the pre-acquisition losses in which event there is no reduction.

Entitlements to future on-going tax deductions that the joining entity was entitled to pre-consolidation, but which the head company becomes entitled to post-consolidation (via the consolidated group being treated as a single tax entity) are also deducted from the joining entity's allocable cost amount, under the same 'double benefit' principles for losses described above.

All pre-consolidation roll-overs of assets among the members of the group under the previous CGT roll-over regime occurring after 16 May 2002 are to be ignored for the allocable cost amount calculation, that is, such assets are treated as still being held by the transferring company at the time of formation of the consolidated group, and any consideration provided is

treated as still being held by the recipient company. There is a relaxing of this rule for assets rolled-over from foreign resident companies.

To ensure the relaxing of the roll-over exclusion described above cannot be exploited by groups with foreign parent companies, another step in the calculation of allocable cost amount makes an adjustment if the joining entity is a subsidiary member and has had an asset rolled-over to it. The adjustment applies if the roll-over is by a foreign resident company under the grouping rules (which still permit CGT roll-overs where foreign residents are concerned, even after consolidation, as foreign residents cannot be part of a consolidated group) or the joining subsidiary is directly owned by the head company and it owns a direct or indirect interest in an entity which has had an asset rolled-over to that entity by a foreign resident company.

Consequences of a negative allocable cost amount

If the joining entity's calculation of allocable cost for its assets is negative after adding the cost of equity and liabilities and adjusting for rollovers, an immediate capital gain arises to the head company equal to that negative amount which is taxable in that year unless offset by capital losses.

If the allocable cost amount is positive or zero after adding the cost of equity to liabilities and adjusting for rollovers, but negative after adjusting for pre-consolidation profits and losses, no immediate capital gain arises and the tax cost of each of the joining entity's assets is zero.

MEC groups

The tax costs of the assets of each first onshore company in an MEC group are not reset using the method just described, as each company is effectively a head company of their own 'silo'. As the tax cost of assets for a head company of a consolidated group are not reset, it would be inappropriate to allow foreign-owned companies in an identical position to access the tax cost setting provisions simply because they are in an MEC group.

Allocation of allocable cost amount of subsidiary's assets

Once the allocable cost amount of the assets is calculated, it is essentially allocated across the assets of the subsidiary member. The allocable cost amount is first allocated to the 'retained cost base

assets' of the subsidiary based on their current tax costs, that is, these assets effectively retain their cost and are not reset. These are assets which are unlikely to have varied in value because of their nature (eg Australian dollar cash amounts, receivables, prepayments and trading stock in certain cases). The balance of the allocable cost amount is then apportioned across the other assets (referred to as 'reset cost base assets') of the subsidiary member in proportion to their market values to determine that asset's new tax cost. Restrictions to the allocation rule apply to certain trading stock, depreciable assets and other revenue assets.

If the allocable cost amount is less than the face value of the retained cost base assets, an immediate capital gain arises to the head company equal to the shortfall (the legislative assumption being that the latent loss on the assets will be available to the group upon realisation). Conversely, if an entity only has retained cost base assets, and its allocable cost amount is in excess of the total face value of those retained cost base assets, an immediate capital loss arises to the head company equal to that excess.

Special rules apply if the assets of a subsidiary member include shares or interests in a lower-level subsidiary member of the group. The reset tax cost, not the actual tax cost, of the shares or interest that the higher-level subsidiary member hold in the lower level subsidiary is used as the cost base of those shares or interests in calculating that lower-level subsidiary's allocable cost amount, that is the tax cost of the equity in the lower-level subsidiary. Thus, the cost of the shares or interest to the head company is pushed down step-by-step through corporate chains.

The allocable cost amount allocated to the membership interests in a lower-level subsidiary will depend upon its market value as market value is used to allocate the cost of reset cost base assets as described above. On the basis that certain profits and losses that such lower-level subsidiaries will bring to a consolidated group will be included in their own allocable cost amount calculation as the calculation outlined above is repeated for each subsidiary member in the group, the market value of such lower-level subsidiaries is adjusted for the purposes of allocation of the allocable cost amount by subtracting its retained profits amount and adding its post-acquisition losses amount. This effectively reverses two steps in the calculation of 'allocable cost amount'. Further, its market

value is similarly adjusted by the value of its direct and indirect interests in such profits and losses of other lower-level subsidiary members of the consolidated group.

There are also special rules for assets that are netted-off against liabilities in a subsidiary member's financial accounts (known as linked assets and liabilities), and assets held under finance leases.

Broadly, where an asset and liability are 'linked', the liability is first applied to set the tax cost of the linked asset, with any remainder being allocated to other assets. If the amount of the liability is less than the amount that would otherwise be allocated to the linked asset, the linked asset's tax cost is limited to its market value.

In the case of finance lease assets, the issue is which asset has its tax cost reset; the physical asset which is the subject of the lease, or the right to receive lease payments.

Where a lessor can depreciate the asset under the Australian income tax law, the lessor sets the tax cost in the physical asset. If the lessor cannot depreciate the asset, that is, the lease is treated as a sale and loan, a tax cost in the right to receive lease payments is set. Australia categorises only a limited class of finance leases in the accounting sense as sales and loans for tax purposes.

Similarly where a lessee can depreciate the asset, the tax cost of the underlying asset is set. Where the lessee cannot depreciate the asset, no asset is recognised for tax cost setting purposes, and any liability to make lease payments is not included in the calculation of the lessee's allocable cost amount.

There are special rules for other situations such as mining assets and software rules.

Transitional method

Given the complexity of the allocable cost amount method and the costs associated with obtaining market valuations, for a limited transitional period, the head company was able to elect to retain a subsidiary member's pre-consolidation tax costs in its assets. The decision was made on an entity-by-entity basis within a group.

Generally, groups that consolidated before 30 June 2004 had access to this concession. Although the method was transitional, it will affect many companies for many years to come as the cost of assets needs to be known when they are disposed of.

Mistakes in calculating allocable cost amount

Where a mistake in the calculation is discovered and it would be unreasonable to have to recalculate the tax cost setting amounts, the tax cost setting amounts need not be recalculated. Instead, if the mistake caused the tax costs to be higher than they should have been, a capital gain arises to the head company equal to that overstated amount. Conversely, if the mistake caused the tax costs to be lower than they should have been, a capital loss arises equal to that understated amount.

Liabilities settled for different amounts

Where an accounting liability ends up being different in amount to that included in the calculation of the allocable cost amount, an immediate capital gain or capital loss is deemed to arise for the head company if that difference would have altered the subsidiary member's allocable cost amount calculation. In other words, where the liability is realised for less than the amount included in the calculation, a capital gain arises equal to the difference, provided the realisation for the different amount would have caused the subsidiary member's allocable cost amount to differ. Conversely, where the liability is realised for greater than the amount included in the calculation, a capital loss arises, provided the realisation for the different amount would have caused the subsidiary member's allocable cost amount to differ.

In the case of the original formation of a consolidated group, it is unlikely that these capital gains or losses will arise, even if these liabilities are realised for different amounts, as the difference would have led to a decrease in the liabilities taken into account in the calculation of the amount of liabilities, as well as an off-setting adjustment to either the profits or losses of the subsidiary member which also enter the calculation as described above. Accordingly, these gains or losses are likely to only arise in relation to subsidiary members that join a consolidated or MEC group after the formation of those groups.

Leaving the group: pushing up asset tax costs

When a subsidiary member leaves a consolidated group, the shares or interests in that entity need to be recognised again for tax purposes, and the head company of the exited group must calculate a tax cost in respect of those membership interests for the purposes of calculating its gain or loss on that entity leaving the group.

In many respects this is the reverse of the allocable cost amount calculation, in that the cost base of the membership interests in the leaving subsidiary is calculated having regard to the head company's tax cost in the assets of the leaving entity at the leaving time, less the accounting liabilities of the leaving entity (there are further adjustments for the recognition of intra-group loans etc, between the leaving entity and the exited group). In other words the cost of the assets of the leaving company less its liabilities is 'pushed up' to the shares in the company. There is no need in Australia, unlike most other countries, to keep track of the cost of the shares or interest in subsidiary members while they are in the consolidated group. The cost on exit has no direct relationship to the cost of the shares on entry to the group. This method of setting cost on exit is adopted to overcome problems that can be caused by value shifting within corporate groups (eg transactions between group companies which are not at market prices).

Losses

The basic principle is that a company which becomes part of a consolidated group should be allowed to bring its various losses (eg revenue, capital and foreign losses) with it into the group. However, there are detailed provisions which limit:

- the losses that can be brought into the consolidated group, and
- the utilisation of those losses by the head company within the consolidated group.

Transferring losses to a consolidated group

In order for its unused losses to be transferable to the head company of a consolidated group, the joining entity must satisfy the modified versions of the existing loss recoupment rules at the time it becomes a member of the consolidated group.

The transferable losses are determined using the following steps:

- determine the amount of unused carry forward losses of the joining entity for an income year that ends at or before the joining time, and
- apply the modified loss recoupment tests (outlined below) to the unused carry forward losses.

The modified tests are based on the existing loss rules, that is:

- there must be a greater than 50 % continuity of beneficial ownership in the company at all relevant times, *or*
- the company must carry on the same business as it did immediately prior to the change in majority beneficial ownership, *and*
- no person must start to control the company's voting power for the purpose of gaining a tax benefit or advantage.

The separate but similar trust loss rules must be considered in relation to trusts in consolidated groups for carry forward of revenue and foreign losses (but not capital losses for which there are currently no special rules).

The tests are applied on the assumption that the joining entity had sought to use the loss in an income year that ended when it joined the group.

The modified ownership test

In broad terms, the joining entity must test ownership continuously from the start of the income year in which the loss was incurred to the end of the 'trial year', that is, the 12 month period which ends at the joining time. This also applies to non-membership period losses which are losses incurred during part of a year where the entity was not a subsidiary member.

Additionally, the joining entity must not fail the control test. The control test is failed if a person starts to control the entity's voting power for the purpose of gaining a tax advantage or benefit. In relation to non-fixed trusts, the control test is failed if, at any time during the test period, a group commences control of the trust.

The modified business test

The same business test must be applied to the trial year. The test for companies is applied in the following manner:

- for losses of an income year commencing before 1 July 1999—the business carried on immediately before the failure of the ownership and control tests must be carried on for the trial year, and
- for losses of an income year commencing on or after 1 July 1999—the company must carry on the same business;
  - immediately before the end of the year in which the loss was incurred,
  - throughout the year in which the ownership and control tests were failed, and
  - for the whole of the trial year.

The same business test is further modified for listed public companies and their 100 % subsidiaries to reflect the fact that they are only required to test for substantial continuity of ownership at certain times, namely, when there is an abnormal trading in the company's shares and at the end of a year of income.

Part year losses

Losses referable to only part of an income year can also be transferred. The modified loss transfer tests are applied over a period to reflect the fact that these losses were effectively made for a shortened income year.

Effect within the consolidated group

A loss transferred to the head company of a consolidated group is taken to be made by the head company for the income year in which the transfer occurs. However, in relation to losses transferred to the head company which pass the ownership and control tests, changes in the ownership of the loss company before joining the group are taken into account in applying the ownership test to the head company in respect of that loss. In contrast, only changes in ownership after the joining time are taken into account in applying the ownership test to the head company in respect of losses which are preserved by the same business test and transferred to the head company. That is, these transferred losses are effectively refreshed at the joining time.

All losses retain their original loss type (eg tax losses, net capital losses and foreign losses), even after transfer.

Determining whether transferred loss can be used

A consolidated group's use of a transferred loss may depend on which of the loss recoupment tests were met at the transfer time.

Losses transferred to the head entity are broadly categorised as either ownership test losses, same business test losses or neither.

In general:

- losses generated within the consolidated group must be used before losses transferred to the head company by a joining entity
- ownership test concessional transferred losses (refer below) must be used before other transferred losses
- all transferred losses belong to loss bundles. A loss bundle represents all of the losses transferred to a consolidated group by an individual joining entity, and
- the annual rate at which a head company can deduct or apply transferred losses other than 'concessional transferred losses' is limited by reference to their 'available fraction'.

Broadly, the available fraction for a bundle of losses is applied to the amount of the consolidated group's assessable income of the relevant class after it has been reduced by:

- current year deductions
- prior year group losses, and
- concessional transferred losses.

The above result represents the maximum amount of a transferred loss from a subsidiary which may be used by the head company in a given income year.

Calculation of the available fraction

The available fraction is calculated for each bundle of losses transferred to a group by a joining entity.

Essentially, it is the proportion that the joining entity's market value (excluding the value of membership interests in subsidiary members)

bears to the market value of the whole group when the bundle is first transferred to the head company.

While there are various measures to prevent the inflating of available fractions from pre-consolidation events (eg the injection of capital or a non-arm's length transaction), the available fraction may be increased if the 'value donor' concession applies (see below).

The basic idea of the available fraction is to provide a proxy measure for the rate at which the joining company would have been likely to use the loss if it had remained outside the group.

Transitional concession rules for losses

There are three concessional measures provided for losses to groups that consolidated during the transitional period, 1 July 2002 to 30 June 2004.

The first measure relates to ownership test losses transferred to a group when it consolidates during the transitional period and that were made in an income year ending on or before 21 September 1999. These losses can be used evenly over a three-year period rather than their utilisation being determined by reference to the available fraction.

The second measure allows the available fraction for a loss company to be increased where that company has losses that it could have transferred to one or more other group companies under the previous loss transfer rules available to 100 % related corporate groups. The available fraction is increased by one company (the value donor) 'donating' some of its market value to the loss company. The value donor can also donate its losses (not including foreign losses) to the loss company so that they can be included in the loss bundle of the loss company with the increased available fraction.

The third measure allows a head company to elect that a member with foreign losses at the time of formation of a consolidated or MEC group be excluded from that group for a maximum of three years from that time. In other words, the 'one in, all in' principle does not have to apply to an entity with foreign losses. This concession recognises that the foreign loss making entity may be capable of using the foreign loss at a faster rate if it remains outside of the group, rather than entering the group and having the 'available fraction' apply to that loss.

Even though the foreign loss maker remains outside the group, it is still not eligible to transfer its losses to other entities. Further, the value shifting provisions may apply to transactions that occur between the consolidated or MEC group from which it is being excluded and itself.

Announced changes to loss rules that will affect consolidated groups

Major changes to loss rules generally are in the pipeline which will have significant impact on consolidated groups. At this stage it is not possible to predict precisely how loss rules in consolidation will change.

The first change is the removal of the same business test for unconsolidated companies or consolidated groups with a turnover in excess of $100 million in an income year.

The second change is the relaxation of the rules for testing continuity of ownership of listed companies (which will apply to many consolidated groups). Draft legislation was released for these measures early in 2005 and they are due to take effect from income years commencing on or after 1 July 2005.

The third change was announced in the 2005 Budget and involves the removal of the current special treatment of foreign losses which are not able to be offset against domestic income and are segregated for different baskets or types of income. Both the quarantining of foreign losses and the use of baskets is to be abolished with effect for income years commencing after the date of Royal Assent. The earliest possible commencement date for most companies is likely to be 1 July 2006. The abolition will not affect existing losses that are quarantined which will still have to be recovered against foreign income in the relevant basket.

Imputation rules

Australia has a full imputation system under which companies keep account of corporate tax paid and attach it to dividends paid to shareholders. The tax paid is recorded in the ‘franking account’. On the formation of its consolidated group, the head company maintains a franking account on behalf of the entire group. Each subsidiary member’s franking credits are effectively transferred to the head company’s franking account. If a subsidiary member’s account is in deficit (indicating that the company has attached more tax credits to dividends paid than it has paid

corporate tax), the subsidiary member pays franking deficit tax (which effectively makes up for the deficit), the debit balance is not transferred to the head company, and the head company is entitled to off-set this tax payment against future income tax liabilities. The subsidiary member's franking account remains dormant while it is a member of the group and any intra-group dividends do not give rise to any franking credits or debits in the group's franking account. A subsidiary member that leaves a consolidated group does not take any franking credits with it.

Foreign owned consolidated groups

Australia has special imputation rules for companies with 90 % ownership in the hands of foreign residents or tax exempt taxpayers. These rules deny the benefit of imputation to the company (as the shareholders will not benefit from the imputation system) to prevent the company being tempted to enter into imputation credit trading arrangements with companies which can use the credits. Such companies excluded from the imputation system are referred to as 'exempting companies.' They can still pay dividends free of non-resident dividend withholding tax. The imputation status of a consolidated group, that is, whether it is an exempting entity, former exempting entity or neither, will depend upon the pre-consolidation status of both the head company and its subsidiary members. In most circumstances, the head company's status will not change, but it may be required to keep an exempting account in respect of former exempting companies in the group.

Where a provisional head company is appointed for an MEC group, the franking account balance of the MEC group is transferred to that provisional head company. In an MEC group, it is possible for one of the first onshore companies in the group which is not the head company to make a distribution outside the group. If the normal consolidation imputation rules applied, this distribution could not be franked as that company is not the head company. To counter this, all distributions by first onshore (tier 1) companies are treated as if they had been made by the head company for imputation purposes.

Similar rules to those above apply to distributions by subsidiary members of a consolidated or MEC group to interposed non-resident entities, which is the only other time that members of a consolidated or MEC group can make frankable distributions to an entity other than

the head or provisional head company, respectively. Non-resident entities may be interposed between a head company and subsidiary members in certain transitional circumstances—see 'Group membership requirements' above.

International taxation of consolidated groups

Foreign dividends received by consolidated groups

In order to allow Australia to be used as a headquarters location, there is an accounting mechanism which allows dividends received by Australian companies from foreign companies in which they hold more than 10 % of the voting shares to pass through Australia tax free. These rules are currently being extended to capital gains on the shares and other forms of foreign income received by Australian companies with legislation expected in 2005. The mechanism used for this purpose is called the 'foreign dividend account'.

In relation to consolidation, the head company of a consolidated group operates a single foreign dividend account for the group. This is done by pooling the balances transferred to it by subsidiary members at the joining time. The head company should be able to use the surplus of the group to pay its non-resident shareholders unfranked dividends free from dividend withholding tax.

A company that ceases to be a subsidiary member of a consolidated group cannot take a foreign dividend account balance with it on leaving.

CFC and FIF rules

As part of its controlled foreign company (CFC) and foreign investment fund (FIF) regimes, Australia uses accounting mechanisms to keep track of income that has been subject to taxation under the CFC or FIF regime. This income can be repatriated to Australia as dividends free of further Australian tax (as well as generating foreign tax credits for any foreign dividend withholding tax on the dividends). Only the head company can operate the relevant accounts during the period of consolidation. The pre-consolidation balances of these accounts held by entities that become subsidiary members of a consolidated group are transferred to the head company. The subsidiary members will have inoperative accounts during the period of consolidation.

However, upon leaving the group, the head company will return to the leaving entity a proportion of the account surpluses the leaving entity has in relation to the interests in a CFC or FIF that leaves the group.

These measures apply to a provisional head company of an MEC group in the same way as they do to a head company of a consolidated group.

Foreign tax credits

The previous rules concerning grouping within a 100 % related corporate group of foreign tax credits applied until the time a consolidated group was formed or until 1 July 2003, whichever was the earlier (these dates vary for companies with substituted accounting periods). Thereafter, the single entity principle will continue to allow the carry forward and use of excess foreign tax credits for five years.

Once a group is consolidated, excess foreign tax credits held by an entity that becomes a subsidiary member of the group are transferred to the head company.

Under the transitional provisions, the head company of a wholly-owned group that consolidates during the period 1 July 2002 to 30 June 2004, will be able to use the excess foreign tax credits of subsidiary members at the end of the income year in which the group is formed. The additional transitional rules ensure that the current and amended rules will apply in an appropriate manner to entities with substituted accounting periods and to a head company that forms a consolidated group part way through an income year.

When an entity leaves a consolidated group, it will not be able to take any excess foreign tax credits with it.

Thin capitalisation

The previous thin capitalisation grouping rules for 100 % related groups ceased to operate from the time a group consolidated or 1 July 2003 whichever was the earlier, subject to certain exceptions for companies with substituted accounting periods.

The existing thin capitalisation rules now apply to consolidated groups on the basis of the single entity principle. Australia has a complex thin capitalisation regime, the details of which may be obtained on the Australian Taxation Office (ATO) website www.ato.gov.au by searching for thin capitalisation.

Further, Australian branches of foreign banks are able to be treated as part of the head company of either a consolidated group or an MEC group or part of a single Australian resident company for thin capitalisation purposes for all or part of an income year, provided that the head company or the Australian company and the foreign bank were members of the same wholly-owned group during that period and where certain other conditions are also satisfied. This grouping treatment is in the process of being extended to other foreign resident financial institutions.

Joint and several liability and tax sharing agreements

The head company of a consolidated group is solely liable, at first instance, for the group's tax liabilities. However, where the head company does not meet a group's tax liability by the time it is due and payable, all other members of the group will be jointly and severally liable for the group's tax liability. This means, even though an entity may have left the group, it could still be liable for the group's unpaid tax liabilities which were incurred while it was a member of the group.

Tax sharing agreements

If a valid tax sharing agreement is in place, the liability of each contributing member is limited to the amount determined under the agreement. To be valid, the agreement must list the name and Australian Business Number of each contributing member, and contain each contributing member's contribution amount to the group's tax liabilities, or a way of working out that amount. The allocation of contribution amounts among group members must be reasonable (suggested methods include basing the contribution on what the subsidiary member's tax liability would have been outside consolidation, or on the proportion of its profits for the year as compared to the consolidated group's profits).

On a technical level, a valid tax sharing agreement displaces the joint and several liability principle for outstanding group tax liabilities. Practically, the agreement is likely to exist alongside an intra-group contract that determines the payments each subsidiary member will make to the head company to meet the instalment and annual tax payments of the consolidated group (commonly called tax funding agreements).

Clear exits

A subsidiary member can leave a group clear of any group tax liabilities which become due and payable after the leaving time under a so-called 'clear exit' rule. To constitute a clear exit, the liability must be covered by a valid tax sharing agreement in place at the time the subsidiary member leaves the group, and the subsidiary member must have paid its estimated contribution amount (as determined under the agreement) to the head company at that time.

However, the clear exit rule will not protect a leaving entity in respect of an amended assessment issued to the head company after the leaving time where the original assessment related to tax that was due and payable before the leaving time. Hence in contracts for sale of a subsidiary it is necessary to provide for appropriate warranties and indemnities so that the buyer does not become saddled with tax liabilities that really should belong to the seller.

Company tax instalments

Once the first consolidated group tax return is received by the ATO, it will determine a consolidated group tax instalment rate for the head company which is used in the Australian system to collect company tax on a pay as you go basis. When this notice is received, the head company will pay instalments on behalf of the entire group, and the subsidiary members will cease to make them. Until this notice is received, subsidiary members are still required to pay their own instalments, as if they were not a member of a consolidated group.

Intra-group payments, based on the allocation contained in the group's tax sharing/tax funding agreements, may be made by subsidiary members to meet the head company's consolidated group instalments.

If the membership of a consolidated group changes, the Commissioner has the power to increase or decrease the head company's instalment rate.

Losses and value shifting

Australia has detailed rules to prevent doubling up of losses in the corporate sphere and to prevent value shifting between related companies. Details of these measures can also be found on the ATO website. These measures will operate as if a consolidated or MEC group were a single entity. The usual result is that the rules will have no operation within

the corporate group because transactions between group members are disregarded. The rules may operate between the consolidated group and related companies, eg between the head company and less than wholly-owned subsidiaries which are not part of the group.

Special rules have been created to govern the interaction of these rules on the formation of a consolidated or MEC group and where entities join and leave a group. Broadly, the application of the rules on the occurrence of these events can be summarised as follows:

- where a consolidated or MEC group is formed, or an entity joins the consolidated group, if the same business test is not satisfied by a joining entity for the trial year (ie generally the 12 months prior to the time the entity joins the group), then:
  - there are reductions to the joining entity's allocable cost amount calculation, and the affected assets are tagged, which can affect the calculation of the cost of equity on exit from a consolidated group, or the gain or loss recognised by the consolidated group if that asset is sold, and
  - any losses brought into the group are placed in a 'loss denial pool', which may cause their utilisation to be limited
- where a subsidiary member leaves a consolidated group, the same business test is applied to the head company—if that test is failed, the tax costs of the assets of the leaving entity are reduced to either market value (or nil), which reduces the cost of equity in the leaving entity. In some cases, the leaving entity may take its loss denial pool with it.

Further amendments and unresolved issues

The Australian Government has foreshadowed further amendments to the consolidation legislation in a series of press releases since the first legislation was introduced. These are in the nature of correcting technical deficiencies that have been identified by companies and their advisers and many of them have now been legislated. Extensive ongoing consultation is still occurring between government and the private sector. The ATO is in the process of releasing as many as 100 tax rulings to clarify the operation of various consolidation provisions, especially the tax cost setting rules and the single entity rule. Hence investors, foreign and otherwise, who are contemplating purchasing or creating a consolidated or MEC group need up-to-date advice on their Australian operations.

Where to look for further information

Greenwoods & Freehills Pty Limited

www.gf.com.au

The G&F website contains a number of articles and press releases on the introduction and ongoing amendment of the consolidation regime and related issues.

Australian Taxation Office

www.ato.gov.au/consolidation

The Australian Taxation Office's specific consolidation regime webpage, containing links to all rulings, determinations, interpretative decisions and draft pronouncements of the Australian Taxation Office.

Treasury

www.treasury.gov.au

The Treasury website contains links to a number of press releases from the Treasurer, and the Assistant Treasurer of Australia which refer to the introduction of the consolidation regime, and amendments to the existing consolidation regime legislation. Follow the links 'business—taxation—consolidation'.

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All other directors of Greenwoods & Freehills can advise on consolidation. For a list of directors see **www.gf.com.au**