Chapter 25

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A case for reform

Wholly owned groups are not consistently taxed as single entities

25.1 The present tax system taxes each company in a wholly owned group as a separate entity. In addition, there are grouping provisions which allow adjustments to the tax positions of the companies in the wholly owned group. Examples of these grouping provisions include the transfer of losses and capital gains tax deferral (rollover) for asset transfers between companies.

25.2 The tax rebate for intercorporate dividends prevents multiple taxation of income when it is passed through company chains. The intercorporate rebate and the grouping provisions together permit wholly owned company groups to secure some of the benefits of single entity treatment, but in a limited way, and accompanied by complexity and structural problems.

25.3 Not taxing a group as a single entity means that the tax system must account for all intra-group transactions and intra-group (equity and debt) interests. This, together with the grouping provisions and the intercorporate rebate, has resulted in the following problems for the taxation of wholly owned groups:

- *tax impediments to business organisation* — for example, compliance costs and possible tax costs of liquidating a redundant company in a wholly owned company group (discussed further in Appendix A);
- *high compliance costs* — for example, the costs of dealing with the tax implications of intra-group dividends (such as the franking rules);
- *tax avoidance through intra-group dealings* — for example, manipulating dealings between group companies to reduce or defer tax;
- *loss cascading* — where group companies — as well as companies that are less than 100 per cent owned — can use a chain of companies to create multiple tax losses based on one initial economic loss (illustrated in Example 25.1);
- *loss duplication* — where losses realised in carrying on a business or on disposal of assets are realised again on the disposal of equity;
- *double taxation* — where gains realised in ordinary commercial transactions are taxed again on the disposal of equity (illustrated in Appendix A); and

- *value shifting* — by group companies — as well as related companies that are less than 100 per cent wholly owned — transferring assets at under- or over-value between themselves to create artificial tax losses where no economic loss exists (illustrated in Appendix A).

The system has difficulty dealing with multiple layers of ownership

25.4 Most of the above classes of problems, particularly loss cascading, loss duplication, double taxation and, to a large extent, value shifting occur because the tax system must take account of multiple layers of ownership. This can be illustrated by loss cascading (Example 25.1).

25.5 While the simple arrangement in Example 25.1 has been addressed by anti-avoidance provisions, more sophisticated arrangements to achieve the same end have been devised. The structural flaw in the law stemming from the dual asset and equity capital gains tax cost bases — namely, that changes in the value of underlying assets are reflected in the equity interests held in those assets without cost base adjustments consequential on transactions at either level — requires a systemic solution.

A strategy for reform

Achieving a better tax system by taxing groups as single entities

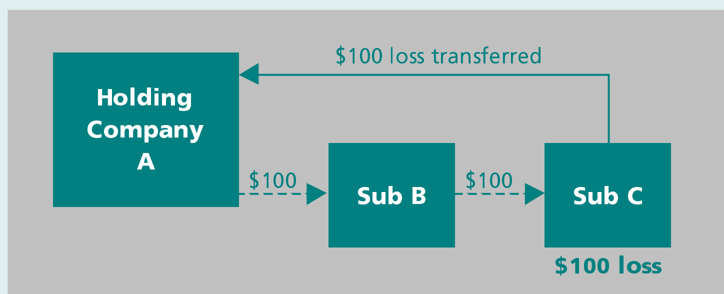
25.6 The problems identified in the previous section are the result of taxing each group company as a single entity and of failing to deal with the dual reflection of value in equity interests and the underlying assets. They are avoidable. *A New Tax System* suggested that a consolidation regime, which focuses on the wholly owned group as the tax entity, would improve significantly the taxation of entity groups. Other measures could deal with the problems outside of consolidated groups.

25.7 *A Strong Foundation* invited debate on tax reform in the context of the national objectives of optimising growth, ensuring equity and facilitating simplification. The arrangements set out in this part would:

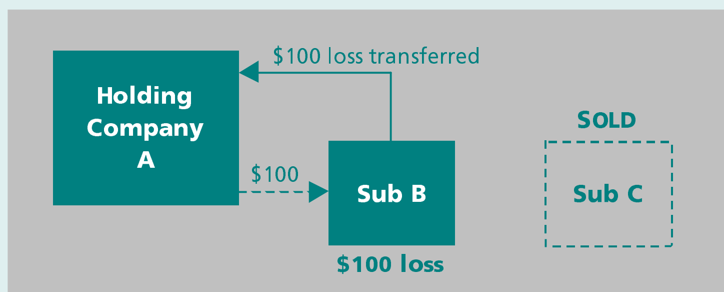
- simplify the tax system and reduce compliance costs;
- promote economic growth by providing a taxation framework that allows Australian businesses to adopt organisational structures based more on commercial rather than tax considerations; and
- promote equity by improving the integrity of the tax system.

Example 25.1: Loss cascading within a company group

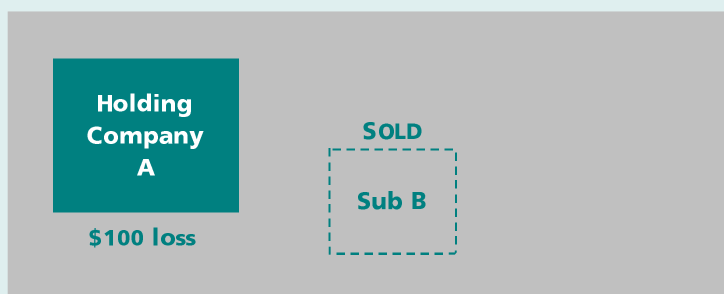
Suppose holding company A capitalises subsidiary B with $100. Subsidiary B, in turn, capitalises subsidiary C with the same $100. Subsidiary C acquires an asset for $100, but the investment is poor and the value of the asset falls to nil. Subsidiary C disposes of the asset for its market value of nil, incurring a loss of $100. The loss is then transferred under the grouping provisions to holding company A.



Subsidiary C has no market value, but subsidiary B's cost base for its equity in subsidiary C is still $100. Accordingly, disposal of subsidiary C by subsidiary B will create a duplicate capital loss of $100, which may also be transferred to holding company A.



A further capital loss of $100 could be created by holding company A through the disposal of subsidiary B. The original loss in subsidiary C would then be multiplied threefold to $300 in holding company A. This form of loss duplication is called loss cascading.



Assisting business through reduced compliance costs

25.8 Taxing the wholly owned group as a single, consolidated entity would mean that intra-group transactions and intra-group interests are ignored. For example, assets and losses could be transferred between group entities, and intra-group dividends could be paid, without tax consequences and without the compliance costs of the existing system.

25.9 Within a consolidated group, revenue losses, capital losses, foreign losses, franking credits and foreign tax credits would be pooled and, depending upon the approach adopted, consolidation may be able to remove numerous compliance obligations on intra-group transactions. Significant tax complexity and compliance requirements that could be removed include the following:

- the deemed dividend rules (section 47 and Division 16K of the 1936 Act);
- the rules for determining capital gains or losses (sections 104-25 and 104-135 of the 1997 Act) when liquidating companies or buying back shares within a group;
- the franking rules relating to intra-group dividends;
- the formal requirements for loss transfers, including the restrictions on transferring capital losses and the requirement to make cost base adjustments following the transfer of capital losses (Division 170 of the 1997 Act) and the additional requirements when losses transferred are subsequently adjusted, in audit or otherwise;
- impediments to group restructuring — mentioned below; and
- related anti-avoidance rules associated with intra-group transactions (such as sections 82KK and 82KL of the 1936 Act).

25.10 The proposal to tax trusts like companies increases the importance of removing the defects of the existing arrangements for taxing companies. In addition, trusts — which are not presently covered by provisions for loss transfer and capital gains tax rollover for asset transfer — would benefit from loss pooling and free movement of assets within wholly owned groups.

Reducing impediments to group restructuring

25.11 Taxing wholly owned groups as a single entity would also remove taxation impediments to group restructuring.

- There would be tax-free movement of assets, even whole businesses, within a group without the need to adhere to formal rollover arrangements or undertake cost base adjustments, such as:

  - the formal rollover arrangements, for both capital gains tax and the depreciation balancing adjustment (Subdivisions 126-B and 42-H of the 1997 Act), for transferring assets between group companies; and
  - cost base adjustments following transactions that shift value between companies within a consolidated group (Division 19A of Part IIIA of the 1936 Act).
- Shares could be bought back in a group company without the possibility of triggering a capital gain or loss.
- A group company could be liquidated without the possibility of triggering either a deemed dividend or a capital gain or loss.

25.12 The transfer of assets (or a business) — or buying back shares in, or liquidating, a subsidiary company — within a consolidated group would have no tax consequences or compliance requirements. How consolidation would reduce the compliance costs associated with liquidating a subsidiary is shown in Appendix A.

Corporations Law reform

25.13 The *Corporate Law Economic Reform Program Bill 1998* introduced into the Parliament on 3 December 1998 would implement new acquisition powers enabling a holding company to compulsorily acquire all of the securities issued by certain subsidiaries.

25.14 These new powers, used either as alternatives or cumulatively, would allow holding entities to consolidate their position within a group of companies and, thereby, improve their ability to take advantage of the proposed taxation arrangements for wholly owned groups of companies.

25.15 It is expected that if consolidation arrangements for taxation were introduced, further Corporations Law amendments could be introduced to assist group restructuring. In a December 1998 discussion paper the Companies and Securities Advisory Committee (CASAC) invited comment on whether the Corporations Law should be amended to facilitate group rationalisations. The Review is liaising with CASAC in relation to its work on corporate groups.

Promoting greater equity

Elimination of double taxation

25.16 The design of the consolidation regime could ensure that the problem of double taxation of a single economic gain is eliminated for consolidated groups. This could be achieved by ensuring accretion of value is recognised at one level only for tax purposes.

Preventing loss duplication and value shifting

25.17 The group consolidation arrangements presented for consultation (Chapters 26 and 27) would also promote equity by enhancing the integrity of the business tax system. In particular, these arrangements would represent structural change to the law that would prevent inappropriate reductions in tax liabilities resulting from intra-group dealings, loss cascading, loss duplication and value shifting, within wholly owned groups that choose to consolidate their tax assessments.

Looking beyond wholly owned groups

25.18 Consolidation, necessarily, can only deal with these problems in relation to wholly owned groups that choose to consolidate for tax purposes. Therefore, supplementing consolidation are options (in Chapters 28 and 29) — again involving structural improvement in the law — that could address loss and gain duplication and value shifting transactions for:

- wholly owned groups of entities that do not consolidate; and
- entities that are not wholly owned but which have a single majority owner or controller.

Appendix **A**

Problems with current arrangements: further details

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Liquidation of a group company: tax implications under the existing law and under consolidation

A.1 Currently, where a group decides to liquidate a redundant company and the liquidator distributes in kind the assets of the company being wound up, difficulties lie in determining:

- whether any part of the liquidator's distribution is income to the shareholder company or companies;
- if part of the distribution is income, whether the intercorporate dividend rebate applies;
- whether the company in liquidation makes a capital gain or loss on the disposal of its assets; and
- whether the parent company or companies make a capital gain or loss on the disposal of their shares in the company that is liquidated.

A.2 Table A.1 compares the tax compliance requirements associated with the liquidation of a group company under the existing law and under consolidation. It illustrates the simplest case, under the existing law, where the company to be liquidated is wholly owned by the company that is to acquire its assets. In this case the liquidation and transfer of assets can be achieved by in-kind distribution by the liquidator.

Double taxation of gains

A.3 It is possible for businesses in the course of undertaking ordinary commercial transactions to be effectively double taxed on a single economic gain. This is illustrated in Example A.1.

Table A.1: Liquidation involving in-kind distribution to a single parent company

<table>
<tr><th>Under the existing law</th><th>Under consolidation</th></tr>
<tr><td colspan="2">Is there a dividend?</td></tr>
<tr><td>There will be a dividend to the extent that the distribution by the liquidator is attributable to income funds.
In determining whether part of an in-kind distribution by a liquidator is income, indexation of the cost base of capital gains tax assets is not allowed.</td><td>There is no dividend. All intra-group transactions are disregarded for taxation.</td></tr>
<tr><td colspan="2">How is a dividend taxed?</td></tr>
<tr><td>The full intercorporate dividend rebate is allowable to:
▪ resident public companies for all dividends received; and
▪ resident private companies for intra-group dividends:
– provided both companies were members of the same group for the whole of the period that both were in existence during the year the dividend is paid; or, alternatively,
– to the extent that the dividend is franked.</td><td>Not applicable.</td></tr>
<tr><td colspan="2">Does the company in liquidation make a capital gain or loss?</td></tr>
<tr><td>The existing tax law treats the in-kind distribution as a disposal of assets at market value.
The company in liquidation is generally precluded from making a capital loss as the law treats the transfer of loss assets within a wholly owned group as being subject to rollover.
▪ There can be an exception. The company being wound up can make a capital loss where it will be liquidated before the end of its current income year and:
– its parent is the ultimate holding company for the group; or
– its parent will be sold out of the group before the end of the income year of the company being wound up.
The company would make capital gains on gain assets unless the group elects to take rollovers.</td><td>The company can make neither a capital gain nor a capital loss. All intra-group transactions are disregarded for taxation.</td></tr>
<tr><td colspan="2">Does the parent company make a capital gain or loss?</td></tr>
<tr><td>The amounts of any interim distributions by a liquidator, to the extent they are not dividends, are deducted from the parent company's cost base for its shares. There will be a capital gain to the extent, if any, the amount of a distribution exceeds the remaining cost base for shares.
The final distribution could result in a capital gain or loss. Any capital gain is reduced by the amount of:
▪ any part of the final distribution that is a dividend; and
▪ where the in-kind distribution was subject to rollover, any overall capital gain that would have been realised by the company in liquidation on the disposal of its assets if the rollover had not applied.</td><td>The parent company can make neither a capital gain nor a capital loss. All intra-group transactions are disregarded for taxation.</td></tr>
<tr><td colspan="2">What if there is more involved than an in-kind distribution to a single parent company?</td></tr>
<tr><td>Liquidations will be more complex, under the existing law, where:
▪ shares in the company being liquidated are owned by more than one group company; or
▪ the group wants to distribute the assets of the company being wound up other than to parent companies according to their shareholdings.</td><td>As there are still only intra-group transactions, these are disregarded for taxation.</td></tr>
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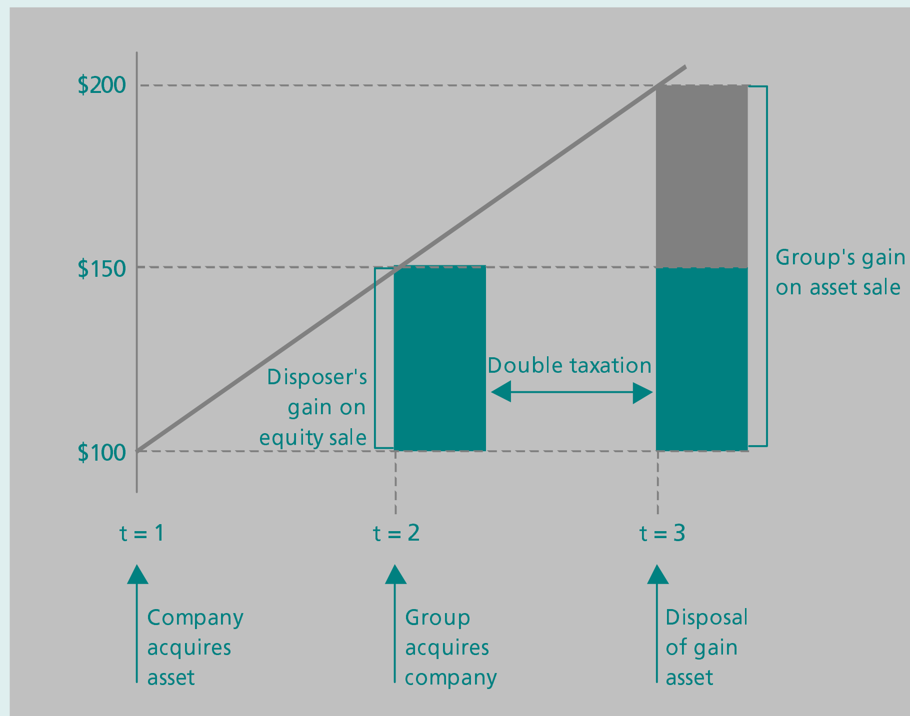
Example A.1: Double taxation of a capital gain



In the first period (t=1) a company purchases its single income-producing asset for $100. The asset appreciates in value over time and its market value is represented by the continuous upward sloping line between $100 and $200. The company subsequently (t=2) is acquired by a company group for the market price of $150 (for the company and its single asset). The capital gain at this point is $50 to the original owner, representing the difference between the purchase price of the asset and its market value at the time it is sold to the company group. But even though the equity in the company is sold for $150, the cost base of the single asset remains at $100.

The company group then sells the asset for $200 (t=3). The capital gain on the asset is assessed as $100 ($200 minus $100 — the original acquisition cost of the asset) for the company group even though half of the capital gain ($50) has already been assessed (at t=2). The identically shaded blocks in the above figure illustrate the possibility of double taxation.

If $100 is distributed to individual shareholders who capitalised the group by $150, those shareholders could sell their shares and obtain a $50 capital loss to offset the double tax. Nevertheless, the double tax is not unwound unless and until the shareholders sell their shares.

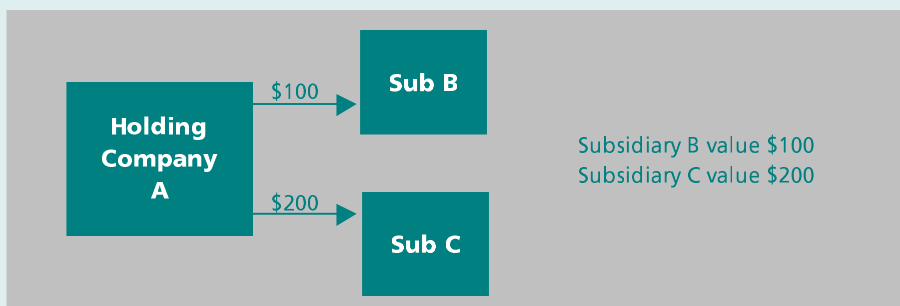
Value shifting

A.4 Example A.2 illustrates how some taxpayers have in the past generated artificial tax benefits by transferring assets around their company group at values other than commercial value.

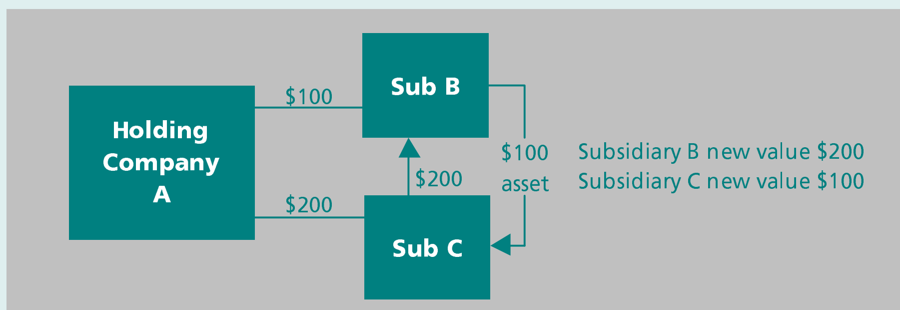
A.5 Anti-avoidance provisions should not be relied upon to address such structural flaws in the capital gains tax arrangements — this time relating to both the dual (asset/equity) cost bases and the treatment of non-arm's length transfers.

Example A.2: Value shifting between group companies

Holding company A subscribes for shares in subsidiary B for $100 and in subsidiary C for $200.



Subsidiary B buys an asset for $100 and immediately transfers this asset to subsidiary C for $200, that is, at 'over-value'. The transfer is tax free because of the grouping (rollover) provisions.



Subsidiary C is then sold for $100, leading to a capital loss. Even though subsidiary B now has a $100 unrealised capital gain, the capital loss provides a timing advantage.