Chapter 26

A FRAMEWORK FOR CONSOLIDATION

Policy objective 545

Developing the design principles announced in *A New Tax System* 545

Framework design principles 545

Principle 1: Consolidation to be optional, but if a group decides to consolidate, all its wholly owned Australian resident group entities must consolidate 545

Principle 2: Consolidated groups to be treated as a single entity 552

Principle 3: Current grouping provisions to be repealed 557

Principle 4: Individual entity losses and franking account balances able to be brought into the consolidated group 558

Principle 5: Carry-forward losses and franking balances to remain with the consolidated group on an entity's exit 564

Principle 6: Provisions to be established for determining the cost bases on exit567

Policy objective

Developing the design principles announced in *A New Tax System*

26.1 In *A New Tax System* the Government proposed a regime for taxing groups as a single entity. The single entity or consolidated taxation regime would cover Australian resident companies, co-operatives and fixed trusts. Consolidated taxation of discretionary trusts would encompass groups of family trusts (and companies).

26.2 *A New Tax System* also outlined six design principles for a consolidated taxation regime. The Review considers these principles are a sound basis for developing options and invites submissions and discussion. This chapter discusses workable arrangements based on five of the principles. The sixth — dealing with provisions to determine cost bases on exit from consolidation — is covered in the next chapter.

Framework design principles

Principle 1: Consolidation to be optional, but if a group decides to consolidate, all its wholly owned Australian resident group entities must consolidate

26.3 A wholly owned group of entities should be able to choose either to be taxed as a single consolidated entity or to continue to be taxed as separate entities. Those groups choosing to enter the consolidation regime would be required to have a resident holding entity at the head of the group in order to give practical meaning to the concept of a single Australian taxpayer.

What constitutes a consolidated group?

26.4 Robust arrangements require all of a holding entity's Australian resident wholly owned companies and trusts, including entities acquired in the future, to be included in the consolidated group. This is referred to as the 'all in' principle.

26.5 The consolidation regime could be exploited if groups were allowed to consolidate some of their wholly owned entities while leaving others to be taxed separately. Such a selective and partial approach to consolidation would continue to allow unintended taxation benefits to be obtained from intra-group

transactions. Other reform measures contained in this discussion paper — such as those relating to loss duplication, value shifting and full franking — would improve the general integrity of the system and thereby lessen the need for an 'all in' principle. However, should these proposals not proceed, the 'all in' principle would be needed to ensure integrity. Specifically the 'all in' principle seeks to:

- prevent exploitation of intra-group transactions to defer tax;
  - for example, transactions between the consolidated part of a group and the unconsolidated parts could involve later recognition of income or earlier recognition of expenses thus giving rise to tax deferral benefits for the group as a whole;
- prevent loss duplication and value shifting; and
- overcome the re-characterisation of interest expenses in order to claim a deduction against tax-exempt income.

26.6 There may be situations where the requirement that an entity be wholly owned in order to be included in a consolidated group cannot be satisfied because some of its share capital is owned by its employees. In other situations, regulations may restrict ownership to a level below 100 per cent. The Review will need to determine whether there are grounds for departing from the wholly owned requirement for factors such as employee share ownership or regulation.

On what basis should discretionary and hybrid trusts be included in a consolidated group?

26.7 Principle 1 may not be appropriate in all cases for determining whether a particular discretionary or hybrid trust should be part of a consolidated group. With a discretionary trust, the objects of the discretion do not have a beneficial interest in the income or capital of the trust until the trustee exercises the discretion in their favour. With a hybrid trust, some of the beneficiaries will have fixed interests in the income or capital of the trust but others are merely discretionary objects in respect of the income or capital.

If the group 'owns' the trust

26.8 Where the only objects of a discretionary trust are members of a consolidated group (for example, a group of companies), it would seem appropriate that the trust be included in that consolidated group on the basis that the group 'owns' the trust.

26.9 Similarly, where all of the fixed and discretionary objects of a hybrid trust are members of a consolidated group, that trust could be included in the consolidated group.

26.10 In the absence of such clear 'ownership', a further test would seem to be required to determine whether a discretionary or hybrid trust should be included in a consolidated group.

If a member of the group is an object of the trust

26.11 One approach could be to include a discretionary trust in a consolidated group if a member of the group is an object of that trust. For example, if a wholly owned company of a consolidated group were an object of a discretionary trust, that discretionary trust would be included in the group.

26.12 However, the discretionary trust would not be included in the consolidated group if it could be shown that the control of the discretionary trust and the consolidated group was exercised by different taxpayers. Broadly, control could be determined having regard to entities, individuals and associates of entities and individuals, either acting alone or together.

26.13 Similarly, a hybrid trust could be included in a consolidated group if all the fixed interests in the trust were held by group entities and at least one group entity was a discretionary object of the trust. Again, the trust would not be included in the consolidated group if it can be shown that the control of the trust and the consolidated group is exercised by different taxpayers.

The need for 'tiebreaker rules'

26.14 Where a discretionary trust could be included in more than one group, 'tiebreaker rules' would be required. For example, a rule could be devised such that a trust would be included in the group which has received the greater share of distributions from that trust over a defined period (for example, a period of up to six years is used in the existing trust loss measures). Alternatively, an election could be allowed to be made.

Treatment of distributions by certain trusts

26.15 A consolidated group may want a discretionary or hybrid trust as its head entity. A discretionary or hybrid trust could only be the head entity where the fixed interests held by that trust in the entities in the group represent 100 per cent direct or indirect ownership.

26.16 Where a discretionary or hybrid trust is part of a consolidated group but is not the head entity of the group, the potential exists for the trustee of the trust to make distributions to discretionary objects outside the group. This would potentially allow the benefits derived by the consolidated group to be distributed outside of the ultimate owners of the group.

26.17 One option for dealing with this situation would be to make all distributions outside of the consolidated group by a trust other than a head trust subject to a final penalty tax regime. The regime could be based on the family trust distributions tax in the existing trust loss measures. The trust loss measures impose tax on certain distributions at the top marginal rate applying to individuals plus Medicare levy. The distributions subject to this tax are then exempt from tax in the hands of the recipient of the distribution.

Application of the goodwill exemption where the consolidated group includes a trust

26.18 *A New Tax System* proposes that the current tax status of certain distributions made by discretionary and fixed trusts would be maintained under entity taxation. One of those circumstances is where distributions are made out of profits exempted from tax by the 50 per cent goodwill exemption. Consolidated groups of trusts would attract this special treatment, but consolidated groups of companies would not.

26.19 This special treatment for trusts over companies could necessitate the introduction of rules for consolidated groups comprising both trusts and companies. For example, if the head entity of a consolidated group was a discretionary or fixed trust and a company within the group disposed of goodwill (acquired pre-consolidation), the goodwill exemption may apply. The tax-preferred income arising from the disposal would potentially be able to be distributed from the group tax free. This would be inappropriate because the company would not have been able to distribute the tax-preferred amount tax free to its ultimate owners had it disposed of the goodwill prior to entering the consolidated group.

26.20 An option for resolving this issue could be to quarantine pre-consolidation goodwill assets owned by companies entering a consolidated group in certain circumstances. This could be achieved by 'tagging' those assets. On the subsequent disposal of these assets by the group, distributions of the tax-preferred amount would not attract special treatment.

26.21 Rules would also be needed to ensure that where a goodwill asset brought into a consolidated group by a discretionary trust or fixed trust is disposed of, and the head entity of the group is a company, the tax-preferred income arising from the disposal would attract the special treatment.

How should family trusts and companies be consolidated?

26.22 The general consolidation regime outlined allows groups of companies and trusts to choose to consolidate their taxation position, where certain conditions are satisfied. It follows that groups of trusts and companies

'owned' by members of the one family could also choose to consolidate their taxation position under the regime, so long as the general requirements of the regime are met. This would be one option for including groups of family trusts and companies in the consolidation regime.

26.23 A second option could be to design a special optional consolidation regime for family groups, drawing on certain features of the existing trust loss measures. The key differences with this option are the availability of transitional rollovers and the greater flexibility with trust distributions. The option is outlined below.

Defining the group

26.24 When including groups of family trusts and companies in a special consolidation regime, the general consolidation principles would be adhered to. Further, a requirement that there be an ultimate head entity of the group, as in the case of company groups, would be important to ensure that provisions dealing with loss duplication and value shifting were not required to operate within the consolidated group.

26.25 The entities which could be included in a family group which chooses to consolidate could be determined by reference to a particular individual and the family members of that individual. The individual and family members could make an irrevocable election for the group to consolidate. Each family member would be able to elect whether or not to consolidate their taxation affairs in the group.

26.26 The family members who could be included in the election could be based on the existing trust loss measures. For example, family members could include defined relatives of either the individual or the individual's spouse. Defined relatives could include, among others, a child, parent, brother or sister. In addition, registered charities could be included in the election.

26.27 The consolidated family group would then include all companies and fixed trusts wholly owned by the family members who elected to consolidate (and the entities that those entities wholly own).

26.28 The group could also include discretionary and hybrid trusts on a similar basis to that outlined above. In this case, where the only objects of a discretionary trust were members of the consolidated group and/or family members who elected to consolidate, the trust would be included in the consolidated group. Similarly, where all of the fixed and discretionary objects of a hybrid trust were members of the consolidated group and/or family members who elected to consolidate, the trust would be included in the consolidated group.

26.29 In other cases, a discretionary trust could be included in a consolidated group if a member of the group was an object of that trust. Similarly, a hybrid trust would be included in a consolidated group if all the fixed interests in the trust were held by group entities and at least one group entity is a discretionary object of the trust. However, a trust would not be included in a consolidated group if it could be shown that the control of the trust and the consolidated group was exercised by different taxpayers.

26.30 Only one entity could be the head entity for the group. The selection of the head entity of the group would determine the ultimate structure of the group. This is because once an entity was selected as the head entity, all fixed interests in other entities included in the group would need to be wholly owned directly or indirectly by that head entity. For example, where a discretionary trust was chosen to be the head entity of the group, the shares in companies previously wholly owned by family members who elected to consolidate (and thus included in the consolidated group) would have to be transferred to the head entity or an entity wholly owned by the head entity.

Facilitating restructure through rollover

26.31 In many cases, family trusts and companies that are to be consolidated would already have a head entity that would own, directly or indirectly, all of the interests in the trusts and companies. The family members would be beneficiaries or shareholders of that head entity.

26.32 As a transitional measure for groups of entities which are not in this position, limited rollover relief could be considered for restructuring necessary to set up a head entity that would hold the interests in the entities to be grouped. For example, rollover relief could be considered for existing family groups (as defined in the existing trust loss measures) which consolidate within, say, two years of the consolidation regime being introduced.

26.33 Under existing State and Territory taxation legislation, stamp duty may be imposed on transactions undertaken by a family group in arranging a head entity that would hold the interests in the entities to be grouped. The proposal to remove stamp duties levied by States and Territories on marketable securities from 1 July 2001, as part of the reform of Commonwealth-State financial relations, should reduce the impact of this.

26.34 It would be open to State and Territory Governments to provide stamp duty rollover relief or other transitional measures to assist family groups to consolidate.

Making distributions from the group

26.35 Under family group consolidation, where a discretionary or hybrid trust is a member of a consolidated group, the trust could make distributions

directly to family members who elected to consolidate, rather than indirectly through the head entity. The trust should not be able to distribute to anyone else because this would potentially allow the benefits derived by the consolidated group to be distributed outside of the family members who elected to consolidate.

26.36 Again, one option for dealing with this situation would be to apply a final penalty tax regime to all distributions made by a trust to an object other than a family member who elected to consolidate. As discussed above, the regime could be based on the family trust distributions tax in the existing trust loss measures.

Transitional issues

26.37 As outlined in *A New Tax System* and in Principle 3 below, a consequence of the introduction of a consolidation regime will be the repealing of existing grouping concessions. For the existing trust loss measures, this would mean that the family group concessions in relation to the income injection test and the deducting of certain losses and debt deductions would be removed.

Can groups or entities switch in and out of consolidation?

26.38 Once a group elects to consolidate it would not be able to revoke its election subsequently. Moreover, if a consolidated group is purchased by an entity that is part of a group which is not consolidated, deconsolidation would be triggered.

What is the accounting treatment for consolidated groups?

26.39 For financial reporting purposes a company is required to consolidate an entity if it has the capacity to determine the outcome of decisions about the entity's financial and operating policies. A company may therefore be required to consolidate for financial reporting purposes non-resident subsidiaries or entities that it controls without their being wholly owned. Accordingly, corporate groups that include non-resident or partially owned entities will be required to maintain some separate records for financial reporting and taxation purposes. However, the availability of taxation consolidation should nevertheless reduce financial reporting and taxation compliance costs.

Principle 2: Consolidated groups to be treated as a single entity

What are the benefits of treating groups as a single entity?

Administration would be simplified

26.40 The consolidated group would:

- lodge a single income tax return and consolidated income tax instalments;
- be jointly and severally liable to pay tax;
- keep consolidated accounts for certain tax purposes (a single franking account; a single 'account' for each of carry-forward revenue and capital losses; and single accounts for particular classes of foreign transactions — for example, foreign losses and foreign tax credits — and for tax exempt income); and
- have a common tax accounting period for all its member entities.

All intra-group transactions would be ignored

26.41 Under the consolidation regime, all transactions between members of a consolidated group would be ignored for income tax purposes. For example, payment of management or any other fees and interest between group members would not be deductible or assessable for income tax purposes. Similarly, intra-group dividends would not be assessable or subject to the 'franking' regime.

26.42 However, to the extent that quarantining provisions currently apply, for example, quarantining of foreign losses, those provisions would also apply to the consolidated group.

What tax attributes would apply on entry to and exit from the consolidated group?

26.43 Members of a consolidated group would lose their separate tax identity on entry to the consolidation regime and subsequently acquire a new tax identity when they exit. Non-preservation of tax identity could pose problems especially in relation to recognising taxable income and ascertaining deductions.

26.44 Among the problems that could be encountered when an entity enters and exits a consolidated group, are:

- a loss of entitlement to claim tax deductions
  - when, say, trade debtors are acquired prior to an entity entering a consolidated group but after entry the group seeks to write-off the debt owed to it and claim a tax deduction; and
- excessive tax applied to a profit stream because franking account credits would not accompany an entity's exit from a consolidated group.
  - For example, company tax could be paid by the group on profits earned and retained by a member company but, when this company was sold, distributions of the after tax profits would not carry franking credits because these would remain with the group. The distributions of these profits would be subject to tax as 'unfranked' dividends. (Description of an exiting entity's tax attributes is covered in Principle 5.)

How would the characterisation of transactions be affected?

26.45 Under the current tax law, the tax treatment of particular transactions can depend on the character of the transaction in the hands of the taxpayer undertaking that transaction. For example, within a group of companies gains on the sale of assets by some companies may be treated as capital gains, while in other companies the gains are treated as 'recurrent' revenue gains. Alternatively, gains may be treated as capital gains if each company is considered separately, but would be 'recurrent' revenue gains if the companies were considered as part of a wider group.

26.46 A generalised unified treatment for investment assets is discussed in the Overview. That approach would remove the current problems with characterisation. However, if this generalised treatment were not adopted, issues may arise for consolidated groups because the character of a transaction should be determined according to the character of the transaction in the hands of the group rather than the individual entity.

What are the implications for international taxation?

26.47 As the consolidation regime would apply to wholly owned Australian resident entities, Australian resident companies or trusts owned by a foreign entity but without an Australian resident holding entity would not be able to participate in the consolidation regime. Foreign owned Australian resident companies or trusts with an Australian resident holding entity would, however, be able to participate in the consolidation regime.

Impact on Australian subsidiaries of a non-resident company

26.48 Repeal of current grouping provisions upon introduction of consolidation would:

- remove the ability of Australian subsidiaries of a non-resident company to transfer losses among themselves; and
- remove the capital gains tax rollover relief on transfers of assets between Australian subsidiaries of a non-resident company.

26.49 Both these outcomes also apply to subsidiaries of a resident group that choose not to consolidate.

26.50 Capital gains tax rollover relief could continue to be available if these subsidiary companies restructured to introduce a resident holding entity so that they could form a consolidated group. Since restructuring could be an option for some non-resident entities, transitional arrangements, such as capital gains tax rollovers, to facilitate the establishment of a resident holding entity could be considered.

26.51 In general, however, rollover relief for non-resident group companies for asset transfers with a close connection to Australia (including land or buildings in Australia) would cease following the repeal of current grouping provisions. This raises a general policy question as to whether capital gains tax rollover relief should in fact be available for asset transfers between Australian subsidiaries of a non-resident group.

26.52 Additionally, rollover relief currently available for asset transfers when determining the attributable income of an Australian controlled foreign company (CFC) would cease to be available with the introduction of the consolidation regime and repeal of the current grouping provisions. The desirability of continuing to provide such relief requires consideration.

- The existing CFC measures claw back tax deferral benefits by taxing residents on their share of certain profits accumulated by a CFC that would be taxable if the entity were a resident of Australia.
- The case for continued rollover relief is that without it Australian based multinationals would be less able to adapt their offshore structures in response to changing business conditions offshore. There could also be less scope for these multinationals to rationalise their corporate structure and asset holdings on acquiring another company group.

Impact of consolidation on controlled foreign company type rules of other countries

26.53 CFC rules of other countries seek to tax resident shareholders on their share of certain income derived in Australia by a CFC. Unless such income is regarded by the foreign tax authority as being comparably taxed in Australia, the CFC rules of that country could impose an additional tax burden on income derived in Australia by the CFC.

26.54 Two potential problems could arise under the CFC type rules of other countries under the proposed Australian consolidation regime.

26.55 First, the Australian consolidation regime, as outlined, would disregard for Australian taxation purposes income earned by a subsidiary — that is designated by another country as a CFC — from another company within the consolidated group. The CFC rules of another country could seek to tax part of the CFC-designated subsidiary's income even though the CFC does not directly pay Australian tax on this income.

26.56 Second, since the Australian consolidation regime would make a consolidated group's holding entity liable for tax, the group's member entities may be regarded by the CFC rules of another country as escaping Australian tax. Were this to occur, the CFC's non-resident shareholders could become liable for additional tax in the foreign jurisdiction.

26.57 In these cases it is also questionable whether a credit would be allowed under another country's CFC rules for tax paid by the Australian resident holding company on profits referable to activities of a CFC-designated subsidiary. Even if a credit were allowed, it could be difficult in practice to ascertain the tax paid by the holding company on behalf of the subsidiary. Problems could therefore arise in determining the amount of a credit that can be claimed.

26.58 How should these problems be addressed? Could other countries be relied on to ensure their CFC type rules do not operate harshly when applied to entities subject to the Australian consolidation regime? In cases where the CFC type regimes of other countries were incompatible, would it be necessary for affected company groups to remain outside the consolidation regime? What would be the consequences for investment in Australia by such company groups?

Treatment of 'attribution account' surpluses where a company ceases to be a member of a consolidated group

26.59 In general, under the suggested principles, tax attributes (such as, losses) will remain with a consolidated group when a company ceases to be a member of the group even though the tax attributes relate directly to the

activities of the exiting company. There may, however, be a case for departing from this principle for attribution accounts maintained for the purposes of Australia's CFC and foreign investment fund (FIF) measures.

26.60 Attribution accounts record amounts which are subject to current year taxation under the CFC and FIF measures and are used to ensure the amounts are not taxed again on distribution. A surplus in these accounts shows the amount of profits on which the Australian shareholders have previously paid Australian tax on a current year basis — that amount can be distributed without any further Australian tax.

26.61 A departure from the general principle may be required for attribution accounts because a surplus can only benefit an entity that holds an interest in the CFC or FIF. Accordingly, a consolidated group would not be able to benefit from an attribution account surplus if the exiting company has the interest in the CFC or FIF. To ensure the benefit is not lost, it may be necessary to provide that the attribution account surplus remains with the entity that holds the interest in the FIF or CFC that gave rise to the surplus.

What are the implications for the capital gains tax regime?

Majority underlying ownership rules

26.62 Currently, if there is a substantial change in the majority underlying ownership of an entity, all of the assets of the entity acquired before 20 September 1985 (pre-CGT assets) cease to be exempt from the time of change.

26.63 Consistent with the principle that consolidated groups would be treated as single entities, the existing rules would apply to a consolidated group so that any pre-CGT assets held in the group would lose their exempt status if there were a substantial change in the majority underlying ownership of the group.

Pre-CGT equity: underlying asset rules

26.64 Although normally exempt, a capital gain could currently arise on the disposal of pre-CGT shares in a non-listed company equal to the capital gain on post-CGT property of the company. This would occur if the value of the company's post-CGT property forms at least 75 per cent of the net worth of the company. The rules apply also to disposals of interest in trust estates.

26.65 These effects would be reflected in the arrangements for consolidated groups. Thus, where pre-CGT shares in the holding company of a non-listed company group are disposed of, the value of property of the

whole group would be taken into account in working out whether a capital gain liability would arise on the disposal of those shares.

Goodwill exemption

26.66 Currently 50 per cent of the capital gain made by a small business on the disposal of goodwill is exempt from capital gains tax. The exemption only applies where the sum of the net values of the relevant business and related businesses is less than an exemption threshold.

26.67 Consistent with the principle that consolidated groups would be treated as single entities, where an entity in a consolidated group disposes of a goodwill asset, the group would be treated as the relevant business disposing of the asset so that the net value of the whole group would be taken into account in working out whether the exemption threshold was satisfied.

Principle 3: Current grouping provisions to be repealed

Why repeal the current grouping provisions?

26.68 Once the consolidation regime commences the current grouping provisions would be repealed, excepting non-concessional elements. (The non-concessional elements mainly relate to the current rules that effectively require a rollover when a loss asset is transferred from one member of a wholly owned group to another — see Chapter 28.) This measure, combined with full franking or inter-entity taxation under one of three options canvassed in Chapter 15, is essential for maintaining integrity outside the consolidation regime.

26.69 The availability of a consolidated taxation regime removes the need to retain the current grouping provisions. The problems with the grouping provisions – high compliance costs and integrity issues — are discussed in Chapter 25.

26.70 In particular, the current tax treatment is unsound whereby, on the one hand, each group entity is treated as a separate taxpayer and, on the other, grouping provisions operate to break down that separation in a partial fashion. Income generated from dealings between group entities is not true income (in the same way that self dealing by an individual does not give rise to income) and should not be subject to taxation. This idea is consistent with the consolidation principle of ignoring all intra-group transactions for tax purposes.

How would non-electing groups be taxed?

26.71 Members of non-electing groups would be taxed as separate taxpayers. In effect by choosing to be treated as separate taxpayers their intra-group transactions would give rise to tax events but without the tax benefit provided by grouping provisions (which would be repealed) or the section 46 inter-corporate dividend rebate in relation to unfranked dividends (which may be replaced by one of three options in Chapter 15).

Principle 4: Individual entity losses and franking account balances able to be brought into the consolidated group

How would entities bring in carry-forward losses on entry into a consolidated group?

26.72 Many companies and trusts would be carrying forward tax losses ('revenue' and 'net capital' losses) at the time of entry into a consolidated group — or at the commencement of the consolidation regime. Under the fourth consolidation principle, a company or trust entering a consolidated group would be able to bring such carry-forward losses into a consolidated group consistent with the principles underlying the existing law. Within a consolidated group, losses would be pooled. This means that losses would be available for compulsory unrestricted transfer within the consolidated group.

26.73 Under the existing law a company can claim a prior year *carry-forward* revenue or net capital loss if it satisfies:

- the continuity of ownership test — the same persons owned shares in the company, that carry more than 50 per cent of all voting, dividend and capital rights, in both the loss year (the year the loss is incurred) and the claim year (the year the loss is being written off against income or gains); or
- the same business test.

26.74 Trusts can claim prior year revenue or net capital losses if the trust satisfies an ownership or control test. Discretionary trusts have also to satisfy a pattern of distributions test.

26.75 A company ('transferor') may also *transfer* a revenue or capital loss to another company ('transferee') in the same wholly owned group if certain requirements are met. Trusts are not able to transfer losses under the existing law.

26.76 Two issues require consideration in the application of the existing rules to a consolidated group. These are:

- interaction of the loss transfer and carry-forward loss rules; and
- suitability of the same business test.

Interaction of the loss transfer and carry-forward loss rules

26.77 The existing carry-forward and loss transfer rules do not blend well with a consolidated group tax regime.

26.78 The existing carry-forward loss rules rely on the losses being identified with a particular entity. Under consolidation entities would lose their individual tax identities on consolidation. Therefore, for tax purposes, income or losses would not be identified with any particular entity within a group.

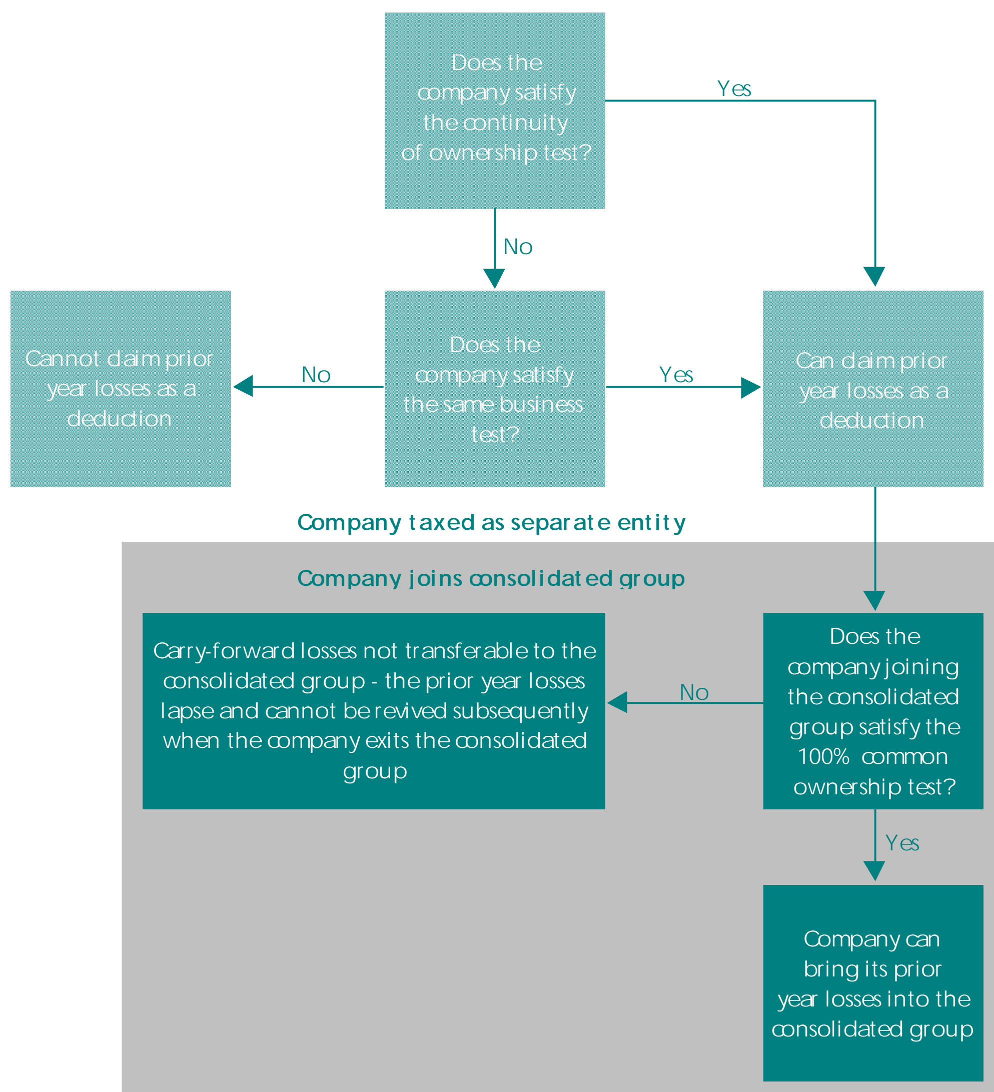
26.79 Even if a particular entity joining a consolidated group were able to satisfy the continuity of ownership test (say, because of the group's longstanding majority ownership of the entity), the entity would be most likely unable to transfer the losses to the consolidated group because of the effect of the loss transfer rules.

26.80 The existing company loss transfer rules would allow a company to transfer its carry-forward losses into the consolidated group only if it was a member of the same wholly-owned group as the holding company from the time the loss was incurred until the time of entry into the consolidated group. As noted, the existing trust loss rules do not allow any transfer of the loss.

26.81 Figure 26.1 illustrates the effect of the existing company loss transfer rules on entry into a consolidated group by an entity with carry-forward losses.

26.82 If the existing rules continued to apply, entities with losses not able to be transferred to the group may be forced to postpone entry into consolidation until those losses are utilised by the entities. For example, a consolidated group, may wish to acquire a 100 per cent interest in an entity, which has carry-forward losses, but the group's inability to claim those losses may force the group to initially acquire a lesser percentage. As a matter of policy, a group's acquisition decisions should not be unduly influenced by tax considerations in relation to carry-forward losses. This is one reason why options need to be developed to enable entities to bring carry-forward losses into a consolidated group.

Figure 26.1: Application of existing tax provisions to a company with prior year carry-forward losses which enters a consolidated group



Suitability of the Same Business Test (SBT) in a consolidation regime

26.83 Setting aside the constraints imposed by the loss transfer rules, it would still be difficult for a consolidated group to satisfy the SBT when an entity carried a loss into the group. Currently, the SBT is failed if the entity, once in an acquiring group, derives assessable income from the following:

- a business of a kind that it did not previously carry on; or
- a transaction of a kind that it had not previously entered into in the course of its operations.

26.84 Due to the treatment of a consolidated group as a single entity, these tests would be applied to the group as a whole rather than simply to the individual entity. Generally, the tests are more easily satisfied by individual

entities because their business and transactions are relatively stable over a period of time. However, entity groups tend to be more diversified in nature with a greater likelihood of undertaking new businesses or transactions that could cause them to fail the test.

26.85 It may seem that some general relaxation of the SBT could be considered — such as, replacing the SBT by a 'similar business test'. This would, however, go well beyond the policy rationale for the SBT. The general principle concerning losses is that a loss can only be claimed by the taxpayer who owned the entity at the time the loss was incurred (hence, the continuity of ownership test). The limited exception to that rule is the SBT which was intended to allow for mergers and the rebuilding of loss companies but only where the same business is carried on by the entity. A 'similar business test' could extend the current limited exception to most acquisitions of loss entities outside consolidated groups. If that were the result, it would have major revenue implications. And with consolidated groups the overriding constraint imposed by the loss transfer rules would remain. (Figure 26.1 also illustrates that constraint with the SBT.)

What are the options for enabling entities to bring carry-forward losses into a consolidated group?

26.86 Some options for enabling entities to bring carry-forward losses into a consolidated group are discussed below. The choice of option will also depend on the approach adopted to address loss duplication (Chapter 28). One option under the loss duplication measures is for the removal of the SBT.

26.87 An option not discussed below is to allow all carry-forward losses to be brought into a consolidated group. This is likely to have an unacceptable revenue impact because of the large store of past losses in entities (on a reported basis only, approximately $44.6 billion revenue losses and $21.7 billion capital losses). It would provide an opportunity for entities to revive currently trapped losses; for example, losses being carried forward which currently cannot be claimed due to the cessation of income earning activities in the loss company.

26.88 Revenue considerations also need to be recognised when considering the options.

26.89 Table 26.1 provides a comparison of the options, including the advantages and disadvantages of each.

Option1: Do not allow losses into a consolidated group, apart from two limited cases

26.90 Consistent with the current loss transfer rules (apart from the limited exceptions discussed below), only losses incurred while in a wholly owned group could be allowed to be transferred (in the case of a consolidated

group that must be while in consolidation). This would be the ongoing rule. As a result, SBT losses and less than 100 per cent continuity of ownership losses (including trust losses which satisfy the ownership or control tests) would be lost on entry into a consolidated group.

26.91 The two exceptions could be transitional rules (that is, applying to groups consolidated at the start of the new regime), namely:

- losses which would have been transferable prior to the commencement of consolidation may be brought into the consolidated group; and
- if a group has a wholly owned entity (say, at date of announcement) with carry-forward losses which cannot be transferred because they arose prior to 100 per cent ownership, those losses can be brought into a consolidated group. This measure would be necessary to safeguard pre-commencement groups which contain entities that are currently entitled to claim carry-forward losses but would be automatically denied those losses on entry into the group.

Option 2: Allow carry-forward losses to be brought into a consolidated group subject to a modified SBT

26.92 The constraints imposed by the existing loss transfer rules could be removed, thereby allowing carry-forward losses incurred by a loss entity to be transferred to a consolidated group on entry.

26.93 Under this option, carry-forward losses could be transferred to a consolidated group, provided that the group satisfies the continuity of ownership test (including the trust ownership or control test where the entity is a trust) up to the point of consolidation — by, say, having majority ownership of the entity in the loss year and the year of transfer into consolidation.

26.94 Where this continuity of ownership test is not satisfied, one approach could be that the transferred loss could still be claimed if the group satisfies a modified SBT. A loss sought to be transferred would be allowed if the loss entity satisfies the SBT in the year the loss is incurred and a specified period immediately before entry into consolidation.

26.95 The modified test could be to allow a transferred SBT loss to be claimed over, say, a 10 year period beginning the year of income in which the loss was transferred. Each year one-tenth of the loss could be added to the group's pool of losses, so that an SBT loss available to the group in respect of a year of income but not able to be claimed by the group may be claimed in a later period. This cap on the usage of SBT losses is needed to limit the revenue cost. Even with the cap this option is more generous than the current law which does not allow the transfer of SBT losses. However, it may be less

generous where the loss entity could have recovered the loss over a shorter period.

Option 3: To reduce revenue costs, add a further test to Option 2

26.96 Reviving previously 'trapped' losses (for example, carry-forward losses which currently cannot be claimed due to the cessation of income earning activities in the loss company) explains the high revenue cost likely from Option 2. Adding a further test for allowing losses to be brought into a consolidated group could significantly reduce the revenue cost. The further test could be that even if the continuity of ownership test or modified SBT is satisfied, a loss could only be brought into the consolidated group if the entity would have (or would have been likely to have) been able to use the loss within a certain period (say one year) had the entity remained outside the group. There may be some cases where the further test could never be met, such as:

- the entity had ceased business prior to becoming wholly owned;
- the entity's gross assessable income for the previous few years was less than a certain percentage of the loss;
- the entity was not actively producing income; or
- the loss is a certain number of years old.

Option 4: Allow a specific proportion of the loss to be brought into the consolidated group

26.97 A continuity of ownership loss could be transferred to a consolidated group to the extent of the proportion of the group's interest in the loss entity when the loss was incurred. Any remaining amount of loss would be denied because the loss entity would lose its identity on consolidation. No SBT losses would be allowed to be brought in or, alternatively, a similar proportionate approach could apply to SBT losses. This option reflects the idea that a portion of the carry-forward loss 'belongs' to the group.

Option 5: Quarantine carry-forward losses within a group

26.98 Another option is to quarantine any carry-forward losses in the loss entity for offset against future income of the loss entity where the consolidated group is not able to satisfy the existing loss transfer rules. If the loss was an SBT loss, the loss entity would need to continue to satisfy the SBT in the claim year. This option requires the re-establishment of the identity of the loss entity inside the consolidated group. There could be a time limit on the recoupment of the loss, say seven years.

Option 6: Leave entities outside the group

26.99 It may be possible to allow groups to leave wholly owned loss entities outside a consolidated group until the carry-forward losses were

recouped. There could also be a time limit on the recoupment of the losses. The loss entity would then be immediately consolidated once the pre-wholly owned losses were recouped or the time limit lapsed.

Acquisition of 'gain entities' by loss groups

26.100 It may be possible for a consolidated group to bring an entity with unrealised gains into the group so as to absorb losses in the group. This is possible as all group losses would be pooled and available for offset against any income or gains in the group. Of particular concern would be the ability of entities to access dormant groups with trapped losses. The current loss transfer rules would prevent this as both the transferor and transferee must be wholly owned at all times between the loss year and the claim year.

26.101 This case can be compared to a single entity with a loss which has income or capital gains injected into the entity to absorb the loss. Under the existing law, some injections of income could result in the denial of the loss. It may be necessary to consider application of a similar income injection test to a consolidated group (see Chapter 24).

What franking credits and foreign tax credits could entities bring into a consolidated group?

26.102 An entity entering a consolidated group would be able to bring franking account balances and carry-forward foreign tax credits into a consolidated group. Within a consolidated group franking credits and foreign tax credits would be pooled.

Principle 5: Carry-forward losses and franking balances to remain with the consolidated group on an entity's exit

What carry-forward losses could entities take on exit from a consolidated group?

26.103 Companies or trusts exiting a consolidated group would be unable to take carry-forward losses with them. As losses are pooled within a consolidated group, it would usually not be possible to attribute losses to a particular entity within a group, including an exiting entity. The implication of this rule is that carry-forward losses would always remain with the holding entity of a group.

Table 26.1: Comparison of options for allowing losses to be brought into a consolidated group

Option	Change to loss transfer rules	Change to continuity of ownership test[(a)]	Change to SBT	Advantages	Disadvantages
1. Do not allow losses in unless currently transferable (subject to limited exceptions on transition)	No (apart from the transitional exceptions)	Yes — no carry-forward on entry into a consolidated group (apart from the transitional exceptions)	Yes — no carry-forward on entry into a consolidated group (apart from the transitional exceptions)	Limits potential revenue impact Existing entities are no worse off Prevents dealing in losses (i.e. buying loss entities solely for the losses)	Does not encourage entities to consolidate — forces 'loss entities' to stay outside a group
2. Allow carry-forward losses in subject to a modified SBT where SBT losses are written off over 10 years	Yes — allows for transfer of some carry-forward losses which are currently non-transferable	No — but the group accesses the losses that pass the continuity of ownership test in respect of the loss entity	Yes — time of applying the test is changed to loss year and period immediately before consolidation Rate of usage spread over 10 years	More generous than existing loss transfer rules	Possible major impact on revenue Scope for dealing in losses
3. Allow carry-forward losses in subject to a modified SBT and an anti-loss-trafficking measure	Yes — allows for transfer of some carry-forward losses which are currently non-transferable	Yes — unable to carry-forward if fail additional loss test	Yes — time of applying the test is changed to loss year and period immediately before consolidation Rate of usage spread over 10 years Unable to carry-forward if fail additional loss test	More generous than existing loss transfer rules Reduced impact on revenue Attempts to prevent dealing in losses	Uncertainty in applying the test as it may not be solely an objective test

Table 26.1: Comparison of options for allowing losses to be brought into a consolidated group (cont)

Option	Change to loss transfer rules	Change to continuity of ownership test[(a)]	Change to SBT	Advantages	Disadvantages
4. Allow a specific proportion of losses brought into the consolidated group	Yes — allows for transfer of some carry-forward losses which are currently non-transferable	Yes — loss carry-forward limited to proportion of ownership in loss year	Yes — no SBT available or alternatively loss carry-forward limited to proportion of ownership in loss year	Reflects group's 'ownership' of its proportion of the loss More generous than existing loss transfer rules	Portion of the current carry-forward loss would be denied Anomaly in that no proportionate denial if held at less than 100% ownership but proportionate denial on 100% ownership[(b)] Need to have record of proportion of ownership in each loss year[(c)] May be difficult to determine the proportion of the group's interest in a non-fixed trust
5. Quarantine carry-forward losses within a group	No	No	No	Maintains existing law Prevents dealing in losses	Inconsistent with objective of treating group as a single entity Erosion of some of the simplicity and compliance cost benefits due to need to determine income related to a particular entity
6. Allow wholly owned loss entities to be left outside a group	No	No	No	Maintains existing law	Jeopardises integrity benefits of 'all in' principle Other benefits of consolidation denied to the entity

(a) Includes trust ownership, control test, or pattern of distributions test.
(b) For example, the whole amount of a loss would be available as a carry-forward loss to the loss company if a group's interest in the loss company were maintained at anywhere between 51 per cent and 99 per cent. However, on achieving 100 per cent ownership the company would only be able to bring in the portion of the loss relating to the group's ownership in the loss year. Therefore, the portion of the loss not relating to the group's ownership would be wasted.
(c) This could be overcome by allowing entities a 50 per cent proportion where they could not identify the ownership percentage for a year. This could not apply to SBT losses.

What franking credits and foreign tax credits could entities take on exit from a consolidated group?

26.104 Companies and trusts exiting a consolidated group would be unable to take with them franking credits or carry-forward foreign tax credits. As the credits are pooled within a consolidated group, it would be difficult to attribute the credits to a particular entity within the group, including the exiting entity. For example, there will be only one franking account, not separate franking accounts for each entity in the group. The implication of this rule is that franking credits and carry-forward foreign tax credits must always remain with the holding entity of a group.

Principle 6: Provisions to be established for determining the cost bases on exit

26.105 When group entities are sold and thus exit a consolidated group there is a need to determine the cost base of the equity that is sold. The next chapter works through the details associated with making these cost base adjustments.