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## *Australia releases exposure draft legislation amending the tax consolidation rules, possibly retroactively*

*May 1, 2015*

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### *In brief*

The Australian government on April 28, 2015, released exposure draft legislation that reflects amendments to the Australian tax consolidation regime first announced in the 2013-2014 and 2014-2015 Federal Budgets. The proposed new rules are aimed at restoring integrity to the consolidation regime. Most significantly, the rules would remove perceived 'double benefits' or 'double detriments' when an Australian target or subsidiary joins a tax consolidated group.

While the draft legislation is still subject to change, taxpayers should consider carefully the possible impact of the changes on future acquisitions. Taxpayers also should revisit acquisitions completed since May 14, 2013, to determine whether they would have to amend calculations of taxable income for prior tax years.

Comments on the exposure draft are due by May 19, 2015.

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### *In detail*

Australia's tax consolidation regime allows wholly owned groups of Australian resident entities (including a parent and its subsidiaries) to form a consolidated group for income tax purposes. A tax consolidated group is treated as a single entity, such that intra-group transactions are ignored. The cost base of the shares in each of the subsidiaries therefore is disregarded. The value of those shares, together with the liabilities assumed, instead is allocated to the

underlying assets of those entities, thereby 'resetting' the tax cost base of the underlying assets, potentially to fair market value.

Conversely, when a subsidiary leaves a tax consolidated group, the cost base of the shares in the exiting subsidiary is recalculated to determine whether a gain or loss arises on the sale. The calculation broadly reflects the tax cost base of the underlying assets and liabilities of the entity leaving at the time of exit.

The exposure draft legislation is aimed at strengthening the consolidation rules by addressing perceived deficiencies in both the joining tax consolidation calculation and the exit tax consolidation calculations.

- **The acquired liabilities measure** is aimed at removing a double benefit (or double detriment) that can arise with regard to certain liabilities held by an entity that is acquired by a consolidated group.

- **The securitized assets measure** would remove anomalies that arise when an entity with securitized assets joins or leaves a tax consolidated group.
- **The churning measure** would prevent the tax cost base of the assets of an entity joining a consolidated group from being 'reset' when no tax is payable by a foreign resident owner on the sale of the entity to the consolidated group and the majority economic ownership of the entity has not changed.
- **The TOFA measure** would clarify the operation of the Taxation Of Financial Arrangements (TOFA) provisions when an intra-group asset or liability emerges from a consolidated group because a subsidiary leaves the group; and
- **The value-shifting measure** would remove anomalies that arise when an entity leaving a consolidated group holds an asset that corresponds to a liability owed from the old group.

Each of these measures is explained in further detail below.

#### ***The acquired liabilities measure***

In connection with the 'resetting' of the tax base of the underlying assets, the acquired liabilities measure is designed to prevent a 'double benefit' from arising when liabilities assumed give rise to future deductions ('deductible liabilities'), such as provisions for employee entitlements such as sick leave and holiday leave, because:

- The deductible liability increases the value that can be allocated to the tax cost base of the underlying assets through the 'resetting'

process, sheltering income through ordinary deductions, tax depreciation, or reduced capital gains; and

- The same deductible liability also provides a deduction to the tax consolidated group when the group pays an amount to discharge the liability in the future.

To address this concern, the draft legislation proposes that when a 'double benefit' arises due to a deductible liability, an equivalent amount should be included in assessable income of the head company over a 12-month period for current liabilities or a 48-month period for non-current liabilities, in effect neutralizing the tax benefit otherwise obtained.

A similar mechanism would apply to create deductions when a joining entity holds liabilities that will give rise to future assessable income, such as unrealized foreign exchange gains.

The acquired liabilities measure contains several exclusions, including ones for 'owned liabilities' (i.e., when the purchaser has a pre-existing interest in the target prior to acquiring 100% of the target), certain insurance company liabilities, TOFA liabilities, and retirement village liabilities amongst others.

#### ***Observations***

The acquired liabilities measure could impede transactions involving companies that carry material deductible liabilities because:

- As part of the 'resetting' of the tax base of the underlying assets, significant value often is allocated to intangibles such as goodwill that are not amortizable for Australian tax purposes. This may result in an income inclusion over 12 or 48

months, without an associated tax deduction until the business is sold.

- The purchase price for the target shares is unlikely to reflect the face value of the liability assumed but rather the discounted cash-flow impact of the liability. This could result in less value being allocated to the underlying assets through the resetting process but a larger income inclusion equal to the face value of the liability.
- Given the arbitrary nature of the 48-month period for income inclusion of non-current liabilities for tax purposes, significant adverse timing differences could arise between when the income is taxed and when the deduction is taken.

The proposed effective date for the acquired liabilities measure is May 14, 2013, so it could affect completed transactions. While Treasury has advised that the government will reconsider the effective date after the public consultation process, taxpayers should review how they treated transactions completed after the proposed effective date to determine whether any amendments to taxable income are required for prior years.

#### ***The securitized assets measure***

The securitized assets measure is aimed at removing an anomaly in the law that arises due to different tax treatment of securitized assets and related liabilities. For tax purposes, a securitized asset may not be recognized — the asset has little or no value given its transfer/equitable assignment to a special purpose vehicle — but the related accounting liability is still recognized — the liability represents the consideration received from the special purpose vehicle. This can produce anomalous

results for an entity joining a tax consolidated group as excess value can be assigned to the residual assets in the joining entity, or in certain circumstances, excess value could trigger an immediate capital loss.

An anomalous result also could arise when a subsidiary with no tax cost base leaves a tax consolidated group. Recognition of a liability could result in an understatement of the recalculated cost base in the shares of the leaving entity or could trigger an immediate capital gain.

To overcome this concern, the draft legislation proposes that an accounting liability that arises from the transfer or equitable assignment of the securitized asset is to be disregarded for purposes of ‘resetting’ the tax cost base of the assets when an entity joins a tax consolidated group. It is also required to be disregarded when recalculating the cost base of the shares in an underlying subsidiary when it leaves the tax consolidated group.

The proposed effective date for the securitized assets measure is May 13, 2014, with transitional measures to potentially apply from 2002.

#### ***The churning measure***

The Churning Measure is aimed at preventing the tax cost base of an Australian entity’s assets from being ‘reset’ when an Australian entity with a foreign parent company is transferred to a tax consolidated group in Australia and there has been no change in the majority economic ownership of the joining entity.

The broad concern was that the foreign company could dispose of its interest in the Australian subsidiary to the consolidated group without triggering an Australian tax — by virtue of Australia not taxing non-residents on Australian capital gains when the underlying assets do not consist principally of Australian

landholdings — while managing to ‘reset’ the tax cost base of the underlying assets of the Australian joining entity.

To overcome this concern, the draft legislation proposes that when such a transaction occurs and there has been no change in the majority economic ownership of the joining entity for a period of at least 12 months before the joining time, there will be no resetting of the tax cost base of the underlying assets of the joining entity.

The proposed effective date for the churning measure is May 14, 2013.

#### ***The TOFA measure***

The TOFA measure would clarify the operation of the TOFA provisions by setting a tax value for intra-group assets or liabilities for TOFA purposes when such an asset or liability arises because a subsidiary member leaves the tax consolidated group, and financial arrangements previously disregarded within the consolidated group become regarded.

The objective of the measure is to set a tax value for the TOFA assets and liabilities so that the entity that holds those financial arrangements after the subsidiary has left the group can determine gains and losses relating to the financial arrangement. This ensures, for example, that a lender is not taxed on the return of the loan principal and that a borrower cannot claim a deduction for repayment of the loan principal.

The proposed effective date for the TOFA measure is the commencement date of the TOFA regime (i.e., July 1, 2010 or July 1, 2009 for early adoption).

#### ***The value shifting measure***

The value shifting measure would remove anomalies that arise when a subsidiary member leaves a tax consolidated group holding an intra-group asset, with the corresponding

liability retained in the vendor group. The problem arises in the recalculation of the cost base of the shares of the entity leaving the consolidated group when differences arise or should arise between the value of the intra-group liability owed to the leaving entity and the corresponding market value of the asset retained by the leaving entity.

To overcome this concern, the draft legislation proposes that the value of the intra-group liability owed to the leaving entity will equal the corresponding tax cost base of the asset of the leaving entity.

The proposed effective date for the value shifting measure is May 14, 2013.

#### ***The takeaway***

The exposure draft legislation aims to improve the integrity of the tax consolidation regime, and in certain instances achieves this objective. Still, some of the proposed changes present potentially significant disincentives for transactions involving companies that carry significant deductible liabilities.

We hope Treasury will relax the proposed effective date of the acquired liabilities measure. Nonetheless, taxpayers should revisit prior acquisitions and consider the impact of the proposed changes on prior-year tax positions. Taxpayers also should consider prospective acquisitions in light of the potential impact of the proposed new rules on purchase-price negotiations and forecasts of future tax cash flows.

## ***Let's talk***

For a deeper discussion, please contact:

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