Australia’s Consolidation Regime: A Road of No Return?

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Abstract

Australia’s consolidation regime is the world’s first “asset-based” model under which multiple levels of ownership in a corporate group are collapsed into one: a bold attempt to deal with the dual cost bases issue. Compared with the consolidation regimes in other countries, the Australian regime represents the strongest application of the enterprise doctrine to date, under which a corporate group is treated as one single entity for income tax purposes. Under this strong single entity concept, the important tax attributes of a subsidiary are changed permanently once it joins a consolidated group. Now that the regime has matured, after operating for seven years, it is an appropriate time to reflect and draw lessons from the experience. This article argues that, in contrast to other countries’ consolidation regimes, the Australian regime provides some unusual attractions under its unique asset-based model. However, the price to pay for these advantages—namely the problems and complexity associated with them—is high, perhaps too high to be acceptable as a model for other countries.

Introduction

The rise of corporate groups in the last century has seriously challenged the traditional separate entity doctrine under which companies are treated as separate taxpayers.1 Tax laws have responded by introducing regimes which to various extents apply the enterprise doctrine, under which a corporate group is treated as one single entity.2 One of the more comprehensive responses is a consolidation regime under which a corporate group is treated as a single taxpayer and files a single consolidated return.3

* University of Sydney. The author would like to thank Richard Vann for his valuable support and helpful comments on earlier drafts of this article, and also the referees for their thoughtful and insightful comments.


3 For the purposes of this article, the term “consolidation” refers to a full consolidation regime under which a group of resident companies is in general treated as one single taxpayer and files a single consolidated tax return, allowing both intra-group losses offset and tax free asset transfers. The term “consolidation” may mean different types of regimes in different contexts. It may be used to include other group taxation regimes, such as group loss relief in the UK and Organschaft in Germany: see, for example, the much broader definition of “consolidation” in T. Stolarek, “The tax treatment of consolidated groups: managing major tax change” in C. Evans and R. Krever (eds), Australian Business Tax Reform in Retrospect and Prospect (Sydney: Thomson Reuters, 2009), at 204 (fn.10).
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The pace of adopting consolidation regimes has picked up in recent years, as the following table shows:

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<th>Year of Introduction</th>
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<td>US</td>
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These consolidation regimes reveal a spectrum of differing extent to which the enterprise doctrine has been applied. At one end of the spectrum is the pooling system under which consolidated members remain to a large extent individual entities for tax purposes (e.g. the consolidation regime in France). At the other end of the spectrum is the model in Australia, under which consolidated subsidiaries are deemed to have ceased to exist for tax purposes. The latter is the focus of discussion in this article.

The diverse policies adopted in these consolidation regimes suggest that they are often the product of difficult compromises between conflicting policy objectives. On the one hand, a consolidation regime may be designed to apply the enterprise doctrine, thus providing neutral treatment for different business structures, namely a subsidiary and a branch. The policies of allowing intra-group loss offset and tax free intra-group asset transfer also achieve the policy objective of competitiveness. On the other hand, the application of the doctrine is often restricted by conflicting policy objectives such as anti-avoidance. A policy choice may also be made on the ground of simplicity. The difficult compromises between these policy objectives are evident in the following analysis of the consolidation regime in Australia.

This article provides an overall evaluation of the Australian regime, which should be of interest to an international audience because it adopts a very different model from all the consolidation regimes in other countries. It is the world’s first “asset-based” model under which multiple levels of ownership in a corporate group are collapsed into one: a bold attempt to deal with the dual cost bases issue. Though group taxation regimes in other countries are not analysed in detail in this article, the alternative policy options

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4 Some countries are considering the introduction of a consolidation regime. For example, in April 2009 Pakistan issued detailed consolidation rules for public comments: IBFD, Tax News Service Online, April 14, 2009, available at [www.ibfd.org](http://www.ibfd.org) [Accessed September 19, 2009]. Italy is included in the list because, when its domestic consolidation regime was first introduced in 2004, it satisfied the definition of “consolidation” for the purposes of this article. In particular, it allowed tax free intra-group asset transfers among consolidated group members. However, this policy was abolished in 2008.
adopted to deal with the same problems are contrasted throughout the article with the Australian model.

Australia’s consolidation regime represents the strongest application of the enterprise doctrine to date. Now that the regime has matured after operating for seven years, it is an appropriate time to reflect upon and to draw lessons from the experience which should be of interest not only to countries that already have a consolidation regime, but also to those that may be contemplating the introduction of such a regime.

The sub-title of the article, “a road of no return”, has dual meaning. First, a review of the history of consolidation regimes suggests that, once introduced, they tend to stay in the tax system and are seldom repealed. This is especially true if the regime provides significant tax benefits to corporate groups. For instance, the Australian policy of allowing a “step-up” basis for assets in a consolidated group is applauded by corporate groups. As such, the introduction of a consolidation regime is likely to be a road of no return for the Government. Secondly, and more importantly for the purposes of this article, the Australian consolidation regime—with its strong single entity concept—changes permanently important tax attributes of a subsidiary once it joins a consolidated group. For instance, the original cost base of shares in a subsidiary is erased forever once it goes through the consolidation cycle. Furthermore, the cost bases of many assets (including depreciating and capital assets) of a subsidiary are also changed permanently. These changes of tax attributes are irreversible, even if the subsidiary subsequently leaves the consolidated group.

This article will first provide an overview of the policy objectives of the Australian consolidation regime. The strong single entity concept and the primary driving force behind it is then analysed, paving the way to a detailed discussion of the resetting of cost bases of assets in a subsidiary when it joins a consolidated group, reconstruction of cost bases of shares in a subsidiary when it leaves a consolidated group, and the treatment of pre-consolidation losses of a joining subsidiary. Problems arising from the interaction between consolidation and other parts of the income tax law are then discussed. The article concludes by arguing that the Australian regime provides some unusual attractions under its strong single entity concept. However, the price to pay for these advantages—namely the problems and complexity associated with them—is high, perhaps too high to be acceptable as a model for other countries.

**Policy objectives of the Australian consolidation regime**

The Australian consolidation regime was introduced in 2002 as part of the business tax reform recommended by the Review of Business Taxation published in 1999 (the Ralph Report). Under the regime, wholly-owned groups of resident companies can elect to consolidate.6

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6 An unusual feature of the Australian consolidation regime is that it allows partnerships and trusts as subsidiary members in a consolidated group: Income Tax Assessment Act 1997 (Australia) s.703-15(2). (“Income Tax Assessment Act” is abbreviated below to “ITAA”).

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Before the introduction of the consolidation regime, Australia had a number of limited “grouping reliefs” applicable to wholly-owned groups, including transfer of losses between resident group companies, and rollover relief for intra-group asset transfer. Despite these reliefs, companies in general are still treated as separate taxpayers.7 The dual cost bases issue arising from the multiple levels of ownerships within a corporate group proved to be problematic and complex anti-avoidance provisions were necessary to deal with tax planning structures within corporate groups. The Australian Government chose to introduce the consolidation regime with the objectives of reducing the compliance and administrative costs associated with the grouping provisions, and also as an anti-avoidance measure to deal with tax planning within a wholly owned group.8

Four policy objectives of the regime are expressly stipulated in the tax law, as follows:

1. to prevent double taxation of the same economic gain realised by a consolidated group;
2. to prevent a double tax benefit being obtained from an economic loss realised by a consolidated group;
3. to reduce the cost of complying with the tax law; and
4. to improve business efficiency by removing complexities and promoting simplicity in the taxation of wholly-owned groups.9

The first two points imply an application of the enterprise doctrine. More importantly, they reflect the primary driving force behind the strong single entity concept in Australia, namely the determination to deal with the dual cost bases issue. More will be said about this in the next part of this article.

Unlike most other consolidation regimes, the Australian regime appears to have a strong focus on tax avoidance. In particular, the Government stated that consolidation (author’s italics):

“will address . . . problems existing in the taxation of wholly-owned entity groups . . . [including]:

— compliance and general tax costs;
— double taxation where gains are taxed when realised and then taxed again on the disposal of equity;
— tax avoidance through intra-group dealings;
— loss cascading by the creation of multiple tax losses from the one economic loss; and
— value shifting to create artificial losses where there is no actual economic loss.”10

8 The Ralph Report, above fn.5, at 51 and 518. Pursuing simplification of group taxation provisions is not unique to Australia. For example, the UK Government has recently issued a consultation paper on simplification of capital gains rules for corporate groups: HM Treasury and HMRC, Simplification review: capital gains rules for groups of companies—a discussion document (2009), available at http://www.hm-treasury.gov.uk/d/consult_capitalgains070709.pdf [Accessed March 12, 2010].
9 ITAA 1997 s.700-10.
Intuitively, one may question the effectiveness of the regime in achieving an “anti-avoidance” objective, given that a corporate group will be subject to the regime only if it elects to consolidate. It is highly doubtful if a taxpayer will elect to be taxed under an anti-avoidance regime.\footnote{11}

The enthusiastic reception of the consolidation regime by the business community casts doubt on whether the anti-avoidance objective is achieved. The regime has been very popular among corporate groups.\footnote{12} In fact, the consolidation regime provides such significant tax benefits to corporate groups that corporations “have been congratulating themselves on the higher cost base of their assets and their ability to utilise previously unusable losses”.\footnote{13} The popularity of the consolidation regime in Australia is partly due to the fact that when the regime was introduced, the Government repealed the old “grouping relief” provisions for most wholly owned groups.\footnote{14} The Government’s intention was effectively to force wholly owned groups to elect to consolidate, thus achieving its anti-avoidance objective. Nevertheless, given the ingenuity of taxpayers and the aggressiveness of their tax advisers, it is not easy to comprehend how an effective “anti-avoidance” regime can have such an enthusiastic reception from the business community.\footnote{15}

Failure to achieve the simplicity objective is more apparent. The consolidation regime occupies over 600 pages of technically challenging legislation, and is supplemented by over 100 tax rulings and determinations.\footnote{16} The Australian Tax Office (ATO) have put in substantial resources to implement the regime, including the publication of the Consolidation Reference Manual (the ATO’s Consolidation Manual) of over 1,400 pages.\footnote{17}

\footnote{11} The fact that very few countries have “anti-avoidance” as the policy objective of their consolidation regime is a strong indication that most countries believe that an elective consolidation regime would not serve well as an anti-avoidance measure. For more discussion of this issue, see A. Ting, “Policy and Membership Requirements for Consolidation: A Comparison between Australia, New Zealand and the US” [2005] BTR 311 at 313–314. It appears that tax practitioners were also confused about the regime’s policy objectives. One prominent tax practitioner, who had been involved substantially in the consultation and design process of the consolidation regime, argued that the “view of some tax practitioners that Australia’s tax consolidation regime is there to provide a wonderful benefit for their clients is flawed. It is at base an integrity measure, designed to stop taxpayers exploiting mismatches” (author’s italics): G. Lehmann, “An assessment of Australia’s tax consolidation regime” in: G. Lehmann (ed), \textit{Business Tax Reform: Meet the Critics}, Australian Tax Research Foundation Conference Series (2007) at 265.

\footnote{12} By 2005, about 4,000 groups had elected to consolidate 30,000 subsidiaries: M. D’Ascenso, “Consolidation: the Intent of the Consolidation Regime” (Paper presented at the Taxation Institute of Australia Consolidation Symposium, May 19–20, 2005).

\footnote{13} Lehmann, above fn.11, at 291. The issues of cost base of assets and utilisation of pre-consolidation losses are discussed below.

\footnote{14} O’Donnell and Spence, above fn.7 at 125.

\footnote{15} Ironically, this “anti-avoidance” objective is possibly the reason for the strong single entity concept in the Australian consolidation regime: Stolarek, above fn.3 at 206; and G. Mackenzie, “Commentary: the taxation treatment of consolidated groups” in Evans and Krever (eds), above fn.3 at 225. See below for detailed discussion of the single entity concept and its significant influence on the key design features of the regime.

\footnote{16} ITAA 1997, Divisions 700–721. The tax rulings and determinations are available at the Australian Taxation Office website: \texttt{http://www.ato.gov.au/}.

\footnote{17} The ATO’s Consolidation Manual is designed to explain to taxpayers how the consolidation regime works, and is available at \texttt{http://www.ato.gov.au/businesses/content.asp?doc=/Content/34764.htm} [Accessed March 9, 2009].
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Strong single entity concept

Under the enterprise doctrine, a corporate group should be treated as one single entity for tax purposes. Putting this deceptively simple statement into practice proves, however, to be a difficult balancing act with constant tension between the enterprise doctrine and the traditional separate entity doctrine. How far should the enterprise doctrine be applied in consolidation? Should the group be treated as a distinct separate taxpayer from all group members (including the parent company)? Should it be treated as an aggregate of all the group members, with group members maintaining individual identities to a large extent? Or should the group be treated as comprising the parent company only, with its subsidiaries deemed to have become divisions of the parent company?

The single entity concept in Australia’s consolidation regime—known as the “single entity rule” (SER)—is expressly stipulated in the tax law. All subsidiary members of a consolidated group are treated as “parts of the head company of the group, rather than separate entities . . .” (author’s italics).18 The consequences of the SER include not only the usual effects of consolidation—including filing a single consolidated income tax return for the group, a common tax accounting period for all group members, and joint and several liability to the group’s consolidated tax liability (if the parent company defaults)—but also some unique tax implications such as “reset” cost bases of shares and assets of subsidiaries.

The impact of the SER is enhanced by two more deeming provisions: the “entry history rule” and the “exit history rule”. Under the entry history rule, “everything that happened in relation to [a subsidiary] before it became a subsidiary member [of a consolidated group] is taken to have happened in relation to the head company” (author’s italics).19 In other words, the tax history and attributes of a subsidiary are deemed to be those of the parent company. This rule is necessary, as a subsidiary is deemed to have “disappeared” upon consolidation under the SER.

When a subsidiary leaves a consolidated group, the “extreme” deemed positions under the entry history rule have to be reversed. The “exit history rule” serves that purpose by deeming that “everything that happened . . . to any . . . asset [, liability or business] . . . while it was that of the head company . . . is taken to have happened . . . to it as if it had been an . . . asset [, liability or business] of the [leaving subsidiary]”.20 This completes the consolidation cycle of a subsidiary under the single entity rule.21

The determination to resolve the dual cost bases issue in corporate groups is the primary driving force behind the strong SER in Australia. This is evident from the

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18 ITAA 1997 s.701-1.
19 ITAA 1997 s.701-5. The Government originally proposed a very different rule, known as the “clean slate rule”, under which a joining subsidiary’s tax history would not be attributed to the parent company: EM to Australian Treasury, Exposure Draft New Business Tax System (Consolidation) Bill 2002 (released by the Treasury in February 2002) at [1.19], available at http://www.taxboard.gov.au/content/downloads/Consolidation_Bill_2002_EM.pdf [Accessed March 11, 2010]. A similar clean slate rule was proposed for a subsidiary that leaves a consolidated group. Due to general objection by the business community and tax profession, the proposed “clean slate rule” was dropped and replaced by the entry and exit history rules.
20 ITAA 1997 s.701-40.
21 The potentially far reaching deeming positions under the entry and exit history rules are overridden on various occasions to make the consolidation work properly. Some of the overrides will be discussed below.
following extract taken from a consultation document which led to the introduction of the consolidation regime (author’s italics):

“The structural flaw in the [tax] 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 . . . The problems . . . are the results of taxing each group company as a single entity and of the failure to deal with the dual reflection of value in equity interests and the underlying assets . . . [A] consolidation regime, which focuses on the wholly owned group as the tax entity, would improve significantly the taxation of entity groups.”

Unlike most European countries, Australia does not have a comprehensive domestic participation exemption regime for corporate equity. The dual cost bases issue therefore represents a serious challenge to the tax system, including double taxation of the same economic gain, double deduction of the same economic loss, and value shifting among group members. The Government believed that the introduction of a consolidation regime was a valuable opportunity to deal with these problems. It adopted the SER in the consolidation regime effectively collapsing multiple levels of ownerships in a corporate group into one single level. In particular, all subsidiaries are deemed to have become divisions of the parent company, and their assets are deemed to be owned directly by the latter. As intra-group shareholdings are ignored in consolidation, the dual cost bases issue is a non-issue within a consolidated group.

The strong SER has a number of important implications. First, as multiple levels of ownership are collapsed into one during consolidation, cost bases of most assets (including depreciating and capital assets) are reset—possibly to a stepped-up basis—and changed forever. Secondly, when a subsidiary leaves a consolidated group, its shares are given a new “reconstituted” cost base which is based on the cost bases (including reset cost bases) of assets it takes away from the group, and not the original cost of its equity. Thirdly,


23 Before the introduction of the consolidation regime, Australia had a number of limited grouping relief regimes providing for intra-group loss offset, asset transfer and dividends: O’Donnell and Spence, above fn.7.

24 For a discussion of these issues in the context of the Government’s justification for the introduction of a consolidation regime, see A Platform for Consultation, above fn.22, Ch.25.

25 However, consolidation can only deal with the dual cost bases issue in relation to corporate groups that elect to consolidate. The tax law still requires other specific provisions to deal with the issue for un-consolidated groups: A Platform for Consultation, above fn.22 at [25.18]. In contrast, a comprehensive participation exemption would be a more comprehensive solution for all corporate groups. A detailed discussion of this policy option is beyond the scope of this article.

26 Assets of subsidiaries in general would have their cost bases reset upon consolidation, unless they are “retained cost base assets” (e.g. cash or debt in Australian currency): ITAA 1997 s.705-35(1).

27 The impact of the SER is also evident in the policy dealing with an important tax attribute of shares: pre-CGT status. In general, assets with pre-CGT status are exempt from capital gains tax in Australia. The status is therefore a precious tax attribute. However, the status may be lost if a subsidiary joins a consolidated group. The Government recognises the problems and announced in 2005 that the law would be amended to “allow the pre-capital gains tax...
the deemed disappearance of subsidiaries during consolidation in practice dictates that pre-consolidation losses of the subsidiaries have to be transferred to the parent company. A complex and problematic regime is required to restrict the utilisation rate of the losses by the group. Last but not least, the strong SER makes the interactions between the consolidation regime and other parts of the income tax regimes more difficult.

The following sections discuss these implications of the SER in detail.

Reset cost bases of assets of subsidiaries

The policy choice of adopting the strong SER, which effectively collapses multiple levels of ownerships into one, leads to an important issue: what should be the cost bases of subsidiaries’ assets that are now deemed to be owned directly by the parent company? At this point, it is important to understand that the more common policy of rollover—which is the predominant policy in most other consolidation regimes—is not an option under the strong SER. Under the rollover policy, gain or loss on intra-group asset transfers during consolidation is deferred and later recaptured when either the transferor or the transferee leaves the group. This policy is ruled out by the determination to deal with the dual cost bases issue which dictates that intra-group asset transfers are ignored completely for tax purposes (author’s italics):

“There would be tax-free movement of assets, even whole business, within a group without the need to adhere to formal rollover arrangements . . . The transfer of assets . . . within a consolidated group would have no tax consequences or compliance requirements.”

The policy of ignoring completely intra-group asset transfer is an important advantage of the strong SER: unlike the more common rollover policy, there is no need to trace intra-group asset movements during consolidation, keep track of any deferred gain or loss on those transfers, or recapture the gain or loss when either the transferor or transferee leaves the group. However, there is a high price to pay for this benefit. Among other things, the pre-consolidation cost base of shares in a subsidiary becomes irrelevant, as the company may carry very different assets when it later leaves the group. It implies that the cost base of shares of a leaving subsidiary would have to be reconstructed.

The Government considered two policy options to reconstruct cost bases of shares in a leaving subsidiary:

status of shares in companies be maintained at the same percentage when they enter and exit consolidation”: Minister for Revenue and Assistant Treasurer, Press Release No.098 “Further Enhancements to Tax Consolidation Regime” (2005) available at [http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2005/098.htm&pageID=003&min=mth&Year=2005&DocType=0] [Accessed March 11, 2010]. The Government has released an exposure draft of the amending legislation on April 28, 2009 for consultation. Unfortunately, even under the proposed amendments, the intra-group shares will still be deemed to have disappeared, potentially still resulting in loss of pre-CGT status of the shares: EM to the Exposure Draft at [1.58]–[1.74], in particular, Example 1.13 available at: [http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1545] [Accessed March 9, 2010]. As pre-CGT status is an uncommon feature of most other income tax regimes, the issue is not discussed in detail in this article.  

28 A Platform for Consultation, above fn.22 at [25.11] and [25.12].  

29 The issue of reconstructing the share cost bases is discussed in the next part of this article.
(1) **Entity-based model**: under this model, the assets keep their pre-consolidation cost bases. The cost base of shares in a leaving subsidiary is determined by adjusting its original cost base for any transfer of assets in the company during consolidation.

(2) **Asset-based model**: under this model, the cost base of shares in a subsidiary is pushed down to its underlying assets upon consolidation. Pre-consolidation cost bases of assets in general are erased and replaced by the reset cost bases forever. When the company leaves the group, the share cost base is reconstructed by pushing up the cost bases of assets that it takes away from the group.30

Australia chose the asset-based model primarily due to the compliance and administrative costs of tracing intra-group asset transfers under the entity-based model.31 The policy choice of this world’s first asset-based model is also consistent with the underlying rationale of the SER, namely to treat the whole consolidated group as one single company with only one level of ownership in the group’s assets.

The decision to adopt the asset-based model was influenced by the experience in the US, whose consolidation regime employs the “entity-based” model. The asset-based model was adopted “in order to avoid the need for the ongoing equity tax basis adjustments for intra-group asset transfers . . . associated with the more traditional ‘entity-based model’”.32 It is understandable why one should steer away from the extremely complex equity-based model. However, it is doubtful if that is a good reason to adopt the asset-based model, which is problematic and equally complicated.33

A complex set of rules—known as the tax cost setting (TCS) rules—are designed to achieve the push down of share cost base to the underlying assets.34 The objective of the TCS rules is stipulated as follows:

“to recognise the head company’s cost of becoming the holder of the joining entity’s assets as an amount [consisting] of the cost of the groups’ membership interests in the joining entity, increased by the joining entity’s liabilities and adjusted to take...”

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30 For a detailed discussion of the two models, their key features and how they work, see “A Platform for Consultation”, above fn.22 at [27.5] to [27.20].

31 The Ralph Report, above fn.5, at 527. This rationale is also stipulated in the law: ITAA 1997 s.705-10(3)(b). For a brief history of the design of the “world-first” asset-based model nicely presented in the form of a personal memoir, see Lehmann, above fn.11. It is interesting to note that “the architect of the asset-based model was . . . a middle level Treasury official . . . close to retirement, who had been an economics lecturer [and did retire before the consolidation design process was concluded]”: Lehmann, above fn.11, at 11 and 13.

32 O’Donnell and Spence, above fn.7, at 124.

33 The Government did not consider other models of consolidation which are relatively simpler to implement, for example the pooling systems in France and Italy, under which group members remain to a large extent as separate entities even during consolidation. Detailed discussion of these alternative models is beyond the scope of this article.

34 The objective of the tax cost setting rule is “to recognise the cost to the head company of such assets as an amount reflecting the group’s cost of acquiring the entity”: ITAA 1997 s.701-10(3). In the Government’s words, “the group’s cost of membership interests is stored in its cost of assets”: EM to May 2002 Consolidation Act at [5.108]. Though appearing to be similar to accounting rules on consolidation, the tax cost setting rules are very different in detail: Stolarek, above fn.3, at 218.
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account of the joining entity’s retained profits, distributions of profits, deductions and losses.”35

In other words, a subsidiary’s liabilities (identified and measured under accounting rules) are added to the cost base of shares in the company and adjustments are made for certain profits and losses of the company to arrive at an amount known as the “allocable cost amount” (ACA).36 The ACA is then generally allocated to the assets in the subsidiary according to their market values at the joining time.37

An important feature of the TCS rules is that it is possible to have a reset cost base higher than the original cost base. This is possible if, for example, a parent company pays a premium price for a subsidiary, exceeding the market values of the underlying assets. Allowing “step-up” of cost bases of assets in a joining subsidiary is a unique feature of the Australian consolidation regime.

The Government repeatedly states that the objective of the tax cost setting rules is to align costs of shares with that of underlying assets of a subsidiary.38 However, it is doubtful if the objective is achieved in practice. It has been observed that (author’s italics):

“In an asset acquisition, the purchase price is allocated to the assets and this becomes the starting tax base [of the assets] . . . In contrast, where the shares are acquired, an ACA calculation is required to be undertaken . . . which through application of the various steps and adjustments . . . may give a very different tax base to that achieved under an asset sale.”39

Problems of TCS rules at joining time

Flawed theory, or no theory at all?

Theoretically, the acquisition cost of shares in a company should represent the net value of assets and liabilities in the company. The relationship may be presented in the following formula:

\[ \text{Share acquisition cost} = \text{Value of assets} - \text{Value of liabilities} \]

Logically, it is possible—in theory at least—to allocate the share purchase cost to each individual asset, as the above formula can be rearranged as follows:

\[ \text{Value of assets} = \text{Share acquisition cost} + \text{Value of liabilities} \]

However, the formula is true only at the time of share acquisition, but is no longer true once values of assets and liabilities change over time.

35 ITAA 1997 s.705-10(2). The amount allocated to assets in a company is computed under an 8-step process stipulated in ITAA1997, s.705-60. For a diagram that conveniently summaries the TCS steps at joining time, see the ATO’s Consolidation Manual, above fn.17 at [C2-2-110].
36 ITAA 1997 s.705-60.
37 ITAA 1997 s.705-35(1)(c). Certain assets (such as Australian currency and receivables)—known as “retained cost base assets”—retain their cost bases: ITAA 1997, s.705-25. The amount of these retained cost bases are subtracted from the ACA before the balance is allocated to the remaining assets (known as “reset cost base assets”): ITAA 1997 s.705-35(1)(b).
38 For example, ITAA 1997 ss.701-10(3) and 705–10(3).
39 O’Donnell and Spence, fn.7 at 136. The same problem occurs in the case of a leaving subsidiary: O’Donnell and Spence, above fn.7 at 137.
In many cases, shares in a subsidiary are acquired at a different time from the joining time. For instance, a parent company may have acquired all shares in a company in Year 1 and then forms a consolidated group in Year 10. Alternatively, the parent company may have acquired shares in a subsidiary in separate parcels at different times before the subsidiary joins the consolidated group. Similar problems apply to liabilities. Some accounting liabilities are measured at fair value, others at amortised costs. Mixing items with different valuation times renders the TCS theory flawed.  

This “apples and oranges” problem has another dimension: the TCS calculation mixes tax and accounting items. While cost bases of shares are determined under tax rules, liabilities are identified and measured according to accounting rules. For instance, deferred tax liabilities—an accounting concept that has no meaning in tax law—are included in the TCS calculation and effectively pushed down into the cost bases of assets. It is doubtful if the amount—which is not a legal liability and would not cause an economic outlay—should be included in the TCS calculation at all.

What do we get by adding together tax items with accounting items? What does the resulting “reset” cost base of an asset represent? It is difficult to find a comprehensible answer. Accounting liabilities include not only loans borrowed by a company to acquire assets, but also other items that have little, if any, relationship with the asset cost. For example, accounting liabilities include “provision for employee benefits” whose value may depend on the fair value of options on the company’s shares. Accounting liabilities for a supermarket chain may also include “provision for self-insured risks” which represents the estimated liability for workers’ compensation and public liability claims based on actuarial valuations. It is puzzling why these items—which basically are estimates required under the accounting standards for financial reporting purposes—should be included in the ACA and pushed down into the reset cost bases of assets in the company.

The fact that a parent company may have a capital gain or loss in the TCS process is evidence of the flawed theory. It is hard to comprehend why at the joining time the parent company can have a capital gain or loss without any transfer of assets. Even under the SER, assets are just deemed to be those of the parent, without any deemed

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40 Some of the adjustments in the TCS calculation (e.g. adjustments for certain pre-consolidation profits and losses in a joining subsidiary in Steps 3 to 5 of the ACA calculation) may alleviate some of the problems. However, the anomalous resulting reset cost bases—as will be illustrated below in the “$74 land” example—suggest that the adjustments are far from sufficient to deal with the problems.

41 Detailed discussion of the issue is beyond the scope of this article. For a discussion of the problems of including deferred tax liabilities in the TCS calculation, see Lehmann, above fn.11, at 292–293.

42 What happens if the provision is different from the realised amount? It would be a nightmare if the TCS calculation has to be redone every time a provision is realised. The solution in Australia is to treat the difference as a capital gain or loss of the parent company under CGT event L7: ITAA 1997 ss.104-530. However, there are many problems associated with the treatment and the Government has recently announced that the CGT event will be repealed: EM to Exposure Draft “Tax Laws Amendment (2009 Measures No.4) Bill 2009: Consolidation” at [1.7] and [1.204]. This means that over- or under-provisions in financial statements will become a permanent component in the reset cost bases under the TCS regime.

43 For example, a parent company may have a capital loss if some of the allocable cost amount can not be allocated to any asset: CGT Events L4 and L8 in ITAA 1997 ss.104-515 and 104-35. In total there are eight CGT events that may be triggered by the TCS calculations.
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transfer of the assets. The only reason for the capital gain or loss is that it is artificially manufactured by the TCS rules.

An alternative view is that the search for a theory behind the TCS rules is bound to be futile. Perhaps the TCS regime has no theory at all. It may be simply a mechanism designed to push down and store share acquisition cost in the underlying assets, waiting for it to be pushed back up to reconstruct the cost base of shares when the subsidiary leaves consolidation. However, a regime without theory runs a high risk of producing arbitrary and anomalous results.

Detailed discussion of the highly technical and complex TCS calculations is beyond the scope of this article. Nevertheless, its problems become obvious if one looks at its end product: the “reset cost base” of an asset. The ATO’s Consolidation Manual—which is prepared to assist taxpayers to understand how the consolidation regime works—ironically provides a telling example illustrating the problems of the TCS rules. In that example, when the parent company A acquired 40 per cent of a subsidiary G on July 1, 2001, G had a piece of land with both cost base and market value equal to $100. On July 1, 2002, A acquired the remaining 60 per cent in G and elected to consolidate. At that time, both the cost base and market value of the land remain $100.

After 16 pages of TCS calculations, the “reset” tax cost of the land is $74. The implication is that if the consolidated group sells the land for its market value of $100 (which is equal to its original cost base), the group would have a capital gain of $26. This “step-down” result defies common sense and logic.

This result is difficult to comprehend, given that both the “real” cost base and market value of the land have always remained to be $100 ever since A acquires G. Why should the group have a capital gain of $26, when it sells the land for its original cost?

Combing through the complicated 16-page TCS calculations reveals two causes for this puzzling outcome:

1. **Appreciated assets in the group**: the subsidiary has other assets that have appreciated in value since July 1, 2001. As allocation is based on market values of assets at the joining time, more ACA is allocated to those assets than to the land (which has not appreciated in value).

2. **New asset recognised at joining time** (i.e. July 1, 2002): before the joining time, the group never recognises any goodwill. However, at joining time, goodwill is recognised in the TCS calculation. In other words, part of the acquisition cost

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44 It is clear that the SER does not deem a transfer of assets from a joining subsidiary to the parent company: Note to ITAA 1997 s.701-35(3). The Government failed to provide any policy explanation for the CGT events at all: EM to New Business Tax System (Consolidation and Other Measures) Act 2003 at [5.127]–[5.131], and EM to Taxation Laws Amendment Act (No.8) 2003 at [a 2.19]–[2.23].

45 One may get this impression after reading the consultation document regarding the policy objective of “determining the cost base for disposal of equity”: A Platform for Consultation, above fn.22, Ch.27.

46 The concept of pushing down tax attribute of shares to the underlying assets is similarly applied to the “pre-CGT” status of shares, creating serious problems and disquiet in the business community: see A Platform for Consultation, above fn.22.

47 It is beyond the scope of this article to explain the detailed technical calculations that result in this number. Nevertheless, the two main reasons for this puzzling outcome are discussed below.

48 What the ATO does not discuss in the example is that in practice, given the creativity of taxpayers, one would expect a step-up basis—instead of step-down—to be more likely.
for the 40 per cent shares on July 1, 2001 is allocated to the goodwill that was not recognised at that time.

In practice, the creativity of taxpayers and their advisers is likely to ensure a higher chance of the reset cost base being stepped-up instead of stepped-down. The TCS regime thus provides ample tax planning opportunities for corporate groups.

The “reset” cost bases will stay with the asset even if the subsidiary subsequently leaves consolidation. This is one of the implications of the “exit history rule”. The anomalous effect of this policy is again well illustrated in the “$74 land” example. The $74 will remain as the cost base of the land if the subsidiary leaves the group. This is so even though the market value of the land has always been $100 and the land has always been owned by the subsidiary throughout the consolidation cycle. In other words, the original “real” cost of the asset is lost forever once it passes through the consolidation process.49

Complexity

The TCS rules are very complex and occupy over 100 pages of legislation.50 The law requires that cost bases of most assets in a group have to be reset on an asset by asset basis.51 Compliance costs are high. This is not helped by the requirement that a joining subsidiary has to prepare a “notional” balance sheet at the joining time (unless the joining time coincides with an accounting reporting date) in order to identify and measure accounting liabilities as at that day.52

In practice, especially for large corporate groups, identification of all assets (especially intangibles) can be an art instead of science. The meaning of “assets” and “liabilities” is also controversial.53 Valuation of assets and liabilities is problematic. For example, how should goodwill be identified and valued, especially if it is internally generated?54 Furthermore, the resetting is based on the market values of assets in the subsidiary, thus requiring a major valuation exercise in many cases. Not surprisingly, some taxpayers encounter significant difficulties in trying to comply with the rules in practice.55

49 The reset cost bases of assets also have significant implications for the cost base of shares in the subsidiary. See discussion on “reconstituted cost base of shares in subsidiaries” below.
50 ITAA 1997 Divisions 705 and 713. When a subsidiary joins a consolidated group, first it has to go through an eight-step process to arrive at the “allocable cost amount”, which will be allocated to each individual asset of the company: ITAA 1997 s.705-60. This is just the first step of a 4-step process to complete the tax cost setting process. The whole process would have to be repeated for every level of shareholdings in the consolidated group, until all costs of shareholdings are allocated to individual assets. The TCS calculations are so complex that the tax law stipulates that certain errors in the calculation would be taken to be correct if, among other things, they are worked out “in purported compliance” with the TCS rules: ITAA 1997 s.705-315. In that case, the mistake will result in a capital gain or loss for the parent company. Detailed discussion of these technical rules is beyond the scope of this article.
51 ITAA 1997 s.701-10(2).
52 ITAA 1997 s.705-70.
53 The ATO have issued several tax rulings explaining their positions on the meanings of “asset” and “liability”: TR2004/13, TR2004/14 and TR2006/6. For an interesting illustration of the problems in relation to “liabilities” and the resulting “notorious provision” in the ACA rules (ITAA 1997 s.705-80), see the “accrued $100 million liability for poisoned pies sold by a pie shop” example in Lehmann, fn.11 at 279.
54 The ATO have issued tax ruling TR2005/17 explaining their position on the issue.
55 For instance, some corporate groups have many thousands of assets, while others may operate different fixed asset systems (e.g. due to acquisitions). These problems are recognised in a Practice Statement of
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The administrative and policing costs of the ATO are also very high.\(^56\) The ATO recognise the practical difficulties of complying with the rules, and has to allow some pragmatic “short cuts”.\(^57\)

Avoidance opportunities

The complex TCS regime provides ample tax avoidance opportunities. Planning opportunities can arise from valuation of assets,\(^58\) different depreciation rates among assets, and the meaning of “assets” (especially identification of intangibles) and “liabilities”.\(^59\) The adoption of accounting liabilities in the TCS calculation provides further scope for manipulation, as accounting standards may allow a choice between alternative accounting policies.\(^60\) Furthermore, the implant of accounting liabilities into tax costs is prone to abuse as the “notional” balance sheet prepared for the joining time is not required to be audited, and the accounting concept of “materiality” implies more flexibility than would normally be acceptable for tax purposes.\(^61\)

Market valuation has a critical role in the TCS regime, as the ACA is allocated to assets generally according to their market values. In other words, the higher the market value assigned to an asset is, the higher its reset cost base will be. The ingenuity of taxpayers and their advisers is further encouraged by the fact that the TCS rules allow “step up” basis of an asset. For instance, it would be beneficial to allocate more ACA to depreciating assets than to goodwill (which is not eligible for depreciation in Australia). Given that tax depreciation is a significant tax deduction item of many corporate groups, it is understandable that the ATO are particularly alert in policing market valuations adopted in the tax cost setting exercise.\(^62\)

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\(^{56}\) In addition to the inherent problems associated with valuation of assets, the policing cost is particularly high as the tax cost setting rule can result in “step-up” basis of assets: ATO, PS LA 2004/12, above fn.55, at [7] and [10].

\(^{57}\) Both the ATO and the Government recognise the problem. The ATO offer some short-cuts to reduce compliance costs of valuation: ATO, PS LA 2004/12, above fn.55. The Government provides certain transitional measures to reduce compliance costs. In broad terms, groups that consolidated before July 1, 2004 could choose to keep the tax written down values of assets for certain subsidiaries, instead of calculating the “reset” cost bases under TCS regime: Income Tax (Transitional Provisions) Act 1997 Division 701. The transitional rules are optional. Furthermore, the parent company can choose which subsidiaries use the “stick” method on a company by company basis. In other words, groups consolidated in the transitional period could cherry pick the best options.

\(^{58}\) Valuation is particularly difficult and inherently subjective for intangibles, such as goodwill. Taxpayers in general would prefer a lower valuation of goodwill in the context of tax cost setting exercise, as goodwill is not eligible for depreciation in Australia.

\(^{59}\) For example, the meaning of “liability” in the context of the tax cost setting rules was the key issue in Evenstra Ltd v Commissioner of Taxation (2008) FCA 249.

\(^{60}\) The ATO recognise the problem and tries to limit the scope: TR2006/6 at [9] and [20].

\(^{61}\) Again, the ATO try to limit the exposure, though it is not certain how successful they will be: TR2006/6 at [13] and [14].

\(^{62}\) The ATO have prepared detailed market valuation guidelines explaining how they will administer the market valuation provisions in the consolidation regime: ATO’s Consolidation Manual, above fn.17, Pt 4. In particular, they have developed the “Advanced Market Valuation Agreements” (AMVA) process. The AMVA concept is similar to transfer pricing Advanced Pricing Agreements and is
The ATO have issued a 45-page document discussing the application of the general anti-avoidance provision to elections to consolidate.\textsuperscript{63} One of the examples illustrates a situation under which the ATO would apply the provision to deny additional depreciation generated under the TCS rules by a consolidated group.\textsuperscript{64}

\textit{Reset cost bases: a good policy?}

The TCS rules offer an advantage that is unusual among other consolidation regimes: intra-group asset transfers within a consolidated group are ignored completely. Unlike the rollover policy in most other consolidation regimes, there is no need to trace movement of assets during consolidation, keep records of any deferred gain or loss, or recapture the gain or loss when either the transferor or transferee leaves the consolidated group. This implies lower compliance and administrative costs. However, there is a high price to pay for the advantage: the problematic and complex TCS regime.

The TCS regime dictates a road of no return for cost bases of most assets in a consolidated subsidiary. The cost bases of many assets are “reset” at the joining time. The “reset” cost base replaces the “real” cost base forever and stays with the asset even if the subsidiary subsequently leaves the group. The original cost of the asset to the subsidiary is erased forever.

A proper recognition of the transitions between the enterprise and separate entity doctrines should ensure that, when the subsidiary leaves the group, the cost base of an asset which has always been held by the company throughout the consolidation cycle should be reinstated to its actual cost. The TCS regime fails to achieve this outcome. The failure to revert back properly to the separate entity doctrine represents a fundamental problem of the asset-based model. It can also result in taxation of artificial gain generated from the TCS resetting process.

The policy of allowing step-up basis under the TCS regime is arguably too generous. It effectively allows converting part of share acquisition cost into depreciable cost bases, the extent of conversion depending on the relative amount of depreciable assets of the subsidiary involved, their market values, and also the aggressiveness of taxpayers in taking advantage of the rules. The step-up basis could also reduce gain or even generate artificial losses on future disposal of capital assets.

\textit{“Reconstituted” cost bases of shares in subsidiaries}

When a subsidiary leaves consolidation (“leaving time”), shares in the company—that have been deemed to have “disappeared” during consolidation—spring back to life. As discussed above, the strong SER, driven by the determination to deal with the dual cost bases issue during consolidation, implies that the original cost base of shares becomes irrelevant and is replaced by a reconstituted cost base under the asset-based model.

At leaving time, the TCS regime operates with the following objective (author’s italics):

designed to reduce uncertainties around the derivation and use of market values in consolidation. A pro forma of an AMVA can be found in the ATO’s Consolidation Manual, above fn.17, Pt C4-1-110.

\textsuperscript{63} ATO, “The application of Pt IVA to elections to consolidate” available at the ATO website http://www.ato.gov.au/ [Accessed October 19, 2009]. The document has been incorporated into the ATO’s Consolidation Manual, above fn.17 Part C9-1-220,

\textsuperscript{64} ATO, “The application of Part IVA to elections to consolidate”, above fn. 63, Example 2 at [9].
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“...to preserve the alignment of the head company’s costs for membership interests in entities and their assets that is established when entities become subsidiary members.”

The cost bases of shares in a leaving subsidiary are reconstructed basically by pushing up the cost bases of assets (including reset cost bases) taken by the subsidiary, less its liabilities.

*Problems of TCS regime at leaving time*

Real cost of asset lost forever

As discussed above, the TCS regime represents a “road of no return” for the original cost bases of many assets in a subsidiary. The “real” cost bases are lost forever and replaced by “reset” cost bases.

Step 1 of the “exit ACA” calculation stipulates that the reconstituted cost base of shares is primarily based on the cost bases of assets—including reset cost bases determined at joining time—that the subsidiary takes away from the consolidated group. The “$74 land” example discussed above illustrates vividly that the permanent replacement of the real cost base by the reset cost base is problematic.

“Double troubles”

One of the main objectives of the asset-based model is to eliminate the dual cost bases issue by the “deemed disappearance” of intra-group shareholdings within a consolidated group. The objective is achieved for intra-group asset transfers and also for disposal of assets to a third party outside the group. However, it is not achieved if a subsidiary leaves the group with the asset. This is because any hidden reserve in the asset would be recognised twice: first in the gain on disposal of the shares in the subsidiary, and again when the subsidiary sells the asset. In other words, the model fails to eliminate the dual cost bases issue comprehensively.

The “$74 land” example in the ATO’s Consolidation Manual again serves as a convenient case to illustrate the point. If the parent company sells all shares in the subsidiary holding the land to a third party and the price reflects the market value of the land ($100), the group would realise a gain of $26 attributable to the land. When the subsidiary subsequently sells the land, the same gain of $26 would be taxable again in the hands of the company. This duplication of gain is created due to the TCS regime.

65 ITAA 1997 s.711-5(2).
66 ITAA 1997 s.711-5(3). The TCS steps for leaving subsidiaries are conveniently depicted in the ATO’s Consolidation Manual, above fn.17 [C2-1-060], 3.
67 See text to fnn 46–49 above.
68 In contrast, a participation exemption regime that applies to both consolidated and non-consolidated groups would be more effective and comprehensive to deal with the issue. Detailed discussion of the regime is beyond the scope of this article.
69 In contrast, if the subsidiary does not join the consolidated group, the cost base of the land would remain as $100. Thus no gain would be recognised when it is sold for its market value $100.
By going through the consolidation cycle, artificial gain can not only be created, but also duplicated.70

Complexity
The TCS process at leaving time is complex. If multiple levels of subsidiaries leave a consolidated group, the TCS calculation has to be performed for each level on a “bottom-up” basis.71 The implant of accounting liabilities in the calculation introduces additional complexity and adjustments.72

If the leaving subsidiary has more than one class of shares, or option/right over shares, the ACA is allocated to the different classes of membership interests according to their respective market values.73 Similar to the issues at joining time, the valuation requirement increases compliance costs of taxpayers, policing costs on the tax authority, and creates avoidance opportunities.

Asset-based model: a good choice?

The effects of a subsidiary going through the Australian consolidation cycle can be depicted as follows:

70 The TCS regime is not the only cause for double taxation in consolidation. Capital gain may be subject to double tax under certain circumstances. For example, double taxation may occur if the disposal contract is concluded during consolidation and the title transfer occurs after the subsidiary involved leaves the group. This is known as the “CGT straddles” issue. The ATO’s “bandage” solution is to allow taxpayers to ignore one of the gains: TD2008/29. The Government announced in 2008 that it will introduce legislation to fix the problem. No legislation has been introduced yet.

71 ITAA 1997 s.711-55.

72 Many adjustments are required on the accounting liabilities at the leaving time: ITAA 1997 s. 711-45. The Government has recently suggested amendments to reduce compliance costs in this respect: Explanatory Material to Exposure draft “Tax Laws Amendment (2009 Measures No. 4) Bill 2009 Consolidation”at [1.117]-[1.128].

73 ITAA 1997 s.711-15(1)(b) and (2).
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Australia’s choice of the “world-first” asset-based model over the entity-based model was based primarily on the advice of US tax officials concerning their difficult experience with the latter.\(^{74}\) It appears that it was a choice between two devils. The asset-based model inflicts the pain primarily at the two transition points between the enterprise and separate entity doctrines. The corresponding relief is that intra-group asset-transfers during consolidation do not require adjustments of the cost base of membership interests. In contrast, the equity-based model inflicts the pain continuously during consolidation when complex adjustments are made to the cost base of shares in a subsidiary. Its relief is the relatively straightforward transition to and from consolidation, without the need for market valuations and the complex and problematic TCS rules.

The TCS regime erases the original “real” cost bases of assets of and shares in a subsidiary. The reset cost bases can generate, and even duplicate, artificial gain or loss. The heavy reliance of the TCS regime on market valuations of assets implies high compliance and policing costs, and ample opportunities for tax avoidance. The incentive to exercise taxpayers’ creativity is boosted by the policy of allowing step-up basis under the reset cost base rules.

Remembering that the main driving force behind the strong SER is the desire to resolve the dual cost bases issue, it is important to note that the asset-based model achieves the goal only during consolidation. The dual cost bases issue re-emerges again at leaving time. Furthermore, the asset-based model can resolve the issue only for consolidated groups, but not un-consolidated groups. In this respect, a general participation exemption regime may be a more comprehensive solution. It is also likely to be simpler than the TCS regime. However, the introduction of a general participation exemption regime in Australia would represent a fundamental reform of the corporate tax system and is a topic for another day.

Pre-consolidation losses of subsidiaries

Losses in general can be carried forward indefinitely in Australia, but no carry-back is allowed.\(^{75}\) Under the strong SER, subsidiaries are deemed to have ceased to exist during consolidation. How should pre-consolidation losses of subsidiaries be treated?

The deemed “disappearance” of subsidiaries under the SER means that the more common policy of quarantining the losses is not an option for Australia. The quarantine policy typically restricts the utilisation rate by allowing offset of pre-consolidation losses only against taxable income generated by the same subsidiary. It is the predominant policy adopted by countries with consolidation regimes.\(^{76}\) The quarantine policy was dismissed in Australia primarily due to the strong SER: “This option requires the re-establishment of the identity of the loss entity inside the consolidation group” (author’s italics).\(^{77}\)

\(^{74}\) Lehmann, above fn.11 at 277.
\(^{75}\) ITAA 1997 s.36-17.
\(^{76}\) Countries adopting the quarantine policy include France, Italy, the Netherlands, New Zealand, Spain and the US.
\(^{77}\) A Platform for Consultation, above fn.22 at 563. Out of six options considered by the Review, this option was the only one not adopted in the final recommendation of the Ralph Report: see the Ralph Report, above fn.5, at 524. Ironically, the concept of quarantining pre-grouping losses is not new in Australia. Under the former group loss relief regime, if a company had carry-forward losses when it joined a wholly-owned group, the losses were quarantined and could only be used to offset its own profits: ITAA 1997 former s.170-30. This was possible as each group company was still treated as a
The extreme deeming provision means that there are two policy options for pre-consolidation losses: (1) the losses are cancelled at joining time;\textsuperscript{78} or (2) the losses are transferred to the parent company.\textsuperscript{79}

Australia had an important constraint in the design of its rules on pre-consolidation losses. Before the consolidation regime was introduced in 2002, Australia had a group loss relief regime which in broad terms allowed intra-group loss transfers among resident wholly-owned group companies.\textsuperscript{80} In other words, wholly-owned groups had been enjoying the benefits of intra-group loss offset. It put pressure on the policy makers to come up with a model that would be at least as attractive as the old group loss relief regime. The pressure was particularly intense as most companies were denied access to the old group loss relief regime after the introduction of the consolidation regime.\textsuperscript{81}

Australia chose the second option of allowing transfer of pre-consolidation losses of subsidiaries to the parent company.\textsuperscript{82} The parent company is deemed to have made those separate taxpayer, each being required to prepare its stand-alone tax computation. However, under the SER, the Government seems to believe that a consolidated subsidiary would not undertake a stand-alone computation anymore. The fact that, in practice, compensation payments are commonly made between the parent company and its consolidated subsidiaries and are determined based on the latters' income tax liabilities on a “stand-alone” basis strongly suggests that the Government’s belief is misplaced.

\textsuperscript{78} This option may seem harsh, but is indeed the policy in Japan: Corporations Tax Act of Japan (CTA (J)), art.81-9(1). The cancellation policy is subject to a limited number of exceptions, e.g. losses incurred due to disasters: CTA(J) art.81-9(2)(i). See also F. Komamiya, “Branch Report: Japan” in International Fiscal Association (2004) 89b Cahiers de Droit Fiscal International : Group Taxation, at 398; and IBFD, “Asia Pacific - Taxation and Investment Database - Country Analysis - Japan (online database)” (2009) at [A.8.2], available at: http://www.ibfd.org/portal/Product_ap.html [Accessed March 9, 2010].

\textsuperscript{79} Theoretically, pre-consolidation losses may also be suspended during consolidation and revert back to the subsidiary when it leaves the consolidated group. However, in practice no country has adopted this policy in a consolidation regime, which is unlikely to be acceptable especially to countries with a loss carry-forward time limit.

\textsuperscript{80} ITAA 1997 Division 170. Upon the introduction of the consolidation regime, the scope of the group loss relief regime has been substantially curtailed and now it is applicable only to foreign bank groups with Australian branches and subsidiaries.

\textsuperscript{81} The recommendations of the Ralph Review on the loss offsetting rules of consolidation regime were designed to “overcome concerns that groups would be discouraged from consolidating because they could not carry forward . . . losses [into the consolidated groups]”: A Platform for Consultation, above fn.22 at 526. New Zealand faced a similar constraint in its design of a consolidation regime, but came up with a more flexible and taxpayer-friendly regime: both consolidation and group loss relief regimes co-exist.

\textsuperscript{82} The parent company can use the transferred pre-consolidation losses to offset against its taxable income, subject to loss carry-forward tests. In general, losses of a company can be carried forward indefinitely in Australia, if the majority of voting rights, dividend and capital distribution rights (\textgt;50\%) is beneficially owned by the same persons—this is known as the continuity of ownership test (COT). If a company fails the COT, it may still be able to carry forward its losses if it satisfies the “same business test” (SBT). The general loss carry-forward tests are modified to apply to a consolidated group. For example, if pre-consolidation losses were transferred to the parent company under the same business test (known as “SBT losses”), the losses are “refreshed” in the sense that previous ownership changes are ignored in subsequent ownership tests for the parent company. However, if the losses were transferred to the parent company under the continuity of ownership test (known as “COT losses”), past ownership changes are still recognised for subsequent tests: ITAA 1997 s.707.210. The law makes it clear that those transferred losses can be used only if the parent company has taxable
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losses in the year when the transfer occurs. To put the matter beyond doubt, it is deemed that the joining subsidiary "had not made the loss for the income year for which the joining entity actually made the loss".

The deeming positions are not reversed when the subsidiary leaves the group. Pre-consolidation losses of a subsidiary remain with the parent company for ever. The Government's argument for not transferring pre-consolidation losses back to the subsidiary seems to be circular: "an entity that joins as a subsidiary member is taken not to have made the loss". Basically, the Government's argument is that the losses would not revert back to the subsidiary because they had been deemed to be made by the parent company, not the subsidiary. It is puzzling why that deeming position during consolidation should prevent it from being reversed at leaving time. It is interesting to note that, among all the countries with consolidation regimes, Australia is the only country with this policy of irreversible transfer of pre-consolidation losses to the parent company.

The policy of transferring pre-consolidation losses to a parent company presents a serious problem to the Government: unrestricted utilisation of such transferred losses would have significant revenue impact. The solution is another invented concept: the available fraction (AF).

AF rules: basic principle and operations

The underlying design principle of the AF rules is stipulated in the tax law (author's italics):

"the amount of the [pre-consolidation] losses that the [parent company] can utilise is to reflect the amount of the loss that the transferor could have utilised for the income remaining after offsetting against its own losses: ITAA 1997 s.707-305(2) and s.707-310(3)(b). In other words, group losses have priority over pre-consolidation losses.

83 ITAA 1997 s.707-140(1).
84 New Business Tax System (Consolidation) Act (No.1) 2002 s.707.140 (1)(b).
85 Similar "no return" policies apply to other tax attributes of a joining subsidiary. For example, a consolidated group maintains only one franking account (which keeps track of the available imputation credits to frank dividends): ITAA 1997 Subdivision 709-A. Any pre-consolidation credit balance of a subsidiary is transferred to the parent company at joining time, and remains with the group for ever even if the subsidiary subsequently leaves the group. An exception to the policy of "parent company keeping tax attributes" is the CFC attribution surplus for CFCs held by a leaving subsidiary: ITAA 1997 Subdivision 717-E. The surplus is transferred to the leaving subsidiary in order to prevent double taxation of the same income that has already been taxed on an accrual basis under the CFC regime.

86 EM to May 2002 Consolidation Act at [6.111].
87 The Government was concerned about the revenue impact of such policy, as it was estimated that there was a "large store of past losses in entities ... approximately $44.6 billion revenue losses and $21.7 billion capital losses": A Platform for Consultation, above fn.22 at 561. To put the numbers into perspective, the taxable income of companies in the 1999–2000 income year was $129 billion: ATO, Taxation Statistics 1999-2000, available at http://www.ato.gov.au/corporate/content.asp?doc=/content/19759.htm&pc=001/009/005&mnu=1 [Accessed March 9, 2010].
88 Another way to restrict the impact on revenue is to impose additional tests (namely, modified ownership and same business tests) at joining time, attempting to ensure that the joining entity would have been able to use the carried forward losses itself if it had not been consolidated: ITAA 1997 Subdivision 707-A. Detailed discussion of these tests is beyond the scope of this article.
income year if the transferor of the loss . . . had not become a member of a consolidated group . . .\textsuperscript{89}

The provision may give an impression that the policy would produce results similar to those of the quarantine policy, namely the amount of pre-consolidation losses of a subsidiary that the consolidated group may use is equal to the amount of taxable income of that company calculated on a stand-alone basis. However, as shown below, the actual effect is very different.

The fundamental assumption guiding the design of the AF rules is as follows (author’s italics):

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In other words, for the purpose of restricting the usage rate of pre-consolidation losses, the AF rules imposes a cap equal to a portion of the group’s consolidated taxable income. The portion is basically determined by the following ratio at the joining time:

$$\frac{\text{market value of the subsidiary}}{\text{market value of the group}}.\textsuperscript{91}$$

This ratio is known as the AF of the bundle of pre-consolidation losses of a particular subsidiary that is transferred to the parent company.\textsuperscript{92} It is important to note that the value of the AF determined at the joining time is not reassessed on a regular basis, even if the market values of the subsidiary and the group change over time.\textsuperscript{93}

\textsuperscript{89} ITAA 1997 s.707-305(3). The idea of using the “market value” of a company as the proxy for its income-generating capacity originated from the “s.382 loss carryover” rule in the US. Detailed discussion of the rule is beyond the scope of this article. In broad terms, it would be triggered if there is a majority change (i.e. more than 50%) of share ownership in a company. If so, the amount of loss offset in general is limited to the value of the company at the ownership change time multiplied by a deemed rate of return. For a brief discussion of the rule and the rationale behind the limitation, see Ault and Arnold, above fn.1 at 318. Australia is possibly the first country to adopt this idea in the context of consolidation. It is interesting to note that the US did not adopt the idea in its own consolidation regime.

\textsuperscript{90} ITAA 1997 s. 707-305(4)(b) and (5).

\textsuperscript{91} ITAA 1997 s.707-320. In particular, the market value of the joining subsidiary is adjusted for (1) items that are deemed to have no income-generating power, namely loss and franking account balance; and (2) intra-group shareholdings to avoid double counting: ITAA 1997 s.707-325 and EM to May 2002 Consolidation Act at [8.75] and [8.77]. The market value of the group is adjusted for items in (1) above: ITAA 1997 s.707-325(1).

\textsuperscript{92} For example, if a subsidiary has $100 pre-consolidation loss (with an AF of 0.5) transferred to the parent company, and the group has a net taxable income of $60 in an income year, the parent company can use up to a maximum of $30 (i.e. $60 x 0.5) of that bundle of pre-consolidation loss for the year.

\textsuperscript{93} The value of AF may be adjusted—which would always be downward—if certain specific events occur, e.g. the consolidated group acquires another loss subsidiary, or the consolidated group is acquired by another group: ITAA 1997 s.707-320(2).
AUSTRALIA’S CONSOLIDATION REGIME

Problems of AF rules

Flawed assumption

The underlying assumption of the AF rules is that “market value reflects capacity to generate income or gains in future”.94 This is a highly questionable assumption. Market value does not necessarily reflect income-generating power. For example, General Motors group may still have a substantial market value, but few people would predict the group to generate any substantial profits in the foreseeable future.95 The market value may simply reflect the realisable values of assets in case of liquidation.

A proxy should not be used if a more precise measure is readily available. Experience in most other countries strongly suggests that a much more precise measure is indeed available: the actual taxable income generated by the subsidiary during consolidation.96 The following statement suggests that the Government had dismissed this “quarantine” policy too readily (author’s italics):

“A proxy [for the actual income generated by the subsidiary] is necessary because immediately after joining, the loss entity’s activities are, for income tax purposes, merged with those of the head company so it is not possible to determine the amount of the group’s income actually generated by the loss entity.”97

This statement is a testament to the overwhelming influence of the strong SER on policy makers in Australia. The experience of most other countries with consolidation regimes suggests that the statement is wrong. It is indeed possible to determine the taxable income generated by the subsidiary during consolidation.98

“Outdated” value of AF

The value of AF attached to pre-consolidation losses of a subsidiary is determined at its joining time, based on the prevailing market values of the company and the group. The value is not updated regularly to reflect changes in market values of the company and group over time.

For example, assume parent company P acquires 100 per cent of a subsidiary A (with pre-consolidation losses of $100) and consolidates in Year 1, and the market value of A is 40 per cent of the market value of the whole group at the joining time. The AF for the $100 loss bundle would be 0.4.

94 ITAA 1997 s.707-305(5).
96 For a brief discussion of this quarantine policy, see text above around fn. 76.
97 EM to May 2002 Consolidation Act at [8.18].
98 The preparation of separate tax computations is often necessary if a group member enters into a tax sharing agreement with the parent company: ITAA1997 ss.721-15(3) and 721-25. In general, consolidated group members are jointly and severally liable to the group tax liability, if the parent company defaults. However, the tax liability of a particular subsidiary may be limited to a certain amount by entering into a tax sharing agreement, under which the limit is determined by apportioning the group liability between group members according to a reasonable methodology stipulated in the agreement. Detailed requirements of the agreement can be found in the ATO’s Consolidation Manual, above fn.17 at [C9-7-110] and [C9-7-510].
Now assume the whole group has a taxable profit of $100 in Year 2, all contributed by A which has turned around in Year 2. If the group has not elected to consolidate, on a stand-alone basis, A would be able fully to utilise its pre-consolidation loss of $100 to offset the taxable income it generates in Year 2. However, if the group has consolidated, under the AF rules, the actual loss offset is limited to $40 (i.e. $100 × 0.4).

This example demonstrates that the AF rules fail to achieve the objective of reflecting the loss that a subsidiary could have utilised if it had not joined the consolidated group. The resulting limit of use rate is therefore arbitrary. One may argue that compliance costs would be too high if regular revaluation of group members is required. However, without such an exercise, the values of the AFs may become more irrelevant over time and even more detached from the actual income-generating capacity of each group member.

The problem of an “outdated” AF is also evident at leaving time. As pre-consolidation losses of a joining subsidiary stay with the parent company for ever, the AF for those losses remains effective even after the subsidiary has left the group.

Obviously, the group will no longer consolidate any taxable income generated by the ex-subsidiary. The continuing use of the historical AF violates again the objective of the AF rules, namely the AF is intended to be a proxy for the use rate of those losses against taxable income generated by that particular subsidiary.

A game of arithmetic.

The sum of the AFs of all loss bundles in a group cannot be more than one. Otherwise, the total amount of offset of transferred losses that could be used in a year would be more than the amount of the group’s taxable income. Therefore, the law provides for specific adjustments of the AFs under certain circumstances to ensure that the sum of all the AFs in a group is not more than one. For instance, an adjustment is triggered if a consolidated group with existing transferred losses either acquires another subsidiary with pre-consolidation losses, or is acquired by another consolidated group.99

It is interesting to note that all adjustment events will never adjust an AF upwards.100 This is so even if a particular subsidiary has turned around and makes substantial profits. The adjustments become mechanical rules to ensure that the sum of the AFs is not more than one, deviating from the original design principle.

Instead of a set of robust and carefully designed rules, the AF provisions resemble a game of arithmetic. Rules to deal with three kinds of situation can be identified:

1. Sum of AFs > 1: This is not acceptable under the rules of the AF game, because “it would incorrectly indicate that the group can generate more income than it actually does”.101 In that case, every AF of a consolidated group is scaled down so that their total becomes 1.102

2. AF = 0: If a subsidiary has a nil market value, its pre-consolidation losses would have an AF of 0.103 It means that those losses cannot be used by any entity in

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99 ITAA 1997 s.707-320(2).
100 This is clearly the intention of the Government, which states that an “adjustment event can never result in an increased available fraction”: EM to May 2002 Consolidation Act at [8.53].
101 EM to May 2002 Consolidation Act at [8.62].
102 In particular, all AFs are adjusted by the factor of “1 / (the total of all AFs)”: ITAA 1997, s.707-320(2) item 5.
103 The Government was fully aware of this possibility: EM to May 2002 Consolidation Act at [8.67].
future. This is so even if the subsidiary actually turns around after joining the consolidated group.\(^{104}\) This rule means that the AF rules as a whole not only fail to achieve their objective, but also can be less beneficial than the old group loss relief rules.

(3) **Negative AF:** It is possible that an AF can be adjusted to a negative number.\(^{105}\) To make the AF rules work in practice, the law stipulates that if an AF is negative, it is deemed to be 0.\(^{106}\) This stipulation implies that the corresponding pre-consolidation losses are lost for ever. This outcome is harsh, and at odds with the objective of the AF rules.

The “game” nature of the AF rules is made more obvious by the option under which a parent company may elect to cancel pre-consolidation losses of a joining subsidiary.\(^{107}\) The effect of the election is that the loss would be lost for ever and cannot be used by any entity.\(^{108}\) Intuitively, one may wonder why a parent company would want to cancel a loss. After all, intra-group loss offset is one of the most important benefits of consolidation. The answer lies in the design of the AF, under which the use rates—in terms of AFs—of all bundles of pre-consolidation losses transferred from different subsidiaries become inter-dependent. In particular, if a subsidiary with pre-consolidation losses joins a consolidated group with existing transferred pre-consolidated losses, AFs of all existing loss bundles of the parent company are always adjusted downwards.\(^{109}\) A parent company may therefore prefer to sacrifice the new pre-consolidation losses rather than have the use rates of its existing loss bundles reduced.\(^{110}\) The option to cancel pre-consolidation losses defies common sense and highlights the arbitrariness of the AF rules. Corporate groups have to evaluate carefully the tax effects before deciding whether or not to cancel the losses.

**Complexity**

Market valuations are inherently uncertain and prone to manipulations. In practice, a range of valuations is possible, thus creating an incentive to adopt a value that gives the best tax outcome. Both compliance and policing costs are high.

\(^{104}\) A possible way to increase the AF value was by a special concession that was available to groups that consolidated during the transitional period (i.e. July 1, 2002 to June 30, 2004). It allowed value to be added to such a subsidiary under the value donor concession regime: Income Tax (Transitional Provisions) Act 1997 s.707-325 and EM to May 2002 Consolidation Act at [8.67] and [9.2].

\(^{105}\) For instance, this bizarre outcome is possible if a consolidated group with existing transferred losses acquires a new subsidiary with pre-consolidation loss, and the market value of the subsidiary is more than the market value of the group at the joining time: EM to May 2002 Consolidation Act at [8.68].

\(^{106}\) ITAA 1997 s.707-320(6).

\(^{107}\) ITAA 1997 s.707-145. The choice is irrevocable.

\(^{108}\) ITAA 1997 s.707-150.

\(^{109}\) The adjustment is done by this factor: (1 minus AF) of the new transferred loss: ITAA 1997 s.707-320(2) item 3.

\(^{110}\) EM to May 2002 Consolidation Act at [6.109]. The cancellation of the losses may also benefit a consolidated group in the context of the TCS calculation, as one of the adjustments in the calculation is to reduce the ACA by certain losses of a joining subsidiary that are transferred to the parent company: Step 6 in ITAA 1997 s.705-60.
In addition, a group is required to trace each bundle of losses with its AF. Anti-avoidance rules are required to target arrangements attempting to manipulate the AF values, including two cases in particular:

1. inflating market value of a joining entity by capital injection or non-arm’s length transaction within four years before the joining time;\(^{111}\) and
2. inflating market value of a group after a loss subsidiary joins the group by capital injection or non-arm’s length transaction.\(^{112}\)

**AF: a good choice?**

The Australian Government claims that the objective of the AF rules is to reflect the loss use rate if the subsidiary has not joined the consolidated group. With the questionable use of “market value” as a proxy for the actual tax positions of a company, and the failure to adjust the market valuations on a regular basis, the AF rules fail to achieve the objective.\(^{113}\)

However, if one accepts that the most important objective of the AF rules is to restrict the use rate of pre-consolidation losses, the mechanical AF calculations seem to serve that purpose well. This is especially so given that the AFs of a group can only be adjusted downwards under all adjustment events.

It may be more accurate to describe the AF rules as simply a rough measure to allocate a group’s taxable income to individual group members for the purpose of controlling the use rates of pre-consolidation losses.

Ironically, another advantage of the AF rules is a result of its arbitrariness. In comparison with models in other countries, specific anti-avoidance provisions are not required in Australia to prevent abuses of loss offset rules by intra-group asset transfers. For instance, specific anti-avoidance provisions are required in Italy and the Netherlands to prevent accelerating utilisation of pre-consolidation losses of a company by intra-group transfer

\(^{111}\) ITAA 1997 s.707-325(2)-(4). The ATO’s position on this provision is stated in TR2004/9 available at [Accessed March 18, 2010].

\(^{112}\) ITAA 1997 s.707-320(2) item 3. The “capital injection” trigger is particularly problematic in practice, as AFs would be adjusted downwards for every capital injection, even if the injection is a normal commercial capital raising exercise without any tax avoidance motive: Stolarek, above fn.3, 212.

\(^{113}\) It is interesting to note that the AF concept was never considered in the consultation process of the consolidation regime. The Ralph Committee had considered six options to deal with the pre-consolidation loss issue: *A Platform for Consultation*, above fn.22 at [26.90] to [26.99]. The final recommendation of the Ralph Committee was a mixture of most of the options: The Ralph Report, above fn.5, at 524. In essence, it recommended that all pre-consolidation losses could be rolled over into the group, subject to a limit of the use rate for certain losses. In broad terms, except for pre-consolidation losses attributable to the group’s ownership, other losses in general would be brought into the group over a five-year period: see the Ralph Report, above fn.5, Recommendation 15.3. The Government did not adopt the recommendation of the Ralph Report. No clear reason was given except the following paragraph (author’s italics): “The available fraction method departs from Recommendation 15.3 of A Tax System Redesigned. It was developed in consultation with interested taxpayers and their advisers after earlier consultations concluded that the method contained in Recommendation 15.3 would be *inequitable in certain circumstances*”: EM to May 2002 Consolidation Act at [8.4]. The Government did not elaborate what circumstances would lead to inequitable outcomes.
of assets with hidden reserves. This kind of provision is not necessary under the AF model, as the utilisation rate is not dependent on a subsidiary’s individual taxable income. It is doubtful if this advantage is sufficient to justify the problematic AF rules, which are detached from the actual circumstances of a company. The AF rules would still apply regardless of whether or not there has been any intra-group transfer of assets with hidden reserves. With this “presumed guilty” effect, one may argue that the AF rules are not fair to all taxpayers.

Corporate groups seem to be content to play the AF game, despite the problematic rules. If a group can generally claim pre-consolidation losses at a reasonable rate, it may not have much incentive to complain. The flexibility in the market valuation process may also provide some room to manoeuvre.

Interactions with other income tax regimes

The SER in Australia makes the interactions between the consolidation and other parts of the income tax regimes more difficult. The SER represents a strong application of the enterprise doctrine which by definition contradicts the traditional separate entity doctrine. The following discussion of three particular issues illustrates the problems arising from the interactions between the regimes.

Elections by individual group members

If group members have made inconsistent elections under income tax law before joining a consolidated group, how should the consolidation regime reconcile the differences?

Under a typical pooling system, group members remain to a large extent as separate entities in the sense that each company prepares its own tax computation on a stand-alone basis first, before aggregating the results to arrive at the group’s consolidated profit or loss. Individual elections made by a group member in general would not affect the tax computations of the others. In other words, a pooling system is flexible enough to cope with inconsistent elections among group members.

Australia’s strong SER deems subsidiaries to become “parts” of the parent company. The fiction of “subsidiaries becoming divisions” poses significant problems if group members have made inconsistent elections. The parent company—which is deemed to have absorbed all its subsidiaries—cannot have inconsistent elections within itself.

114 Testo unico delle imposte sui redditi (Income Tax Code of Italy) art.123(2) and Wet op de vennootschapsbelasting 1969 (Corporate Income Tax Law of the Netherlands) art. 15ae(2).

The potential pain imposed by the AF rules was reduced by specific concessions during the transitional period. In broad terms, there were two concessions available to groups that consolidated during the transitional period (from July 1, 2002 to June 30, 2004): (1) value and loss donor concession: a joining subsidiary might include market value and losses from another joining subsidiary for the purposes of the AF rules; and (2) certain pre-consolidation losses might be amortised over three years, instead of subject to the AF rules: Income Tax (Transitional Provisions) Act 1997 ss.07-325 and 707-350. For a detailed explanation of the concessions, see EM to May 2002 Consolidation Act Ch.9. In practice, it was possible to make use of the value and loss donor concession to put all losses and values in one company, thus achieving an AF of 1 for the bundle of transferred losses from that company. However, groups that consolidate after the transitional period are not eligible for the generous concession. As the concessions were no longer available to groups that consolidate after June 30, 2004, their detailed discussion is beyond the scope of this article.

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The solution is to impose specific overrides of both the SER and the election provisions.\footnote{ITAA 1997 Subdivisions 715-J and 715-K. The rules apply equally to subsidiaries in both joining and leaving cases.} On one hand, though pre-consolidation elections of a subsidiary in general would be deemed to be made by the parent company pursuant to the SER,\footnote{In particular, for the purpose of determining the taxable income of the head company of a consolidated group, the entry history rule deems “everything that happened in relation to a [company] before it became a subsidiary member [of the consolidated group] to have happened in relation to the head company”: ITAA 1997 ss.707-325 and 707-350.} a specific override allows the parent company to ignore pre-consolidation elections. On the other hand, even if the tax law stipulates that certain elections are “irrevocable”, the consolidation regime overrides the restriction and allows the parent company to make a new election which can be different from the original elections.

The elections eligible for these overrides are listed in the tax law.\footnote{ITAA 1997 ss. 715-660 and 715-665.} The Government expects that “additional items will be added to this list as more elections are recognised which require this treatment”.\footnote{EM to Tax Laws Amendment (2004 Measures No.6) Act 2005 at [1.186]. The Government seemingly was quite confident that the list would get longer, as that expectation was repeated twice in the Memorandum at [1.202] and [1.224]. Indeed, the Government is right. For instance, the elections under the “Taxation of Financial Arrangements” regime were added to the list in March, 2009.}

The Australian experience on this issue suggests that a pooling system would be simpler as it is flexible enough to cope with inconsistent elections made by group members. In contrast, a stronger application of the enterprise doctrine tends to be more problematic and make the tax law more complex. Furthermore, elections are irrevocable often for a good reason, for example, because the regime is an anti-avoidance measure. The SER dictates an override of the restriction, effectively allowing consolidated groups to revoke previous elections made by group members. In contrast, revoking an “irrevocable” election is not possible for unconsolidated companies. The policy not only violates the original objective of making the election irrevocable, but also represents a bias towards consolidated groups.

Intra-group assets created during consolidation

This issue relates to intra-group assets that are created during consolidation. What should be the tax treatment if the asset is sold to a third party? Should it be treated as a disposal of an existing asset, or as creation of a new asset between the consolidated group and the third party? The issue arises from the fundamental distinction between two alternative interpretations of the single entity concept under the enterprise doctrine:

1. **“existing but ignored”**: The asset is recognised as existing during consolidation, but does not give rise to immediate tax implications to the consolidated group as long as the asset remains within the group.
2. **“deemed not to exist”**: The asset is deemed not to exist during consolidation, thus does not give rise to tax implications to the consolidated group until the asset leaves the group.

The two alternatives may appear to be similar, as both do not give rise to immediate tax implications as long as the asset remains with the group. However, the distinction can be crucial when the asset leaves the group.
A typical pooling system treats intra-group assets as “existing but ignored”. This interpretation of the single entity concept lies closer to the separate entity doctrine which is the underlying theory for other income tax regimes. Therefore, a consolidation regime with this “recognised but ignored” policy meshes better with the other regimes. In particular, the normal tax rules on disposal of assets would apply comfortably to these assets.

The “deemed not to exist” interpretation poses more serious problems. Under a strong application of the enterprise doctrine, subsidiaries are deemed to be divisions of the parent company. Accordingly, the intra-group asset created during consolidation may be treated as an internal arrangement within a company. In that case, the disposal of the asset may be treated as a creation of a new asset between the consolidated group and the third party. The tax implication of creating as a new asset may be very different from treating the transaction as a disposal of an existing asset.

The Australian consolidation regime provides telling experience on this issue. One may expect that the strong SER would imply adoption of the “deemed not to exist” policy. However, in practice, the tax authority appears to struggle when applying the SER to these intra-group assets, and fails to have a consistent policy on the issue.

The ATO in general override the SER by treating the disposal of these “internally generated” intra-group assets as disposal of an existing asset. The ATO position highlights the shortcoming of the strong SER (author’s italics):

“The SER gives effect to the legislative intention that the consolidated group (being the head company) should be treated in a similar way to a single company for income tax purposes. An analogy used is that the income tax outcomes of transactions within the group should be similar to the outcomes for a single company that operates through divisions. However, the intra-group assets of a consolidated group represent rights between members of the group. Such rights could not exist between divisions of a company. Accordingly, the income tax law has regard to intra-group assets on being transferred to a non-group entity.”

The fiction created by the SER contradicts the fact. The ATO recognise that the intra-group assets actually exist, and decides to apply the tax law according to the fact. The SER has to be overridden to arrive at the appropriate tax outcome.

In other words, the ATO in general adopt the “recognised but ignored” policy. For instance, they recognise that intra-group shares do exist under consolidation, thus overriding the SER that deems subsidiaries as not existing during consolidation. The ATO justify their position with the following argument (author’s italics):

“The single entity rule does not apply to defeat a clearly intended outcome under provisions outside the consolidation rules... intra-group interests... require a level of recognition in applying provisions that have regard to such interests and entities...
we think that a membership interest in an entity that is a subsidiary member of a group is able to be recognised at the time the contract [for the disposal of the interest] is made."

A couple of observations can be made on the argument. First, the ATO recognise the difficulty of reconciling the strong SER with the other income tax regimes (in this case, the capital gains tax regime). It has to make a specific override of the SER in order to ensure that the capital gains tax (CGT) rules can apply properly. Secondly, the ATO appear to be uncomfortable with the override. The choice of words in the tax ruling is unusual: “we think that” is seldom used in ATO official rulings and determinations. It may be a sign of uncertainty in the ATO’s own position on the issue.

The ATO adopt a similar position for options and licences created between group members. However, they fail to maintain a consistent “recognised but ignored” policy on all intra-group assets. In contrast to the positions discussed above, the ATO adopt the “deemed not to exist” policy for an intra-group income stream (e.g. future interest income stream on an intra-group loan). They try to justify their position by the following argument (author’s italics):

“Under the single entity rule, an arrangement between members of a consolidated group is taken to be an arrangement between parts of the head company. Where such an arrangement involves a right to income, the obligations and payments will not be recognised . . .”

The statement represents a faithful interpretation of the SER. However, it is a mystery why the ATO do not apply this interpretation to intra-group shares, options and licences.

123 ATO, TD2004/40 at [3] and [4].
124 Another possible reason for the ATO’s override is to ensure symmetric treatment for both seller and buyer of the shares. By overriding the SER and treating the transaction as a disposal of existing shares in a subsidiary, the capital gains tax regime can apply symmetrically to both parties: TD 2004/40 at [7].
125 ATO, TD2004/34 and TD 2004/35. Pursuant to these rulings, options and licences granted with a consolidated group are recognised as existing assets, thus allowing the normal CGT rules to apply. A careful perusal of the determinations suggests that the ATO appear to be more confident in overriding the SER in these cases. A possible reason is that the override in respect of intra-group shares is a direct contradiction to the statute which explicitly stipulates that subsidiaries “are taken . . . to be parts of the head company of the group, rather than separate entities, during [consolidation]” (author’s italics): ITAA 1997 s.701-1(1).
126 ATO, TD2004/85. The consequence of the “deemed not to exist” policy is that a transfer of the income stream to a third party would be treated as a creation of a new asset by the parent company. A possible reason for the ATO position on this intra-group asset is an avoidance concern. By characterising the assignment as a “creation of contractual rights” similar to borrowing of money by the parent company from the third party, the ATO position ensures that the transaction is subject to the specific anti-avoidance regime (namely ITAA 1936 Division 16E (Division 16E)) dealing with the issue of certain discounted and deferred interest securities. The intention of the ATO to apply Division 16E to the assignment is clear: see TD 2004/84 at [7] and [13]. It should be noted that the original intra-group loan is not subject to Division 16E as it is not recognised under the SER. The ATO also apply the “deemed not to exist” policy on intra-group debt: TD2004/33. By denying the debt as an existing asset, the transfer of debt is characterised as “effectively the borrowing of money” by the parent company: ATO, TD 2004/33 at [1]. This position again ensures that Division 16E can apply to the “newly created” debt: ATO, TD2004/84.
127 TD 2004/85 at [5].
Conversely, it is puzzling why the ATO do not maintain a consistent override of the SER in the current case.

The position of the ATO becomes even more confusing when it argues in a seemingly self-contradicting way (author’s italics):

“Notwithstanding that under the single entity rule the head company did not recognise the intra-group transaction . . . this [intra-group] underlying agreement may still be relevant in determining what rights and obligations the head company is taken . . . to have entered into with the non-member entity.”

It is not clear how the logic works in this argument. If a transaction is not recognised at all, how can it be still relevant in determining tax outcome? The problematic argument highlights the difficult struggle to deal with the constant tension between the enterprise and separate entity doctrines.

Thin capitalisation regime

If a regime is designed to apply different rules to a company depending on its particular circumstances, applying it to a consolidated group may be problematic. For example, the thin capitalisation regime in Australia applies different limitations on interest deductions to different categories of companies, e.g. outward versus inward investors, general versus financial investors, and authorised deposit taking institutions (ADIs) (i.e. banks) or non-ADIs.129

Detailed discussion of the categorisation rule is beyond the scope of this article. It is sufficient for the present purpose to understand that the rules are designed to operate on a company stand-alone basis. Each company is to be categorised before the corresponding tests and interest deduction rules are applied.

The thin capitalisation regime struggles if a consolidated group consists of companies falling into different categories. Under the strong SER, all subsidiaries are deemed to have become parts of the parent company. How can the rules be applied to the parent company that in fact consists of subsidiaries of different categories?

The solution is to have a specific categorisation rule for consolidated groups.130 In broad terms, the rules would apply to a consolidated group depending on one single group-wide categorisation. For example, if, among other things, the group had at least one financial entity, the whole consolidated group would be categorised as an “outward investor (financial)”131. This is so even if some other group members fall into other categories on a stand-alone basis. In other words, the categorisations of individual group members may be overridden by these special rules.

One may question whether the specific override of the categorisation of each group member would defeat the original objective of the thin cap rules. After all, the sophisticated categorisations in the thin cap regime presumably are carefully designed to ensure

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128 TD 2004/85 at [6].
129 ITAA 1997 Division 820.
130 ITAA 1997 Division 820. Another set of special rules apply if the parent company of a consolidated group is a member of a wholly-owned group with a foreign financial institution: ITAA 1997, Subdivision 820-FB.
131 ITAA 1997 s.820-583(3). A similar rule applies if at least one group member is an ADI: ITAA 1997 s.820-583(7).
application of the most appropriate interest deduction limitations to each category of companies. It is doubtful if the overrides of these categorisations within a consolidated group would imply applying inappropriate limitations to the group members.

Conclusion

The Australian consolidation regime is a bold attempt to apply the enterprise doctrine and tax a corporate group as one single entity. The SER—driven by the determination to deal with the dual cost bases issue—is the strongest single entity concept applied in a consolidation regime to date. Upon consolidation, the SER deems that there is only one company left in the consolidated group: the parent company. Subsidiaries are deemed to have ceased to exist for tax purposes and their assets are deemed to be held directly by the parent company.

Under the SER, the consolidation regime has a couple of distinct attractions. First, unlike most other consolidation regimes, intra-group asset transfers within a consolidated group are ignored completely. The transfers not only would have no immediate tax implication, but also would not require tracing of asset movements, keeping record of any deferred gain or loss, or recapturing the gain or loss when either the transferor or transferee leaves the group. Secondly, again in contrast to most other consolidation regimes, pre-consolidation losses of a joining subsidiary in general are transferred to, and can be used by, the parent company, without the need to compute the subsidiary’s “stand-alone” taxable income every year. In other words, once a group enters the “asset-based” consolidation regime, it is a wonderful tax-friendly world to be in.

However, there is no free lunch in the real world. The price to pay for these advantages is high, especially at the transition points when a company goes into or gets out of the consolidation regime. The impact of the strong SER is far-reaching and dictates the following tax implications:

1. Once a subsidiary joins a consolidated group, it loses forever its right to claim its pre-consolidation losses both during consolidation and after it leaves the group.
2. The original cost bases of many assets (including depreciating and capital assets) of a joining subsidiary are erased forever once it joins a consolidated group. This is so even if the leaving company continues to own the assets without any intra-group transfers during consolidation.
3. The original cost bases of shares in a joining subsidiary are also erased forever upon consolidation. They are reconstituted at leaving time based on the cost bases of assets (including “reset” cost bases) that the company holds at that time.

Once a subsidiary joins a consolidated group in Australia, it is a road of no return for the tax attributes referred to above. These tax attributes are changed or erased forever. There is no mechanism to revert back to the original figures when the company leaves the group. The tax cost setting rules are based on flawed theory, if there is a theory at all. The problems are fuelled by the implant of accounting liabilities into the TCS calculations. They can produce outcomes that are detached from reality and defy common sense. The $74 land example vividly illustrates the problems. Artificial gain can be generated through the TCS process, which can even be duplicated at leaving time. In practice, well-advised taxpayers are more likely to turn this “double trouble” into duplication of losses.
policy of allowing step-up cost bases of assets is arguably too generous, and encourages taxpayers’ creativity.

The AF rules on pre-consolidation losses are based on questionable assumptions and can produce arbitrary and anomalous results. They fail to achieve the Government’s stated objective of approximating the loss use rate as if a subsidiary has not joined consolidation. Nevertheless, if one accepts that the primary objective of the AF rules is to restrict the usage rate of pre-consolidation losses, they have in practice effectively achieved that objective despite being a rough, if not arbitrary, means to do so.

The heavy reliance of the TCS and AF rules on market valuations of assets and companies implies high compliance and policing costs, and provides avoidance opportunities.

Another problem of the strong SER is the difficult interactions between the consolidation regime and other parts of the income tax system. Most regimes in the tax law are designed under the traditional separate entity doctrine, which by definition contradicts the enterprise doctrine squarely. The strong SER renders application of other tax regimes to consolidated groups more difficult.

Despite all these problems, the Australian regime is likely to be a road of no return for the Government. Businesses are busy celebrating the “step-up” cost bases and offset of pre-consolidation losses against group profits. Reversing these policies is therefore politically unacceptable. Nevertheless, it remains doubtful whether the regime—with the problems discussed above—would be an attractive model for other countries.