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Tax Consolidation Not Always a Happy Marriage

Many of our readers will have seen Ben Stiller's new movie (or at least the trailer) "The Heartbreak Kid". In the movie, Ben Stiller marries a woman who he believes will bring him eternal happiness only to find she was a nightmare. And so it can be with entry into the tax consolidation regime. What appears in the first instance to be a perfect match provides hidden nasties.

This article focuses on identifying the nasty surprises. Before doing so, however, to prove we are glass half full people at JR, a quick bullet point review of the possible benefits of tax consolidation.

- Profits and losses within the consolidated tax group can be offset;
- All franking credits in the consolidated group are immediately transferred to the head company;
- Assets can be transferred between companies in the consolidated group without taxation consequences (note though that stamp duty may still apply);
- Dividends can be paid between companies in the consolidated taxation group without taxation consequences (in the absence of tax consolidation, unfranked dividends between companies are taxable).
- The tax cost of assets in subsidiary companies may be uplifted on entry into the tax consolidation regime;

- Taxation losses carried into the tax consolidation regime under the restrictive same business test may be refreshed as continuity of ownership test losses (preserving them in circumstances where the same business test was likely to be failed).

Nasty No. 1 – Rate of Usage of Transferred Tax Losses

The rate at which tax losses transferred into a consolidated group can be used is regulated by what is referred to as an available fraction.

In simple terms, the available fraction is the market value of the loss company divided by the market value of the entire consolidated group at the time the loss company joins the group. The amount of transferred tax losses that can be used in any particular year by the consolidated tax



group is calculated by multiplying the taxable income for that year by the available fraction.

The lower the available fraction, the lower the amount of tax losses that can be used in that particular income year (note, the balance can be carried forward subject to satisfying the normal tests).

The available fraction is proportionately reduced for capital raisings in the period four years before consolidation and then any capital raising post tax consolidation (where transferred losses remain unutilised). Accordingly, in many circumstances, the available fraction will be so low that the losses have little value. → page 2

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In the absence of tax consolidation, it is possible that losses could be recouped at a much faster rate in the relevant subsidiary (although it will be critical to be mindful of the requirement to satisfy a same business test).

Tip If losses are being transferred into a tax consolidated group, it is critical to determine the impact of past and future capital raisings on the available fraction.

Nasty No. 2 – Reset of the Tax Cost of the Assets in the Subsidiary is Unfavourable

It is generally understood that where a premium is paid over the net book value of assets when acquiring a subsidiary that the reset of the tax cost will be favourable.

For illustration purposes, consider a subsidiary which holds only one asset being land and no liabilities. Assume the land has a book value (cost) of \$100 and a market value of \$200. If the subsidiary is acquired for \$200 and then consolidated for tax purposes, the tax cost of the land will be uplifted to \$200. To illustrate the hidden nasty, assume that the subsidiary was not consolidated for tax purposes until twelve months after the acquisition date.

During the twelve month period post acquisition (and pre tax consolidation), the company commenced a business on the land. Assume that the business was funded with new capital as follows:

- \$200 to buy stock
- \$100 to buy plant and equipment

The business was a roaring success and made a profit of \$400 for the year. On the basis of the first years trading, the goodwill of the business is valued at \$1,600. We will also assume the market value of the land has not moved. Further, assume that all profits were paid out immediately prior to tax consolidation and there was no depreciation charge. The closing stock figure immediately prior to tax consolidation was \$100.

Immediately prior to tax consolidation, the cost of the shares was \$500 (being \$200 initial acquisition plus the \$300 introduced as new capital). As there are no liabilities or retained profits in the subsidiary at the date of

consolidation, \$500 becomes the allocable cost amount (or the amount used to reset the tax cost of the assets in the subsidiary).

A summary of the assets of the subsidiary on consolidation is as follows:

Asset	Book Cost (Existing Tax Cost)	Market Value	%
Land	100	200	10
Stock	100	100	5
Plant & Equipment	100	100	5
Goodwill	-	1,600	80
		2,000	100

The allocation of the \$500 allocable cost amount (ACA) is as follows:

Asset	%	Allocation
Land	10	50
Stock	5	25
Plant & Equipment	5	25
Goodwill	80	400
	100	500

This rather extreme illustration shows how the allocations to land, plant and equipment and stock are all lower than their original tax cost prior to consolidation.

There are a number of circumstances where this adverse outcome can arise, as follows:

- 1 A subsidiary is acquired at a discount to its market value;
- 2 The consideration paid for shares in a subsidiary does not reflect the market value of the subsidiary at the date of consolidation (because of say a creeping acquisition of shares over time);
- 3 The tax cost of assets in a subsidiary is greater than the market value of the assets at date of acquisition;
- 4 Intangibles in the subsidiary increase in value in the period between acquisition and tax consolidation;
- 5 The allocable cost amount (ACA) by definition excludes certain liabilities such as provision for rehabilitation or leased asset liabilities (note however that leased assets do not receive an allocation of ACA).

This can cause a shortfall in the amount available to allocate to the company's assets.

Tip Check there are no unfavourable outcomes from resetting the tax cost of assets prior to making a decision to consolidate.

Nasty No. 3 – CGT Event L3

In resetting the tax cost of the assets in a subsidiary, the ACA amount is firstly allocated to assets such as cash, debtors and receivables on a dollar for dollar basis. These assets are referred to as retained cost assets. The balance of the ACA amount is then allocated to the remaining assets in the manner set out in the example provided in Nasty No. 2. These remaining assets are referred to as reset cost assets.

Where there is not enough ACA to allocate to the retained cost assets, a capital gain arises to the parent company on consolidation equal to the deficiency. The capital gain arises under CGT Event L3.

Consider the following illustration. A subsidiary company with a single receivable of \$100 is to be acquired for \$90. The \$10 discount reflects some uncertainty regarding the quality of the receivable. The ACA amount of \$90 is not sufficient to cover all the retained cost assets (\$100). Accordingly, a \$10 capital gain arises on consolidation.

Tip Ensure there is enough ACA to cover the retained cost assets.

Nasty No. 4 – Future Spin-off of Subsidiaries and Lost Franking Credits

As mentioned above, on consolidation, the franking credit balances in subsidiaries are transferred to the head company. In many circumstances this is viewed as a positive as sometimes these credits have been trapped in subsidiaries with insufficient retained earnings to release them.

Following tax consolidation, the following events will cause the subsidiary to leave the consolidated tax group.

- The subsidiary is sold;
- The subsidiary is demerged;
- The subsidiary raises share capital from a third party;
- The subsidiary is no longer 100% owned (with the exception where less than 1% of the shares are held by employees under an employee share scheme).

The subsidiary does not take any franking credits with it when it leaves the consolidated group.

Where the subsidiary has not distributed out its retained earnings prior to leaving the tax consolidated group, the new shareholders will be left with a future tax issue as the company may be forced to pay out unfranked dividends. It is also worthwhile noting here that subsidiaries leaving consolidated tax groups also leave behind all tax losses.

Tip Review the possible need for subsidiaries to retain franking credits before a decision is made to consolidate for tax purposes.



Nasty No. 5 – Same Business Test

To explain this nasty, it is necessary to firstly overview the rules regarding the testing of losses which have been transferred into a tax consolidated group. Firstly, the losses must have passed amended versions of either the continuity of ownership test (COT) or same business test (SBT) to be available to the tax consolidated group. Where the losses satisfied a COT on transfer to the group (referred to as COT losses), they will retain this status post consolidation. However, any changes in ownership post consolidation will be measured against the historic pre-consolidation period (that is the COT is not reset). If the COT is failed post tax consolidation, the group will have to rely on satisfying SBT to be able to utilise its losses in future years.

SBT is measured against the business activities of the consolidated tax group at the time the COT is failed (not at the time of tax consolidation). As mentioned above, SBT losses transferred to a tax consolidated group are refreshed as COT losses. Changes in ownership are then measured against the share register at the date of tax consolidation. It follows from the above that consolidated groups will not have to immediately rely on the SBT post tax consolidation. However, it is when changes in the beneficial ownership of the consolidated tax group arise and the COT is failed that the SBT must be relied upon. The Commissioner considers that the SBT is measured against the entire business operations of the consolidated tax group. That is business activities in subsidiaries are treated as divisions of the head company. Any change to these business activities may cause the SBT for the entire consolidated group to be failed.

Consider the example of a consolidated tax group which runs four separate businesses. If one of these businesses is sold, the Commissioner considers the SBT for the consolidated tax group will be failed. The use of these losses may be easier to manage without tax consolidation (as a subsidiary will only need to satisfy a SBT in respect of its own activities).

Tip If it is likely that the COT will be failed and there are proposed changes to the business operations of the consolidated tax group, it may be wise to reconsider or delay tax consolidation where significant losses may be forfeited.

Could be Nasty No. 6 – CGT Event L5

Rather than a pure nasty, CGT Event L5 only rates as a could be nasty. Could be nasty means that it will only be nasty with inadequate planning. When a subsidiary leaves a consolidated group, the head company is required to calculate the cost of the shares in the subsidiary for taxation purposes.

In very simple terms this cost is the tax cost of the assets in the subsidiary less the liabilities in the subsidiary at the time the subsidiary leaves the tax consolidated group.

Note that the liabilities are reduced for any unclaimed future tax benefit (i.e. 30% of leave provisions). Where this calculation is negative (i.e. adjusted liabilities exceed the tax cost of assets), a capital gain arises in the head company under CGT Event L5.

Where a potential CGT Event L5 may arise it is relatively easy to improve the net asset position of the subsidiary by forgiving intercompany debt with other group members or capitalising debt with other group members prior to exit.

As these transactions are conducted within a tax consolidated group, they are ignored for tax purposes (i.e. no commercial debt forgiveness issues).

Consider the following balance sheet of a subsidiary prior to exit:

Assets	
Cash	100
Debtors	200
	300
Liabilities	
Creditors	100
Intercompany (Parent)	400
	(500)
Net Assets	
	(200)

On exit CGT Event L5 would give rise to a capital gain of \$200 in the head company at the time of exit. However, if \$200 of the intercompany loan to the parent is either forgiven or capitalised into shares, no capital gain will arise.

Tip Check the balance sheet of subsidiaries prior to an exit for any CGT L5 exposure and take any corrective action.

Tax Office to Target Cross Border Financing

The differences between the Australian tax systems treatment of debt and equity and the treatment afforded by various overseas jurisdictions creates the opportunity for what is referred to as tax arbitrage.

In simple terms this means that it is possible to create financial instruments which are treated as debt in one country and equity in another. The implication arising is that the interest on the debt may be tax deductible in one country whilst the return is treated as a dividend in the other. The dividend in many jurisdictions will not be subject to taxation.

Accordingly, a global 30% tax benefit arises from the interest deductions on the debt (there is a withholding tax leakage which results in a minor reduction to this benefit).

To provide a simple illustration consider the following scenario. Aus Co. has a 100% owned NZ subsidiary (NZ Co.) NZ Co. borrows \$10 million from a NZ bank and subscribes for \$10 million preference shares in a new Australian subsidiary of Aus Co. (Aus Co. Sub).

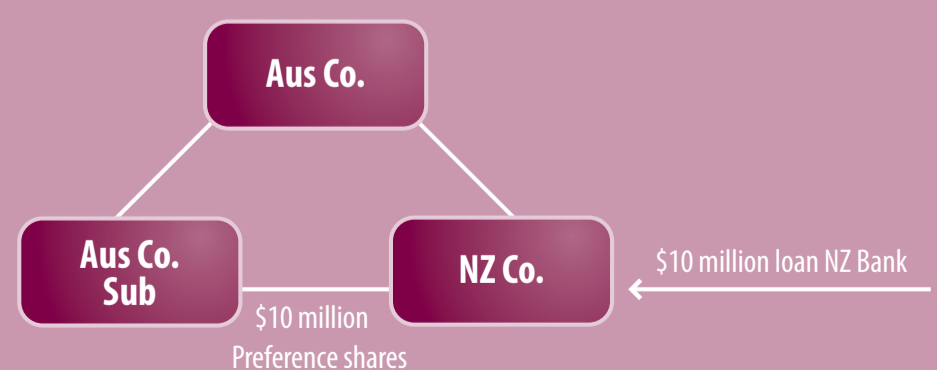
The preference share is treated as a debt instrument in Australia as Aus Co. Sub has a non contingent obligation to repay the face value of the share (and the preference share has a life of under 10 years). In NZ the return on the preference share is treated as a dividend and does not crystallise a taxation liability. Aus Co.

Sub is required to withhold tax at 10% on the interest payment. This tax does not realise a credit in NZ (as the dividend is not taxable). This is a simple illustration of a transaction which has numerous variations on the same theme.

The ATO has indicated a desire to review these structures. Assuming that the preference share is correctly structured as a debt instrument this is going to prove a difficult journey for the ATO auditors. Presumably, any attack will come under the general anti avoidance provisions contained in Part IVA of the 1936 Act.

In very general terms for the ATO to be successful they must establish an alternate hypothetical transaction which the parties would have utilised in the absence of the preference share instrument (which created the so called tax benefit). The starting point in any defence by the taxpayer would be that a generic debt instrument would have been used as the alternative financing structure. In Australia this debt instrument would have identical taxation outcomes to the preference share (which is also treated as a debt instrument). Accordingly, the ATO may not be able to prove to a Court that a tax benefit exists (and hence Part IVA will not apply).

It is early days on these issues, however, it appears the battle lines are being drawn.



ATO Postures to Attach Salary Costs on Capital Projects

The generally accepted position regarding the deductibility of salary and wages costs for employees working on capital projects (i.e. construction of assets) is as follows:

- (i) The salary and wages costs for ongoing employees are deductible.
That is, it is not necessary to apportion (capitalise) that component of the ongoing employees wages that are spent working on capital projects;
- (ii) The salary and wages costs of employees hired to work specifically on capital projects should be capitalised.

This means that amortisation/depreciation allowances are available rather than an outright deduction.

The ATO has challenged this conventional wisdom in a discussion paper issued in July "Income tax treatment of direct internal labour costs incurred on self constructed depreciating assets".

The ATO is taking the view that the salary and wages on employees involved in systematic work that directly results in the construction of assets is capital in nature.

This means that where ongoing employees are involved in material projects, the ATO view is that the salary and wages are capital in nature notwithstanding the employment status of the staff.

At first blush this conclusion appears inconsistent with existing case law and it is likely that this issue will now manifest itself into a dispute.

Watch this space.



Transfer Pricing Dispute

A major transfer pricing dispute has arisen between pharmaceuticals company Roche Products Pty Ltd and the Commissioner of Taxation.

The case has provided guidance on the Tribunal's view as to the appropriateness and application of accepted transfer pricing methodologies (refer below discussion). The case also highlights how in some cases small adjustments to profit margins can realise significant taxation adjustments.

As most readers will be aware at the heart of transfer pricing (be it in domestic tax legislation or Double Tax Agreements) is the requirement for cross border related parties to price transactions with each other on an arms length basis. Where the Commissioner of Taxation considers that arms length pricing has not been adopted he will make a transfer pricing adjustment potentially increasing the taxation payable in Australia.

It does not necessarily follow that the relevant overseas jurisdiction will agree to reduce the tax payable on the other side of the transaction.

In Roche Products the Commissioner of Taxation increased the tax payable in Australia for a number of income years following a transfer pricing audit.

In recent years the ATO have favoured transfer pricing methodologies which look to the level of profit derived in both jurisdictions by the parties as a function of risk and reward. That is at a holistic level how much profit is made in each country. The Administrative Appeals Tribunal appears to favour what is referred to as Comparable Uncontrolled Price (CUP) and similar traditional transaction methods. In simple terms, CUP involves looking at transactions between the relevant company and unrelated parties as a basis for setting the price in related party transactions. This has always been considered problematic by the ATO as it is difficult to find an apples vs apples comparison.

In other words, the terms of trade between unrelated companies are different to those between related companies making CUP a difficult methodology to apply. The case highlights how difficult it can be to manage a transfer pricing dispute with the ATO and how risky a legal battle on a transfer pricing issue may be.

At a practical level the minimum approach to any material transfer pricing issue should include the following:

- A document which overviews cross border transactions and justifies the pricing adopted;
- The use of an accepted methodology in setting the transfer price;
- Reconciliation with comparable transactions with unrelated parties;
- A level of management intuition that the transfer pricing can be defended as being at arms length.

New Faces in our Corporate Practice

JR is delighted to welcome Warwick Face to our Corporate Practice.

Warwick was most recently the CFO at RP Data Ltd and prior to that was a partner at Deloitte and a principal at Ernst & Young in Sydney. He will be actively involved in both our corporate finance and audit practices bringing both a commercial and technical focus to our Corporate work.

Warwick has particular skills in evaluating and executing acquisitions so if you are in the market give Warwick a call on (07) 3222 8302.



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