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New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

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New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002

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Date Introduced: 27 June 2002

House: House of Representatives

Portfolio: Treasury

Commencement: Other than the demerger provisions, which will commence on Royal Assent, the measures described in this Digest commence immediately after the commencement of the proposed *New Business Tax System (Consolidation) Act (No. 1) 2002*. However, all measures will apply from 1 July 2002, the date of commencement of the consolidation regime.

Purpose

To:

- introduce a general value shifting regime which will apply as an integrity measure to prevent tax minimisation through the shifting of value from one asset to another
- provide capital gains tax relief where a separate entity is demerged from a group if certain conditions are met
- introduce further, largely technical, components of the consolidation regime, many concerned with the treatment of international income, and
- amend the simplified imputation system to incorporate existing integrity rules.

Background

As there is no general background to the measures contained in the Bill the background for the measures described in this Digest will be discussed below.

Main Provisions

Value Shifting

While the proposed value shifting rules have an association with the consolidation regime, they will also apply to capital gains tax events which are not connected with a consolidation. The proposed rules are known as the general value shifting regime (GVSR) to emphasise their general application and also to distinguish them from the specific rules applying to value shifting which currently apply in relation to certain share arrangements and asset stripping. The proposed GVSR is an integrity, or anti-avoidance, measure.

The term 'value shifting' applies in cases where the value of one asset is increased while there is a decrease in relation to another asset held by the same entity in order to achieve a better tax position for the asset holder. As the valuation relates to assets rather than income, the taxation advantage sought to be achieved relates to the capital gains tax (CGT) rather than income tax.

As noted above, the proposed rules, while of general application, are associated with the introduction of the consolidation regime, which will substantially increase the opportunities for companies to revalue asset values as subsidiary companies join the consolidated group. As under the consolidation regime there will be no CGT implications from the change in ownership (so long as the consolidation rules are followed) and there will be opportunity to value assets in such a way as to achieve the best CGT result. This is particularly the case for smaller individual assets, such as trading stock, and intangible assets, such as goodwill, for which a range of valuations may be made.

Currently there are specific rules relating to value shifting in relation to share value and asset stripping. Briefly, a tax advantage can be denied where there is a scheme under which value is shifted from one share to another to reduce the CGT payable on the disposal of the share from which the value has been shifted. This can be achieved in a number of ways, such as by the issue of discounted shares to the taxpayer or an associate which reduces the value of the shares already held, or by transferring value from shares subject to CGT to pre-CGT shares. Asset stripping can occur where value is transferred between companies under common ownership with the result that either a capital loss is triggered or a capital gain reduced. The *Income Tax Assessment Act 1997* (ITAA97) contains provisions to deny a tax advantage where there is value shifting or asset stripping but these rules have been subject to some criticism.

The Review of Business Taxation in it's report 'A Tax System Redesigned' (the Ralph Report) found many problems with the current legislation, including:

- inconsistent application with, for example, value shifting applying to shares in companies but not to interests in trusts

- rules only applying where companies are under 100% common ownership rather than under the same control
- there are high compliance costs associated in ensuring that there is no technical breach of the rules, and
- the legislation containing the rules is very complex, largely as a result of it being 'without a solid base' and needing to be constantly amended.[1]

To overcome these and other difficulties with the existing rules, as well as improving the integrity of the tax system, the Ralph Report recommended a system of general value shifting rules. As part of the recommendations, a de minimus exemption was proposed (under which value shifts below a certain value would be ignored to remove the need to examine all transactions). This was seen as desirable to reduce compliance costs. The Ralph Report stated that following consultation it was considered that:

> A comprehensive de minimus exemption is needed which balances integrity considerations and containment of compliance costs.[2]

The Ralph Report also made a number of recommendations regarding the new GVSR, including:

- the GVSR apply to all entities and their associates
- that the rules apply where there is control of the other entity rather than ownership
- a de minimus rule be introduced, and
- that value shifts be recognised at the time they occur rather than at the time they are realised.[3]

The implementation of a GVSR was foreshadowed in the Treasurer's initial responses to the Ralph Report. That announcement was connected with the initial deferment of the proposed entity taxation regime, which it now appears will not be implemented. The GVSR to be implemented by this Bill was announced by the Assistant Treasurer on 27 June 2002 as part of the second instalment of legislation dealing with consolidation. The proposals were described as an integrity measure to prevent revenue loss arising from asset revaluation when entities consolidated.

The Explanatory Memorandum to the Bill estimates revenue gain from the GVSR at nil for 2002-03, $150 million for 2003-4, $160 million for 2004-5 and $170 million for 2005-6. From this revenue estimate it can be seen that there is not expected to be a 'spike' in revenue returns during the initial period of the operation of the consolidation regime, which could be expected if entity groups were waiting for the current legislation to be passed. It is also not clear whether the gain to revenue will be over revenue loss that could be expected if the GVSR was not introduced or from existing law, although the revenue gain appears to result from the extension of the rules to entities other than companies.

The GVSR will be introduced by **Schedule 15** of the Bill which will insert a number of new Divisions into the ITAA97. **Proposed Division 723** deals with the situation where value is shifted from a non-depreciating asset, including trading stock. The proposed Division will apply where an asset has been revalued to create a right in the asset to another entity which reduces the value of the asset from the original holder of the asset and this leads to either the owner or an associate of the owner receiving an interest in the asset and this interest results in a lower CGT value of the asset.

Where the interest created in the asset is greater than $50 000, or under arrangements where there are multiple rights created that exceed $50 000, and the creation of the interest does not give rise to a CGT event, the proposed Division provides that any decrease in the taxable value of the asset for CGT to be assessed as if the interest was not created. This will principally apply to capital losses created through the change of interests in the asset. However, the rules will not apply where the interest relates to conservation covenants over land or certain interests created due to the death of the asset owner (**proposed section 723-20**). Where only part of an asset is realised and is subject to the proposed rules, there will be a proportional assessment of the additional value based on the market value of the asset (**proposed section 723-25**).

Where there is an arrangement that results in a capital loss being generated in a non-depreciating asset 'just before' its disposal, **proposed subdivision 723-B** provides that the relevant cost base is to be reduced to take account of the arrangement.

Simplistically, **proposed Division 725** deals with situations where, under a scheme:

- a debt or equity interest in a company or trust has its value decreased
- the change in value is shifted to another interest in the trust or company, and
- the same entity has control of the interests.

In addition to applying to the controlling entity, the rules will also apply to associates of the controlling entity and to other active participants in the scheme (**proposed section 725-85**).

The rules have a number of restrictions, including that they do no apply to companies or fixed trusts that have more than 300 members or beneficiaries (**proposed section 725-65**).

A de minimus rule is contained in **proposed section 725-70** under which a scheme will only fall under the proposed Division if the total amount of the value removed from assets under a scheme is $150 000 or more.

Proposed subdivision 725-B deals with the circumstances where a direct value shift is deemed to have occurred. This will be where:

- there is a decrease in the market value of equity or loan interests in an entity

- the decrease is reasonably attributable to a scheme, and
- the decrease in value is due to the issue of interests at a discount from its market value or there is an increase in the market value of other equity or loan interests as a result of the scheme (**proposed section 725-145**).

If the increase in market value or the discount is only partially due to the scheme, only the proportion relating to the scheme will be subject to the new rules (**proposed section 725-165**).

Proposed Subdivision 725-C deals with the tax consequences of a value shift. The action to be taken will depend on a number of variables including the nature of the interest involved, whether value has been shifted to or from the asset, whether there are income tax as well as CGT issues involved, how the value shift occurred and which of the various formulas contained in the proposed subdivision apply. Due to the large number of variable positions and possible results involved, and their very technical nature, these provisions will not be examined in detail in this Digest. As a general rule, where the value of an asset has been decreased, its cost base is to be adjusted down so that the amount of CGT payable will remain the same as before the value shift when the asset is realised and the cost base of an asset which has gained in value will be increased to achieve the same result. Where realisation of the item is included as income, as may occur when trading stock is sold, values and deductions may be varied to place the taxpayer in the same position as if the value shift did not occur. The provisions are examined in detail in the Explanatory Memorandum to the Bill.

Proposed Division 727 deals with indirect value shifting. This will occur where:

- value is shifted from one entity to another
- the transaction is not at arm’s length, and
- the indirect value shift has effects further up a chain of entities (**proposed section 727-5**).

However, the proposed rules will only apply to a limited range of indirect value shifts, including where:

- the entity losing value must be a company or trust
- the gaining and losing entity must have the same ultimate controller
- the only interests effected are those of the entities involved or their associates
- entities involved in the simplified tax system (there are a range of eligibility tests for the STS, including that average turnover is less than $1 million) or fall under the small business CGT threshold (assets of $5 million or less) are exempt, and

- non of the exclusions apply (**proposed sections 727-15**).

The exclusions are contained in **proposed subdivision 727-C** and include:

- where the indirect value shift is $50 000 or below (de minimus rule)
- where the transfer of a CGT asset or a right is made and while this is at less than market value the decreased value is not reflected in the tax values available to the transferring (losing) entity
- subject to a number of conditions, the provision of services is at least 95% of the value shifted (there are number of rules to calculate the value of services to ensure that the services provided are calculated at market value to prevent the valuation of services being used to disguise the transfer of an asset)
- the distribution is to a member or beneficiary of the entity and the taxation consequences of the transfer flow through the distribution (eg the distribution is included in the income of the entity to which it is made or cost base of an asset is increased to reflect the distribution).

Proposed subdivision 727-D deals with the calculation of the market value of certain indirect value shifts. These rules apply if the asset is subject to depreciation, it's depreciation value is to be less than $1.5 million and, according to the book value for the transferring entity, the other entity acquired the asset for between 80% and 120% of its market value. In such cases, the market value will be the greater of the adjustable market value (which is to be calculated according to accounting standards) and the value assigned in the transferee's books. In other cases, the actual market value of the asset will need to be determined.

Proposed subdivision 727-F deals with the consequences of an indirect value shift where the above rules apply. As with a direct value shift there are a number of technical factors to be considered in calculating the amount of the value shift and the economic benefit gained, including the nature of the interest acquired, the relationship of ownership of the entities and the method of valuation used. These issues will not be dealt with in detail in this Digest as there are no general rules other than that the provisions seek to reverse any benefit gained.[4]

Demerger

Simplistically, demerger refers to the situation where an entity which operates in more than one area separates the various businesses activities into individual operations with separate identity and legal recognition and the interests in the new and old entities are in the same proportions. Currently, a demerger would result in CGT consequences for the owners of the interests in the old and new entities as the sale of the new entity would be considered as a realisation of the value in the old entity and so a realisation of any gains or losses made as it constitutes a CGT event.

The Ralph Report recommended that, subject to a number of conditions, a demerger should not give rise to a CGT event. The main recommendations of the Ralph Report were:

- that there be no tax consequences where a widely held entity (generally one with 300 or more members) splits its operations into separate entities so long as:
  - the members interests remain the same in nature and proportion (ie in the same economic position as prior to the demerger), and
  - the tax value of the members interests be spread over the old and new interests
- that a demerger be taken to be a realisation of assets not subject to CGT as they were owned prior to the introduction of the CGT regime on 20 September 1985. The assets would receive a value equal to that immediately after their acquisition as part of the new structure, and
- that post-CGT assets have their value apportioned according to their existing CGT value (ie that there not be a CGT event) and in the same proportion as their interests in the new entities.[5]

The recommendations were made in the context of the introduction of the entity taxation regime which now appears to have been deferred indefinitely according to reports concerning proposed recommendations by the Board of Taxation which have not been denied.[6] The Ralph Report recommended that the demerger rules have effect from the same time as the entity taxation regime came into effect.[7]

Demerger relief will be available under **proposed Division 125** which will be inserted into the ITAA97 by **item 1 of Schedule 16**. An entity may choose relief if it is the head company or trust of a demerger group, a demerger occurs and as a result a CGT event occurs. Relief will not be available if the entity is a foreign resident and does not have a sufficient connection with Australia or relief could be obtained under another provision of the Act (**proposed section 125-55**). The general rules for demerger relief are described below.

A demerger will occur where there is a restructuring of a group and a number of conditions are satisfied, including:

- the group dispose of at least 80% of a member of the group to owners of original interests in the head entity
- at least 80% of the ownership interests of the members of the group in a member entity of the group end and new interests are created

- a combination of the above results in members of the group ceasing to own at least 80% of the interests in another member of the group and:
  - An entity in the head entity acquires a new interest solely because it owned the original interests and
  - neither the original or new interests are in a superannuation fund
- each owner of an interest in the head entity receives the same, or as near as practicable the same, proportional interest in the demerged entity as was held in the head entity, and
- the arrangement is not an off-market share buy-back (**proposed section 125-70**).

In calculating the proportional interests held in the original entity and the demerged entity, interests under employee share schemes are generally to be disregarded (**proposed section 125-75**).

Proposed section 125-80 provides that, if an entity chooses demerger relief, the demerger will not trigger a CGT event. In determining the CGT cost base of the new interests acquired:

- for interests currently subject to the CGT, the new interest will be valued according to the same proportion of the value of the demerged entity as held in the original entity, and
- for CGT exempt interests, the CGT exemption will remain, calculated in the same proportion as the pre-CGT proportion held in the original interest (eg. if all of the original interests in the original entity were CGT exempt so will the interests acquired in the demerged entity) (**proposed section 125-80**).

If demerger relief is not chosen, the various cost bases of the assets acquired in the demerger will be adjusted to reflect the proportion of the value of any new assets acquired as a result of the demerger (**proposed section 125-90**).

Consolidation

For a general background of the consolidation regime refer to the Bills Digest for the New Business Tax System (Consolidation) Bill (No. 1) 2002 (No. 173, 2001–02). As noted in that Digest, while the principles behind the consolidation regime are relatively straightforward, the provisions implementing the regime are complex and technical with many different circumstances being covered. As with that Digest, only a broad outline of the measures contained in this Bill will be provided and the Explanatory Memorandum to the Bill should be referred to for a detailed analysis of the specific measures in the Bill.

Schedule 3 will insert a **new Subdivision 705-B** into the proposed consolidation regime to modify the valuation rules that apply when a new subsidiary joins a group and that entity holds membership interests in other members of the group. In such a case, when calculating the value of the new member of the group the value of the interests in the head company and other subsidiary members of the group are to be calculated by examining those members first to determine the value of such interests to the group. The remaining interests of the joining entity are then added to determine its value for the consolidated group.

Proposed Division 717 in **Schedule 6** deals with foreign tax credits (FTC) for a group (FTCs allow an entity to claim a credit for foreign tax paid when the income to which the tax relates is included in its assessable income). Generally, the head company will be able to claim the FTCs acquired by members of the group so long as the related income is included in assessable income of the head company (**proposed section 717-10**). Where the joining entity has FTCs relating to an income year prior to the year when it joined the group, the FTCs in excess of those used by the joining entity will be transferred to the head company. For the period when the joining entity is not a member of the group, including a period during the year of joining, the current tax regime will apply to the joining entity (**Schedule 6**).

Foreign investment fund (FIF) rules apply where a resident, including companies, invests in a vehicle which operates in an off-shore low tax area. The rules aim to prevent the use of such vehicles to minimise tax, although there are a range of exemptions from the FIF rules for genuine investments. FIF attribution accounts operate to allow a credit in respect of tax paid to prevent double taxation of investment returns due to taxation in the low tax area and Australia.

Proposed subdivision 717-D deals with the treatment of FIF attribution accounts when a company joins a consolidation group. The basic rule is that any FIF attribution account surplus available to the joining company will be transferred to the head entity. The subdivision also generally provides that if a surplus was subject to various provisions of tax law, these will continue to apply to the transferred surplus. Similarly, **proposed subdivision 717-E** provides for the same principles to apply when a company leaves the group to the extent to which the FIF surplus is attributed to that company (**Schedule 6**).

Transitional Rules

Transitional rules will apply in respect of groups which consolidate in 2002-03 and 2003-04 (**proposed Division 701 – Schedule 7**). The main impact of the provisions is that a prospective head company may choose to have certain entities joining the group to be treated as 'chosen entities' which will receive concessional treatment, including:

- the value of trading stock need not be recalculated
- value shifting and loss transfer rules will not apply, and

- existing CGT cost bases may be retained for assets which have a value lower than their depreciated value.

The provisions aim to allow the head company to accept the current tax valuations used by the joining entities during the transitional period.

Imputation

Schedule 13 of the Bill will introduce a number of technical rules aimed at preventing the trading of franking credits by companies which would otherwise not receive a benefit under the imputation system as, for example, they are non-residents or receive exempt income.

Following the introduction of the simplified imputation system (SIS) as part of the New Business Tax System reforms[8], most provisions relating to the imputation system were transferred from the ITAA36 to the ITAA97. However, anti-avoidance rules relating to franking trading, under which a company unable to achieve a franking benefit trades the credits with entities which are able to achieve the benefit, remained in Part IIIAA of the ITAA36. The amendments contained in Schedule 13 will transfer the anti-avoidance rules to the ITAA97 and make a number of consequential amendments to the SIS. As the measures do not contain new policy they will not be examined in this Digest.

Endnotes

1 Review of Business Taxation, A Tax System Redesigned, p. 262.

2 ibid., p. 263.

3 ibid., pp. 261–5.

4 The provisions are complex and deal with the large number of individual situations which may arise. Dealing with the possible permeations involved are beyond the resources available and are likely to be of little general interest. They are dealt with in greater detail in the Explanatory Memorandum to the Bill and at the ATO website at: http://www.taxreform.ato.gov.au/DocTree.asp?placement=TR/BT/GVS&from=TR/BT

5 Review of Business Taxation, A Tax System Redesigned, pp. 618&9.

6 The Australian, 30 August 2002.

7 Review of Business Taxation, A Tax System Redesigned, p. 619.

8 For further information on the simplified imputation system see: http://wopared.parl.net/library/pubs/bd/2001-02/02bd165.pdf