Tax Consolidation for SME's
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CCH Learning:

Hi, everyone, and welcome to today's webinar regarding tax consolidation for SMEs. I'm Alison Wood from CCH Learning, Wolters Kluwer, and I'll be your moderator for today. Just a few quick pointers before we get started: If you are having sound problems, you can try toggle between audio and phone, and your PowerPoint is saved in the handout section, and your e-learning recording will be ready shortly after the session. We will send you an email to let you know when. You can ask questions at any point during the session today, simply type them in the questions box. I will collect those questions and ask them at the Q&A towards the end of today's presentation.

CCH Learning also offers a subscription service, which many people have termed "Netflix for professionals". It provides members with access to our entire library of recordings, as well as live webinars for a very competitive flat fee. That's for over 500 hours of content. For CPD purposes, your viewing is logged automatically. Your presenter today is Corey Beat from Crowe Australasia, an affiliate of Findex. With over 20 years of accounting and taxation experience, Corey is passionate about understanding the needs of clients and solving their complex tax challenges, delivering complex taxation advice in an easy to understand way, across a range of industries. Corey works with clients large and small, and was recognised as a finalist in the Tax Institute's SME Tax Advisor of the year category, and I will now hand you over to Corey to commence today's presentation.

Corey Beat:

Thank you, Alison. We are going to be testing that theory that I can break down complex matters in an easy understand way, because we're going to be talking consolidation today. So good afternoon everyone, or good morning if you are in sunny Perth with myself. Today we're going to be looking at a high-level overview of the tax consolidation regime, hopefully with some practical pointers for our SME clients, looking at the key issues we need to consider when we're looking at applying the rules to our clients, and going through some practical tips and traps from our first-hand experience of implementing the rules in our client base.

Quick overview of the provisions: We know that eligible wholly owned groups can consolidate to form a single reporting entity for income tax purposes. The rules are optional, but once we make that election to consolidate, it's irrevocable. We can't deconsolidate. Intragroup transactions are ignored for income tax purposes whilst we're in a group. We can transfer assets between entities within a group without worrying about income tax consequences, but important to remember that it only relates to income tax if we have FBT, pay-as-you-go withholding, or other withholding GST, any other tax obligations. These are outside the tax consolidation provisions and will remain with each of the subsidiary members of the group.

So today, what are we going to look at? We'll look at the benefits for why should we look at consolidating our eligible SME clients. We'll look at membership rules, and who can and cannot consolidate. We'll look at the entry ACA process, which looks at how do we set the tax cost of assets for the head entity in the group, and how do we deal with losses that are transferred on entry? We'll spend a quick few minutes looking at exit. If we have a subsidiary that exits the group, what happens then? Some important record-keeping rules for our groups, and then some practical tips.

So why should we consolidate our clients, our clients' corporate groups? So we know why we use companies for our clients: It provides asset protection for our clients from the company to the shareholders. We can access the flat corporate tax rate. The corporate structure itself is well known. We can sell shares in the company quite easily if we want to sell the business. It's a common structure, but what happens when the entity's business, the company's business gets complex? We want to maybe split. We've got one business that started, it's now into two businesses. We're operating them from the same company.

We want a bit of flexibility to be able to say, "Well, I want to sell one business but not sell the other." Or, over time, we might have acquired companies, and we now have a somewhat complex corporate structure. What can we do? Well, we can look at the consolidation rules, and it's important to realise that these rules don't just apply to large, complex groups. Many tax advisers lose sight of the fact that we can actually use consolidation for our SME clients to increase flexibility and to reduce administration for them. Can also offer us opportunities to access tax value that may be locked into our companies, such as tax losses and/or franking credits.

So some of the things that SME groups can benefit from by consolidating, including the pooling, offsetting of profits and losses within the group, pooling of franking credits, ignoring the tax consequences of intra-group transactions, the administrative benefits from having a single income tax return, and also getting a potential uplift in asset values for tax purposes when we elect to consolidate. And we'll talk about these things in a bit more detail in the coming slides, but one thing to always bear in mind is that tax consolidation can be a useful tool for us, but we must take careful consideration to make sure that we're using the tool appropriately for our clients. It's not a one tool fits all. Consolidation can have some downsides, and we need to make sure that we mitigate those as best possible for clients, or simply make a decision that consolidation is not appropriate for those clients.

So one benefit is the pooling and offset of profits. So consolidation has a single entity rule that treats the group as a single entity for tax purposes. This means that income from some members of the group can be offset by losses derived by others, which is great when you've got a group that has profitable businesses, but may also have a startup in startup phase that's burning through cash and generating tax losses. In the absence of making that consolidation election, those losses can be trapped in that loss-making entity, with no means of being able to offset against profits in the other company. The tax office do frown on profit shifting type transactions, where there's no actual service being provided. So we can't just charge a fee from the loss company to a profit-making company if there's no service being provided to use those losses.

Once we make that election to consolidate and we're pooling our profits and losses, if we have losses carried forward, they're simply carried forward, and we only need to worry about the tax ownership and business continuity rules on an entire group level going forward. We note, and we'll talk about this in later slides, but there are ordering rules that apply for the use of group losses. So losses where we have made an election to consolidate and those losses are generated post-consolidation or transferred losses, which are pre-consolidation losses that transfer on an entity joining the group.

Franking credits is another one. So franking credits are also pooled or transferred from subsidiary companies up to the head company on consolidation, or consolidation, or joining an existing consolidated group. And this pooling can overcome the difficulty of having franking credits trapped in a subsidiary that is dormant or not potentially active, but there are franking credits there that could be used by other entities within our group.

Intra-group transactions are also ignored for tax purposes, which means that we can move assets around our group without triggering an income tax or a CGT consequence, which is great if we'd like to set up a subsidiary to operate a new business and there's assets that we want to transfer into that subsidiary. If we do that when we're in a group environment, we have no income tax. It can also mean that we can forgive debts between members of the group without any tax consequences. We don't then have to worry about debt forgiveness provisions and calculating whether we've got to adjust assets, or losses, or things like that.

It also allows for the payments of profits from subsidiaries up to the head company, without any tax consequences, as dividends are also ignored under the intra-group transaction rules, which is great where we've got profits being generated by a subsidiary that doesn't have sufficient franking credits to be able to pay a fully-franked dividend. Administratively, once you make an election to consolidate, we only have to lodge a single income tax return for the group going forward.

So I had a client in a former life who had a group with 20 entities, a head company in 19 subsidiaries. So rather than having to do 19 separate tax returns for that group, we only had to do a single tax return, which cut down on the administrative requirements quite significantly. We deal with the returns both on a bottom-up and a top-down basis. So the bottom up, we look at each individual entity's PL and balance sheet, make the adjustments there, and then roll that up to the top entity, taking into account eliminations for intra-group transactions. The administrative benefits also extend to having the head company being solely responsible for pay-as-you-go instalment payments for the group, which is great, so you don't have to worry about, "I've got 19 entities that might have quarterly, or some of the monthly, pay-as-you-go instalments, and trying to keep track of those through the year."

We can also get a potential uplift in our asset values through the tax consolidation process. So the idea generally behind consolidation, particularly in an acquisition circumstance, is that we're trying to put the acquiring entity in a similar position, not necessarily identical position, but a similar position if they were to acquire the assets of the business, as opposed to buying the shares in the company and then consolidating, so we can get an uplift. Unfortunately, sometimes, we can actually get a downshifting value. So it's always important to properly model the consolidation process prior to making that decision. So resetting the cost base can impact on revenue deductions such as our trading stock, and our tax written down values, and cost base of our depreciating and other CGT assets. So again, we can get benefits going forward by consolidating. It's important to model that, to see whether there will be benefits or not.

So we've got the brief overview of the rules. Who can consolidate? So a consolidated group consists of an Australian resident head company and at least one eligible wholly-owned resident subsidiary. We can't consolidate unless we have those two. If the group decides to consolidate, all eligible resident wholly-owned subsidiaries must be included in that group. It's one in, all in. We can't pick and choose who's part of our group.

The head company must be an Australian resident, have some of its income taxed at the general company tax rate, not be a subsidiary member of another consolidated group or a wholly-owned subsidiary of another Australian resident company, and it mustn't be an excluded entity, such as an entity that is tax exempt. So we need to have a company resident and not a subsidiary of any other company or any other consolidated group. Who can be a subsidiary? Must be an entity that is wholly owned by the head company directly or by the head company and other subsidiary members of the group indirectly.

A subsidiary member of a group can be a company, a trust or a partnership. So we're not limited to just companies in our tax consolidated group. Where we have a trust or a partnership member, it must be immediately owned by Australian resident entity. So if there's any non-resident ownership of those entities, we cannot have that member as a part of our group. Whilst a trust can be a member of a consolidated group, it's highly unlikely that a discretionary trust could be a member without significant changes to its class of beneficiaries.

In order to be a member of the consolidated group, all members of the discretionary trust would need to be members of the group. So an ordinarily family trust with a widely defined beneficiary class wouldn't be able to be a member of a consolidated group, but a fixed trust or a unit trust absolutely can be. So we'll quickly whip through some examples. So in this case, we can form a consolidated group here with company as head company.

We have company A and B, which are wholly-owned subsidiaries directly and indirectly of the head company, as well as the unit trust. So all of these entities will form part of the consolidated group.

This structure cannot consolidate as the shares in each company, A, B and C are not held by an Australian resident company. They're held by a trust. Similarly, in this case, the shares are held by an individual, not a company. Therefore, we cannot consolidate this group. This is a somewhat complex example, but if we have a look, we've got five subsidiary companies under company A, a fixed trust, and a partnership, and if we trace all of the ownership and all the beneficiaries, all of the ownership and all the beneficiaries of the trust are within the wholly-owned group.

Therefore, if we elect to form a group, all of these entities would form part of that tax consolidated group. We compare that to this example, where we have Company A, that is the sole beneficiary of Fixed Trust T. Company A and Fixed Trust T between them own 100% of Company B. However, Company C, Company A only has a 90% interest in. 10% is held by an individual outside of the group. So we can elect to form a group here, but the group would only be comprised of company A, Fixed Trust T, and Company B. Company C and Partnership P would not form part of the group, as they are not wholly-owned subsidiaries of Company A.

Very, very briefly, there's a different type of consolidated group that we can form called a multiple entry consolidated group. This is for Australian entities that are owned by a foreign parent, and it might be that foreign parent has what we call multiple entry points into Australia. So the simplest example is you might have a US parent which has two direct wholly-owned Australian subsidiaries, so they would be sister companies.

Those two could not form a tax consolidated group, because they're not subsidiaries of each other, but they could form what we call a MEC group. So the MEC group rules are complex as to how we can form a group, the membership requirements, but once you decide to form a MEC group, the tax consolidation rules apply pretty much the same for MEC groups as for ordinary tax consolidated groups, with a couple of exceptions.

So if we flip over to the example slide, we have foreign company with our two subsidiaries, Company A and Company C. Company A also has its own subsidiary, wholly-owned subsidiary Company B. So there's actually two choices here. What the group can decide to do is that, if they want, they can just form a tax-consolidated group comprised of solely Company A and Company B. Company C would not form part of that tax-consolidated group. If we wanted to get Company C into the group, then they would need to form a MEC group, which would include all of Company A, Company C, as well as Company B. With that, we'll pause and head to poll question number one.

CCH Learning:

Thank you very much, Corey. All right, everyone, first poll question is up on the screen for you all: So under the tax consolidation regime, an eligible head company can also be a subsidiary member of a consolidated group. So we're just looking for is this a true or false statement? Perfect. Many of you underway voting. If you are looking for how to participate, on your bottom toolbar, please look for a blue or orange icon and that will bring up GoToWebinar in its entirety, and then you can click in true or false for this first poll question. We've just got two polls in our session today. All right, almost at majority. I'll just give those last few people a couple of seconds, and let's have a look at these responses. So 63% false. Thanks, Corey.

Corey Beat:

Thanks, Alison. And that's the correct answer. It's false. So if we have an eligible head company that's a subsidiary member of a consolidated group, it can't be an eligible head company in its own right. If we have an existing group that becomes a subsidiary member of another consolidated group, that original group would potentially

de-consolidate. So once we've made our election to consolidate, we've got to go through the tax cost setting process, which is probably the most complex part of the consolidation rules. So the effect of the single entity rule in the consolidation regime is to treat assets of subsidiary members as if they were assets of the head company. Assets that are acquired or disposed of by subsidiary members are treated as disposals or acquisitions of the head company, and any transfers between the group members are disregarded. So we can do that without any income tax or CGT implications.

The problem, though, is with this single entity rule, when an entity joins a consolidated group, we have to go through a process that actually sets the tax values for assets bought into the group. So again, coming back to my earlier comment, the idea behind these rules is to put the acquirer in not a significantly different position if they were to have acquired the business assets directly, as opposed to buying the shares in the company and bringing it into the tax-consolidated group.

So we do this through a process called the allocable cost amount or ACA calculation. So as we've mentioned, it can be one of the more difficult aspects of the consolidation rules, and it involves a three-step process: So the first thing we do is that we calculate the ACA, which is designed to represent our true cost of acquiring the entity. We reduce that ACA by retained cost-based assets in the subsidiary entity, and then we allocate the remainder to the subsidiary entity's reset cost-based assets in proportion to their market value.

So this process is designed and we call it a push-down. So we push down the cost of the subsidiary down to the underlying assets of the subsidiary, and there are then eight steps in the ACA process: We start with the cost-based of shares. We then make various adjustments to that through steps two to seven to result in our ACA. Once we have our ACA, as we've said, we allocate that first to our retained cost-based assets before then applying the rest to our reset cost-based assets.

So what are retained and reset cost-based assets? So a retained cost-based asset, as it says on the label, are assets that retain their costs from the joining entity. Most commonly, these are things like Australian currency, bank accounts, deposits, things like that, as well as rights to receive Australian currency. So it will include our trade receivables, and the idea here is why these retain their cost, is you don't want a situation where particularly with bank accounts, I might have a $100,000 in a bank account, I don't want to post-consolidation, have to deal with it potentially having a tax cost of $80,000, or a tax cost in excess of $100,000. So that's why we have retained cost-based assets effectively retain their cost.

Reset cost-based assets, therefore any asset that are not retained cost-based assets. So that'll include depreciating assets, trading stock, capital gains tax assets, and goodwill. And goodwill is an important one, because even if Goodwill is not recognised in the accounts of the subsidiary, because it's internally-generated goodwill, we still have to take that into account in our cost-setting process. Again, if the head company were to acquire the business, it would likely have a goodwill component that would be acquiring as part of that business acquisition. So this cost-setting process is designed to put us in that same or similar outcome. Let's quickly go through the steps in that process: So step one, we look at the cost base of shares. So it's effectively what is the heading to this cost base for the joining subsidiary, but it's not always that simple.

If we have a market value that is in excess of the cost base, we can just use the cost base. However, if the market value of that interest at the time of joining is less than the cost base, but greater than the reduced cost base, we're actually capped at our market value. If our market value is less than the reduced cost base, then we're capped at our reduced cost base. So very quick example here, we've got a series of attributes: We've got the cost base, the reduced cost base of $800, a market value of $1,500. There's also a loss transfer adjustment made pre-consolidation of $500. So our step one amount, because our cost base is less than market value, we use $1,000, take off the loss transfer adjustment. Our step one amount is $500.

Step two brings in the liabilities of a joining entity, which makes sense, because if we've acquired a joining entity, we're now responsible for those liabilities going forward, and that adds to effectively our overall cost. There are a number of adjustments that need to be made to liabilities to arrive at our final step two amount. The simplest one to explain is future deductible liabilities. So things like provisions for annual leave and long service leave, the head company will get a benefit for these when it pays those in the future. Therefore, the ACA process removes that from the ACA, so that we don't get effectively a double benefit. We get an increased ACA, which we can push down into the cost base of our assets, plus we get a benefit of a deduction in the future when we pay it.

Step three, we add in any undistributed taxable profits that the joining entity could have distributed whilst we owned the interest. This is designed to say, "Well, if we paid a fully-franked dividend out and then reinvested those profits, that would form part of our step one amount, our step one cost base." So it's only fair to add that in at step three if we haven't made that distribution. Step four takes out dividends paid by the joining entity to the head entity out of any pre-acquisition profits. So if we've paid an amount to acquire an entity with profits, the entity pays a dividend, that dividend will reduce our step one amount, or should reduce our step one amount. So that's brought in at step four.

Step five adjusts for carry forward tax losses that are owned by the head entity. So this only applies where the head entity and the joining entity make a decision to consolidate sometime after the head entity acquires the joining entity. So again, these losses, the reason for this step is the losses are reflected in the asset values, and if we weren't to pull those out, we could potentially get an increase in our cost base of assets under the tax cost setting process. So it's designed to prevent a sort of double dip.

Step six is an important one. If there are losses that are being transferred to the head company, we actually have to reduce our ACA for that. The losses get multiplied by the tax rate to determine what that reduction is. And again, the same reason why we make these adjustments for the same as step five, it's to prevent a double benefit. So if we have a... Bringing in the losses would reduce our ACA, which would mean would have less tax costs that we can allocate to assets of the joining entity.

If we didn't reduce the ACA, then we'd get the double benefit, we'd get the benefit of the losses when we deduct them, plus an increase in our tax cost of assets. Step seven, similar to step six, if there are inherited deductions of the joining entities such as borrowing expenses, 4880 costs, software development costs, these reduce the ACA, and step eight is our final ACA amount. If the amount is positive, that is what we call our ACA, and we use that amount to then allocate to our retained and reset cost base assets. If the amount is negative, it's nil, and we've potentially got a capital gains tax event we need to deal with. If it's positive, as I say, we reduce the ACA amount by our retained cost base assets, and anything remaining after that is then allocated to the reset cost base assets in proportion to their market values.

So one thing that is required or recommended as part of any consolidation process is getting market valuations or assets to do the ACA allocation appropriately. Where the tax cost setting amounts for our retained cost space assets, so that's our cash, that's our receivables exceeds our joining ACA, we have a CGT L3 capital gain triggered. So this is where we've effectively deemed to have acquired the joining entity at a discount, and it's a sufficient discount that it's actually less than the value of our cash and receivables. On the flip side, if the entity has no reset cost basis assets, so we might've acquired a dormant sub and we've had to allocate some ACA to it, any excess ACA remaining is treated as a capital loss for the head company.

If we have reset cost base, there are certain assets that are limited in how much we can or tax cost we can allocate to them, and these are what we call revenue-type assets. So that would include our trading stock and our depreciable assets. When we're allocating ACA amounts to these reset cost base assets, based on the proportionate market value, we're actually limited to the greater of the assets' market value and the terminating value of that asset. So terminating value being effectively the written down value for tax purposes. So we can't go

above terminating value, even if the market value exceeds that, or vice versa: If we've got a terminating value that might be in excess of the market value, we can't go above the market value when we're allocating tax costs to it.

There are some specific rules for the old, and I say very old, accelerated depreciation rules. Probably the more important one for our current clients is that where assets have been claimed by adjoining subsidiary under the TFE rules or the instant asset write-off rules, the cost setting is limited to the assets' terminating value, which in these circumstances is going to be nil. So we would get no uplift on consolidating adjoining entity with these assets into our group. The double whammy is that if we do have an excess, we actually can't allocate that excess to other reset cost base assets. It's lost completely. So there may be some circumstances where, if we're acquiring an entity that all of its assets depreciating assets have been written off under TFE and instant asset write-Off, we may not be in a very good situation if we acquire it and consolidate it into our group. We may be better off acquiring the assets directly from the vendor.

Just very quickly, if we do have some pre-CGT interests, there are rules that apply to preserve the pre-CGT status of any interest that the head company has in a joining entity, and it's designed to ensure that that's maintained if that entity should leave the consolidated group in the future. There's also an integrity rule that ensures consistent treatment for any pre-CGT shares under these proportion rules, and can be triggered if assets, the leaving entity brought to the group ceased to be pre-CGT assets under the Division 149. So there's have been change of majority underlying ownership, which is deemed a pre-CGT asset to be a post-CGT asset. So this is designed to broadly align the tax treatment that would arise under Division 149 if the entity was not a member of a consolidated group. If this integrity rule does not apply and the shares maintain their pre-CGT status, we would still need to consider the possible application of CGT event K6, if we were to sell those shares in the future.

Tax losses, again, somewhat complex, but we'll do our best to try and break this one down today for you. So whilst we're in a group, group losses are retained by the head company, but we can also, on joining, transfer losses of subsidiaries up to the head company. Once we transfer the losses, they'll remain with the head entity, even if the joining entity subsequently leaves the group through liquidation or through sale in the future.

The losses will retain their loss type on transfer, So if we transfer revenue or capital losses, they'll retain that. However, there are restrictions on the head company's ability to use those losses, which is aligned with the rate of use the joining entity could have used, and it's based on the market value of the joining entity relative to the overall group, and we'll talk about that shortly. To bring losses in, the loss company must pass continuity of ownership and business continuity tests in order to have those losses transferred. Going forward, the head company then has to pass modified versions of these continuity of ownership and control tests or business continuity tests to use those losses. If it's a trust, then the test that must be passed is the 50% state test for a fixed trust, or a modified pattern of distributions test for a non-fixed trust.

Where an entity has losses and it transfers those to a head company, we call that a loss bundle, and the different types of losses in that bundle will retain their characters. So we might have a bundle of losses from a subsidiary comprised of revenue losses, capital losses, and foreign losses. The quick example is if we have three subsidiaries in the group and each has losses, the head company has three different loss bundles that it has to deal with. Where we have both group and transferred losses, there's actually a rule on how... Well, in what order we have to apply those losses when we have income in the future.

We have to apply group losses first, and that is the losses that have been incurred by the consolidated group after it has elected to consolidate, and transferred losses get used second. So anything that gets transferred to the head company can only be used after all group losses have been utilised. Transferred losses are also known as available fraction losses. So you might see those two terms used interchangeably. I prefer transferred losses,

because that's what the tax return loss schedule labels use. Transferred losses are always subject to an available fraction restriction on the use, whereas group losses aren't subject to that restriction.

In this quick example, we've got a head company in subsidiary. The head company has group loss of $100,000 available fraction losses, with an available fraction of 0.225, and those losses total $200,000. If the head company has $800,000 income, we subtract the group losses first to get to a subtotal of $700,000. We then apply the available fraction number to that. So 700 by 0.25 gives us a deduction for the year of $150,500. So we have net taxable income of $542,500. You'll see on that second bullet point, we've not used all of our available fraction losses, and so the balance of $42,500 are carried forward. Notwithstanding we have taxable income for the year, we are limited at the rate we can use those losses by that available fraction.

So each transferred loss to a head company will have an available fraction, and that will include any pre-consolidation losses of the head entity. So the head entity would have to work out its own available fraction for its losses on electing to join the group. It's generally done by dividing the joining entity's market value by the market value of the group at the joining time, but with adjustments as follows: So we're working out the modified market value of the loss entity and dividing that by the adjusted market value of the head entity or the whole group. The modified market value of the loss entity is done on a few assumptions: It assumes that the loss entity has no losses or the balance of the franking account is new, so we can't attribute value to those for this calculation. The subsidiaries in the group are all separate entities for the purpose of the calculation, so we exclude that, and it does not include an amount attributable to an interest we hold in another group member.

For the adjusted market value of the head entity, again, that's effectively the market value of the group, but ignoring losses and assuming that the head company is in the old franking account balance. Again, important to get market valuations to support these calculations in the event of an ATO audit or review. The available fraction calculation on joining can be impacted where we have capital injections, and this is designed to stop entities trying to overly inflate the value of the subsidiary to get a higher available fraction on joining. So if we convert some debt to equity, we've technically increased the value of that entity, but if that capital injection, that conversion of debt to equity occurred within four years of us joining the group or the entity joining the group, that capital injection gets stripped out and we don't get to take it into account to inflate our value.

We can also have a dilution in the available fraction where we have a new member joining an existing group, and the new member transfers a bundle of losses to the head entity. So we'd not only have to work out an available fraction for that new bundle coming in, that new bundle coming in would then dilute the available fraction for any existing transferred losses we have. We'd also have to undertake a dilution calculation where the head company is acquired by and joins a new consolidated group. So the rules are quite complex and can impact the ability to use your losses in the future.

So it's always important to look at our clients and say, even though there might be five, 10, 15, $20 million worth of losses potentially available, will the available fraction be so low that we're not able to use it within a reasonable period of time? Would we be likely to only use over 10 years, 15 years? Furthermore, coming back to our ACA calculation, if we bring the transferred losses in, it actually reduces the amount of ACA we can allocate to the tax base of assets. So it's important to model not just the available fraction calculation, but the impact it will have on our ACA, and therefore the potential tax cost base of assets for our head company going forward. It might sometimes be better to cancel losses, despite there being 10, 15, 20 million worth, if it means we get better cost uplift of other assets of the joining subsidiary, which brings us to poll question number two.

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... very much, Corey. All right, again, I'll launch this one straight up on the screen for you all: So which bundles of tax losses need to be used first in a consolidated group? A, transferred losses or B, group losses? Perfect. So if you just click in A or B for this second and final poll question in our webinar today. And just a reminder, if anyone is thinking of questions during the session, please pop those in to the questions box and I will collect those and ask them at our Q&A at the end. We've got 21 minutes left in our session today. All right, we are slowly getting up to majority on this poll. I'll just give those last few people a couple more seconds, and let's have a look at these responses. So 67% on B. Thanks, Corey.

Corey Beat:

Thanks, Alison. That's bang on. We have to use our group losses first before we use our transferred losses. Another reason why it's important to model whether it's worthwhile bringing losses into a group. We'll quickly go through the tax cost setting rules on exit. So we had our ACA calculation, which pushed down cost into assets. The cost setting on exit rules are designed to reverse that and effectively take the tax base of assets, lessening liabilities to arrive at a value which becomes the head company's cost base for the shares in that entity when it leaves the group. And this is done because the shares in the subsidiary are not recognised under the single entity rule whilst the subsidiary is a member of the group.

The exit ACA has four steps: So we start with the terminating values of the assets that leaving entity takes with us. That's our cost base of depreciating assets, trading stock, even our cash and receivables. We add in certain inherited deductions that the entity would take with it. So that's, again, back to our borrowing costs, our 4880, costs and our software. Step three, we add in any intra-group liabilities owed to the leaving company the leaving time. And again, we have to add this in for tax purposes, because that intra-group liability is ignored whilst we're in a consolidated environment. We then subtract any liabilities and any other membership interest treated as liabilities to arrive at our final exit ACA. So if it's positive, that is the tax cost base of our shares in the subsidiary or the head company shares in the subsidiary for when it subsequently decides to sell the subsidiary. If it's negative, then we've got a zero cost base and we've potentially got CGT issues to deal with.

If we've got more than one class of membership interest, we then have to allocate that exit ACA across those membership interests on a proportionate basis, so that we set a tax cost for each class of membership interest appropriately. And a quick example, we might have an initial cost base of our subsidiary of $10,000 before we consolidated. Once we've consolidated the group, we're at a point where we want that subsidiary to exit. It has income producing property with a tax cost of 200,000, depreciating assets with a tax cost of 100, liability of $200,000, and the balance is reflected in equity. So in our five-step process, we start off with our terminating value of our assets, which is $300,000. In this case, there are no inherited deductions, no intra-group liabilities. We subtract the liabilities that will leave with the group, and the ACA for the leaving entity, the cost base for the head company of those shares is $100,000.

Quickly talk about tax sharing and funding agreements: This is one of those important record keeping things. So a tax sharing and tax funding agreement is not compulsory, but is strongly recommended when forming a tax-consolidated group. So whilst a group has formed, the head company is the entity that is responsible on behalf of the group for payment of any income tax related liabilities to the tax office. However, if the head company is unable to meet those obligations, subsidiary members become jointly and severally liable. So jointly and severally means that an entity, subsidiary member may be liable for a tax debt in excess of what its debt would've been on a standalone basis. This can be avoided by having the group enter into a tax sharing agreement before the tax is due and payable by the head company.

And this is vital as part of any tax due diligence process if we're acquiring an entity that's in an existing tax-consolidated group, because we don't want to acquire an entity that has been a member of tax consolidated group and potentially has exposure to liabilities for the group. So in this case, we've got two group: Just a quick example, head company two acquires sub-co one from head co one. If there's no TSA and TFA in place, then head co two potentially has the risk of future liabilities associated with sub-co one's membership of group one whilst it was a member. However, if a TSA and TFA is in place and sub-co one makes the appropriate exit payment, it gets a clean exit and head co two doesn't then have to worry about contingent liabilities from head co one's group being called on by sub-co one in the future.

So the TSA, the tax sharing part is an agreement between the head company and its contributing members that allows the group liability to be apportioned between the members according to the methodology set out in the agreement. That's the sharing component dealing with the income tax liability. The TFA, the tax funding agreement is more designed for the group itself to document how tax payments are made, and even payments for tax benefits are recognised within the group's accounts. So it's not just for payment of liabilities. If an entity's making losses and those losses are being used by other group members, the TFA recognises that that's a benefit that's being provided, and the loss entity can get payment for that from other members. So again, these are not compulsory, but are vital in the context of members leaving a consolidated group, as it allows them to obtain a clean exit.

We'll run through some practical examples that we've seen on where consolidation can be beneficial for our clients: So the first one is franking credits and BRE. So we can look at tax consolidation where we have companies in a wholly-owned group that have different tax rates. So we might have a mix of BRE and non-BRE taxpayers, and the issue can arise where holding companies of base rate entity and receives a dividend from a non-base rate entity subsidiary. So we may have a subsidiary that owns a commercial property, passive income taxed at 30%, then pays a dividend to the holding company who is a base rate entity, and only pays tax at 25%. So we've got a bit of an excess franking credit problem there.

The other thing that consolidation can do is when we're looking at the base rate entity rules, you calculate that percentage on a whole of group basis. So if you've got, in this case the subsidiary with a commercial property, but you've got other members in the group that are carrying on active businesses, if you consolidate the group, you calculate your BRE passive income percentage on the group basis. It may mean that you have the group treated as a BRE and you're then taxing that passive income at 25%.

So quick illustration there of how that would work: We have a subsidiary with that only drives rental income and interest, not a base rate entity. So it's being taxed at 30%, and pays dividends at 30% to the holding company. If the holding company's only income is the non-portfolio dividend from the subsidiary, that's not passive income for BRE purposes, and therefore, you have the holding company is treated as a BRE, and pays tax at 25%. You then have the excess franking if there's no other income and no other tax to pay. You're just generating losses in holding company going forward. Electing to consolidate solves that issue. The group income in this case would be taxed at 30%. We can then also pay a dividend out from our holding company at 30%.

Another time this pops up is if we have an entity in the group deriving non-assessable, non-exempt income. So we might have a subsidiary that either has a foreign subsidiary that receives a dividend from that's exempt from tax in Australia, or the Australian subsidiary is carrying on an active business in a foreign country and deriving exempt branch income. The exemption's great, the subsidiary level, but the problem arises when that subsidiary wants to pay a dividend to its parent company. It's paying an unfranked dividend, and the parent company will then be paying tax on that. If we elect to consolidate the unfranked dividend paid within the group, it's not taxable. We don't have to then worry about the parent company having to pay tax on receiving an unfranked dividend.

So again, similar example, we've got the subsidiary paying a dividend to the holding company. If we don't have a consolidation election in place, that dividend would be assessable to the holding company. We've got to pay tax on that. If we elect to consolidate, we remove that taxing point at the holding company level. But the one thing to watch out for is that we've potentially got an unfranked dividend paid out from the holding company to its shareholders when it pays it out. This would work much better if we have a group that has some active Australian businesses and we might have excess ranking credits in that group that we can apply to this exempt income from the subsidiary, and be able to pay that out as a franked dividend.

Another [inaudible 00:48:40] deemed capital gains on entry into the group. So in this case, this can happen where we acquire an entity at a significant discount or we've got significant adjustments in our ACA process. So the example here, we've got a membership interest of $100,000 cost base. We've got trade debtors of $500,000 cash for 100 land and buildings of $200,000 and trade creditors of $50,000. So our retained cost base assets, which are our trade debtors and our cash are $600,000. At joining ACA, on this basic example is the membership interest of $100,000 plus the liabilities, being the trade creditors. We then have an excess of retained cost base assets over our ACA of $450,000, which triggers an L3 capital gain.

We can use consolidation to effectively liquidate subsidiaries and potentially get assets out of a subsidiary into a head company without triggering an income tax liability. It also allows us to transfer franking credits from that subsidiary and tax losses from that subsidiary up to the head entity, and we don't lose those. They're not cancelled when we liquidate the subsidiary in the future. It could potentially give us a cost base step-up of assets of the subsidiary. So given the liquidation process would involve, we've called it selling here, it's an in specie distribution, which would trigger a CGT event if we weren't consolidated.

We can have that transfer take place in the consolidation environment, have no tax on that, and we're effectively deferring any potential future capital gains consequences to when the parent entity sells the assets. We can potentially get an uplifting cost base on that too, reducing the tax that we would have to pay. Important to note that we don't always get a step-up in cost base. For assets, we actually may get a downshift. So it's important to model those entry calculations before electing to consolidate, to make sure we're not triggering those problems.

It can also help with acquiring entities both from a vendor and a purchaser side. So historically, when we're selling a business, purchasers have often been reluctant to acquire the company. It's because they generally don't want to pick up any of the skeletons in the closet from that company going forward. When you acquire a company, you're acquiring its full history. If we sell the entity, though, rather than the underlying business, we can provide a better after-tax result both for the vendor and for the purchaser. So for the vendor, the vendor could potentially get access to tax concessions, whether it's the 50% discount or even small business CGT concessions.

The purchaser, if it consolidates with an existing group, what the purchaser can do is once it's acquired, you've done your tax cost setting, it can move those assets out of the acquired entity, either to the head company or to another entity within the group, and then can liquidate that acquired entity. That overcomes concerns we may have with potential legal claims and that acquired entity. We've transferred the assets and liquidated it, it no longer exists. For the purchaser, acquiring shares can also result in lower duty, if it's provided we're not acquiring a land rich entity. So there's winners all round if we use consolidation in that circumstance.

It's always important to establish the correct membership interest cost base on entry, as this example will show: So we've got financial statements of Head Co, showing that it acquired Sub Co for $4.5 million. The carrying value of Sub Co's assets on entry is $1.5 mil and it's principally internally-generated goodwill. We have an entry ACA resulting in an uplift of cost base of Sub Co's assets by $3.5 mil. We've got a $4.5 mil step one amount, plus 0.5 in liabilities, less than 1.5 in carrying value, $3.5 million uplift, with large returns for two years claiming depreciation on these uplifted values. But then, we've had a look and realised, "Hang on, we acquired Sub Co under a script for

script rollover, where we weren't eligible for a market value uplift, and we actually inherited the vendor's cost base of only $200,000."

So the real effect of resetting the cost base of the assets is that we've actually reduced the cost base by $0.8 mil. We've then either got to go back, we either trigger a capital gain if it's too hard to go back and recalculate the ACA amounts, or we've got to go through the process of recalculating ACA, amending returns, paying tax, potentially paying penalties. Other traps to watch out for, just the deemed capital gains on entry. If we have a negative amount after step three of our ACA calculation, we trigger a capital gain. Same happens with L3 event, which happens when we have the tax cost setting amounts for our retained cost base assets exceeding our joining ACA. And so the tax cost of our cash, our receivables exceeds the ACA we can allocate to them. So again, we've got a capital gain being the amount of the excess.

That's a quick example to look through when you have time. We can also have a capital gain L5, when the amount of our leaving ACA is negative. So if we have an entity leaving our group and its liabilities exceed the tax cost of assets, that triggers a capital gain. So the view there is you've managed to actually offload a bunch of liabilities as part of an entity leaving the group. Those liabilities exceed the tax cost of the assets. Therefore, that triggers a capital gain. One to watch out for again, particularly where we've got entities with a high amount of plant equipment, where we've claimed TFE or instant asset write-off, so there might need to be a bit of modelling to ensure that we don't trigger that. There is an example for you to go through in your own time on CGT event L5.

We've got the mechanics of the ACA process when we're doing our tax cost setting allocation can skew towards long-term assets like goodwill or intangibles and away from plant equipment. Whilst it's good we get an uplifted cost base for those CGT assets, we don't get a deduction for those until we actually dispose of those in the future. If we don't do it right, we're skewing away from trading stock and away from plant equipment, which we could get deductions for when we sell, or through depreciation going forward. Finally, just very quickly on tax losses, we've got to obviously test tax losses on entry to make sure they're available. We have to look at the available fraction to see if it's actually worthwhile us using those. Will the rate of recovery of those losses be worthwhile, as opposed to cancelling the losses and getting an increased ACA? There's costs involved with actually determining the available fraction where we have to get valuations.

We've got to test those losses going forward. If we're not going to use those losses quickly, post-consolidation, will we have an event in the future that causes the failed COT and potentially fail business continuity tests? So it's important to look at losses. Don't just automatically give up losses without testing and making sure our available fraction calculation is correct. Have we made the right adjustments? Is it high enough that we know we're going to be able to use those losses within a relevant period of time? That is a very, very high-level overview of tax consolidation. Hopefully, we've given you some good examples and some good practical examples of how these rules can be useful for our SME clients. I'll now hand back to Alison for questions.

CCH Learning:

... very much, Corey. Okay, we have had a couple of questions come through. Quick reminder, if anyone else would like to quickly pop one in the questions pane, then I can add that to the Q&A. In the interim, our upcoming webinars: So tomorrow, we're looking at combining strategic operational leadership, then selling more to existing clients. Also, role of financial advisor in regards to elder abuse, update on handling ATO debt strategies, our session on tax and motor vehicles, and then looking at transition to retirement pensions. So jump on the CCH learning website and you can find all the details of those sessions. Okay, Corey, let's have a look at these questions here. So Paul has asked, "Is there any small business rollover concession for shares owned by individual transferred to parenting company for tax consolidation?"

Corey Beat:

It would depend on the circumstances. So it would just be an ordinary... You would deal with the transfer of the shares from the individual to a parent company. That would trigger a capital gain or loss, and the individual would need to look at whether or not they would be eligible. So there's no specific concession available to say, "Well, I'm transferring this share into a company." Sorry, no specific small business concession, would just be a transfer. You would look an A1 event, I should, say a CGT A1 event. You'd look at that and say, "Well, is the individual eligible for small business relief?"

The good news, if you do use small business relief to transfer shares into a consolidated group, is that the consolidated group gets market value. So whatever the value is has been agreed to acquire those shares, the process, that forms part of step one. If you're using rollovers to get shares from an individual into a wholly-owned group, whether it's trying to set up a 122A group by putting assets into a company or potentially script-for-script, you can have problems where the cost base and your step one amount is actually the individual's historical cost. But yes, on the initial question, if the individual was to transfer the shares, if they're eligible for small business relief, they can get it. The only flag would be making sure you've got good commercial reasons for making that transfer into the company. Otherwise, the commissioner may look at part 4A if it's solely being done to obtain a tax benefit.

CCH Learning:

Corey, next question here from Alice. There's a few details in this one, so we'll see if we can cover it here and now.

Corey Beat:

Do you want me to speed up?

CCH Learning:

Yes. Thank you, Corey. "So if consolidating a group whereby subsidiary has been 100% owned since establishment accruing losses, cost base of shares is negligible and step five losses would wipe any ACA down to $0. Noting CGD event L3 applies here, is the gain simply the total value of retained cost base assets?"

Corey Beat:

It would depend on... So there's also step two, if the entity has liabilities, you'd need to take that into account. Yeah, you can have issues where you have somewhat dormant subsidiaries with retained losses and very low cost base. Trying to think, depending on the gain, if it has retained cost base assets, you've potentially got that L5 event. There's also the potential L3, where you have a negative ACA after step 33A. So yeah, again, would need more detail, but just depending on other variables within that entity, you could be triggering a couple of capital gains there.

CCH Learning:

Thank you. Corey. This is the last question for the moment from Victor: "So how does it work for the COT test for the head entity of a consolidated group in using transferred tax losses from a subsidiary? Does it need to be regarded from the transfer time to the claim year?"

Corey Beat:

Good question. I could probably talk an hour on just the loss rules. We did go through that very quickly. So quick rule of thumb on transferred losses: If the transferred losses are bought in and fail COT, so this would ordinarily happen where a head company acquires a subsidiary straight away and brings those losses in, they would be SBT losses when they're brought in, and SBT losses actually get refreshed when they get brought into the group, which would mean that the head company, they become COT losses for the head company. But you've only got a look from the point that the entity joined the group going forward.

If it's an existing group, it's been in place for a long time, and there's losses of a subsidiary that get transferred up to the parent, and the loss transfer is a COT loss, because we haven't had a change in underlying ownership throughout the period of ownership, the head company's got a satisfied COT, but it actually has to go back to the pre-consolidation time, when the loss was initially incurred by that subsidiary that it held. So short answer is, it depends, but if it is a loss that fails COT, [inaudible 01:03:19] can particularly happen where we acquire a subsidiary outside of the group and have it join immediately. That gets refreshed and becomes a COT loss from the date of joining going forward.

CCH Learning:

Perfect. Thank you, Corey. That is all the questions that have come through for today, so appreciate you running through those.

Corey Beat:

Fantastic, thank you. Thank you for those you've sent the questions in, too.

CCH Learning:

Yes. Thank you, Corey. All right, so we'll just have a look at our next steps now: So we're just asking everyone to please take a moment to complete the feedback survey that will pop up, and we will also send you an email when the e-learning recording is ready. You can also access the verbatim transcript, CPD certificate, and PowerPoint presentation. So thank you to Corey for the session today, and thank you to everyone in the audience. Appreciate you sending through those questions and getting involved for today's session, and we hope to see you back online for another CCH Learning webinar very soon.