

Tax Insight



Tax consolidation reforms require action by groups

At a glance

- ▶ Long-awaited government announcement on rights to future income affects financial reporting and disclosures
- ▶ Groups need to review transactions spanning three time frames to identify impact
- ▶ Prior year amendments may be needed
- ▶ Taxation of Financial Arrangements (TOFA) interaction with tax consolidation is also to change, with prior-year impact for groups
- ▶ How Ernst & Young can help

On 25 November 2011, Assistant Treasurer, Bill Shorten, announced the long-awaited changes to Australia's tax consolidation laws. The wide-ranging changes affect consolidated groups' recent and future transactions and prior returns; including the treatment of rights to future income (RTFI) and 'residual revenue assets', potentially back to the commencement of tax consolidation in 2002.

The government also announced changes to the Taxation of Financial Arrangements (TOFA) interaction with tax consolidation which will affect some groups' TOFA projects.

The wide-ranging announcements need immediate action by management and boards of tax consolidated groups. The effects will vary depending on groups' tax positions taken and the extent and nature of acquisitions.

Suggested actions include:

- ▶ For recent transactions including reorganisations, review any previously-reported tax positions and balances. Accounting and continuous disclosure requirements may require immediate action.
- ▶ Impact assessment for any transactions currently being planned, negotiated or implemented, including due diligence and forecasts.
- ▶ Review of tax risk management and tax return strategies pending the legislation emerging in the autumn 2012 parliamentary sittings.
- ▶ Possible submissions, including the treatment of groups' costs in complying with the 2010 law.

Groups should also allow for possible further tax consolidation changes not yet announced.

Wide-ranging changes for RTFI and residual revenue assets - the principles

The government's [announcement](#) and accompanying papers arose from government concerns that the 2010 amendments to the tax consolidation RTFI and revenue asset rules resulted in outcomes and revenue costs not anticipated by government. On 30 March 2011 the government announced it had asked the Board of Taxation (the Board) to consider the 2010 amendments, and the Board's [report](#) (pdf, 259kb) has also now been publicly released.

The changes go further than modifying the 2010 amendments and will affect mergers, acquisitions and restructure arrangements. Most consolidated groups will be affected.

The government has announced three time periods with differing impacts:

- ▶ The 'retrospective period' for consolidated groups in the period from 2002 to the commencement of the 2010 amendments, with 'protected claims' for returns lodged, assessments issued and matters subject to private rulings prior to 31 March 2011
- ▶ The 'transitional period' for entities joining under arrangements based on the 2010 amendments, with some 'protected claims'
- ▶ The current or 'prospective period' for entities joining after 30 March 2011, unless the entity was acquired under an arrangement before 30 March 2011

The retrospective impacts will upset many corporate groups that had not acted inappropriately, and were still working with or awaiting further guidance from the Australian Taxation Office (ATO) on the RTFI and revenue asset rules in the 2010 amendments. Some groups have incurred significant costs in complying with the law which will now be retrospectively amended.

RTFI will be classified into three categories for the purpose of the proposed changes:

Category 1: Work in progress	Unbilled income and work in progress where the work has been done, or the goods or services have been provided, by the joining entity before the joining time.
Category 2: Future income under present contracts	Where the work will be done, or the goods or services provided, after the joining time under a contract entered into <i>before</i> the joining time. Exclusions apply for rights contingent on renewal or potential extensions of a contract, or a potential future contract.
Category 3: Expected future contracts	Expectations of future revenues from customer relationships or rights to income that are contingent on the renewal of the contract.

The outcomes depend on the time of the arrangement under which an entity joined the tax consolidated group, not just the joining date. The time of the arrangement will be determined as follows:

- ▶ On-market takeover bid - the date of announcement
- ▶ Off-market takeover - the ASIC notice of bidder statement
- ▶ Scheme of arrangement - the date of application for court order
- ▶ Other transactions - the 'day on which a decision to enter into arrangement (including an Initial Public Offering) was made'

The application of the arrangement rules to creeping acquisitions, with multiple potential arrangements, is unclear at this stage. The arrangement timing rule will require careful analysis of recent transactions, to correctly allocate the arrangement into the relevant time periods for the proposed new rules.

1. Entities joining before 12 May 2010

These changes apply to subsidiary members that, broadly, joined a consolidated group in the period from 2002 until 12 May 2010. Arrangements entered into before 10 February 2010 will also fall into this category irrespective of the joining time. The law will significantly narrow the scope of the 2010 amendments as outlined below:

RTFI assets	Limiting claims to unbilled income and work in progress assets (Category 1) excluding RTFI Category 2 or 3. A new additional-value test requires that RTFI assets arising from an underlying asset have additional value separate to the underlying asset (e.g. rents from chattel leases).
Revenue assets	The revenue asset rules originally enacted in 2002 with a new specific deduction for consumables, but excluding: <ul style="list-style-type: none"> ▶ Mine site improvements ▶ Value of in force business of insurance companies ▶ RTFI Category 2 or 3 assets such as customer relationships and similar intangibles

However, there is some protection provided for certain claims made prior to 31 March 2011 as follows:

- ▶ Tax claims which received ATO private binding rulings, or were disclosed in advance compliance arrangements (ACA) will be preserved.
- ▶ Claims in tax returns lodged or assessments issued prior to 12 May 2010 will be allowed, applying the original revenue asset rules only excluding customer relationship assets, know-how or other accounting intangible assets.
- ▶ Claims in tax returns lodged or assessments issued between 12 May 2010 and 31 March 2011 will be allowed, applying the 2010 amendments as modified under the transitional period rules (see below).
- ▶ No protection applies for returns lodged after 30 March 2011 or where private rulings or amendments were requested but not issued by the ATO until after 30 March 2011 or are still outstanding.

2. Transitional period - Entities joining under arrangements based on the 2010 amended law

The most beneficial treatment applies to entities which join under arrangements entered into between 10 February 2010 and 30 March 2011, where the joining time was anytime on or after 12 May 2010 (including joining times after 30 March 2011).

The 2010 amendments will be limited as follows:

RTFI assets	Exclude value of 'customer relationships', contract extensions and contracts cancellable with no penalty. Those values will be allocated to goodwill. A new additional-value test requires that RTFI assets add value to the underlying asset (e.g. rents from chattel leases, contracts arising from underlying assets).
Revenue assets	Revenue asset rules in 2010 amendments will apply but mine site improvements are excluded and deemed goodwill assets are likely to be treated on capital account.

Protection will apply for tax claims which received ATO private binding rulings or were disclosed in ACAs by 30 March 2011. In this time period there is no additional protection for returns lodged and assessments issued by 30 March 2011.

These changes will affect the tax and financial outcomes for joining entities under recent mergers, acquisitions and restructure arrangements. Groups should review tax warranties and indemnities in transaction contracts.

3. Entities joining under arrangements after 30 March 2011

Extensive changes apply to entities that joined a consolidated group from 31 March 2011 (unless the joining was under an arrangement before 30 March 2011). They:

- ▶ Will affect recent transactions, and may require review of contractual terms
- ▶ No protection applies for returns lodged after 30 March 2011 or where private rulings or amendments were requested but not issued by the ATO until after 30 March 2011 or are still outstanding.

RTFI rule	Limited to work in progress (WIP) assets - goods and services provided up to the joining time. RTFI other than WIP will be retained cost assets , using the joining entity's terminating value.
Revenue assets	Tax cost setting rules will apply only for assets recognised for tax purposes, including consumables, and not for assets producing blackhole deductions. Customer relationships and other intangibles not able to be sold separately will be treated as part of goodwill. A deemed business acquisition approach will apply, which treats the transaction as if it were an asset purchase rather than a corporate acquisition. The tax outcomes will vary for different acquirers and joining entities. The asset will be treated on capital account in many cases.

TOFA and tax consolidation

The government also announced changes which affect tax consolidated groups which entered the Division 230 TOFA rules.

The rules governing a consolidated head company's treatment and the transitional balancing adjustment were unclear and confusing. Key elements of the announcement are:

- ▶ A joining entity's financial arrangement liabilities come in at accounting value not original value for purposes of the accruals/realisation or hedging method.
- ▶ Changes to calculation of transitional balancing adjustments, where the head company consolidated before entering the TOFA regime and uses the financial reports TOFA method. Only the primary (long-form) method can be used to calculate the difference in pre-TOFA and post-TOFA treatment of financial arrangements for this purpose - the group cannot use the short form method based on tax effect balances in financial statements.
- ▶ The amendments will also clarify that the primary method takes into account the operation of the TOFA/consolidation interaction provisions.

These changes will have potentially significant effects for some groups.

Time limits for amendments, interest and penalties

The ATO will be able to amend assessments to give effect to the proposed changes under its existing amendment powers. However, groups can amend their prior year returns under existing amendment time periods and within a further two years after these proposed changes are enacted. No interest will be payable on any future refunds related to the RTFI or revenue asset rules.

Importantly, there will be no interest or penalties for any additional tax payable for pre 31 March 2011 assessments that are amended to give effect to the announced changes. Groups should review their tax risk management strategies in light of this proposal.

More changes may emerge in 2012

Groups' tax consolidation planning will need to allow for potential further changes to emerge throughout 2012. The government announcement mentions further work by the Board including:

- ▶ Work to resolve two further issues identified in the RTFI review, covering the treatment of liabilities under the consolidation regime and capping the tax costs allocated to certain types of assets
- ▶ Completion of the Board's post implementation review of certain aspects of the consolidation regime

Accounting implications

Groups need to consider how the government announcements might impact financial reporting at 31 December 2011.

It is likely that we will not see legislation introduced into Parliament before mid 2012. In our view, the law will not be substantially enacted at 31 December 2011, and consequently, any impact of the application of the proposed changes that differs from the position currently booked will not be required to be booked.

How Ernst & Young can help

Tax consolidated groups need to immediately consider the impact of this announcement on their groups. Our Transaction Tax Advisory team, together with your tax engagement team, can assist you with:

- ▶ Evaluating transactions underway or planned, including valuations required
- ▶ Consideration of continuous disclosure and accounting (including December financial statements)
- ▶ Considering the financial impact including dividend franking planning where required
- ▶ Tax return preparation processes including current year returns underway
- ▶ Tax risk management and eventual changes to prior year returns
- ▶ Monitoring the tax consolidation environment for more changes to come
- ▶ Reviewing the categorisation and status of RTFI assets and revenue assets
- ▶ Making submissions relating to the draft law.

To discuss the impact of these changes on your group, contact your local Ernst & Young advisor.

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