TAX CONSOLIDATION: 
KEY MERGERS AND ACQUISITIONS ISSUES

By Aldrin De Zilva*

The introduction of the tax consolidation regime in Australia has had a profound impact on the tax implications of mergers and acquisitions in Australia. This article explores a number of practical tax consolidation issues and traps for the unwary which should be considered in a mergers and acquisitions context.

1. INTRODUCTION

The introduction of the tax consolidation regime has forever altered the corporate income tax landscape. It has created significant new opportunities and risks in undertaking certain transactions, especially in a mergers and acquisitions (“M&A”) context.

To date, tax consolidation analysis and commentary has focused on the formation of consolidated groups, particularly during the so-called “transitional period”.¹ However, as most corporate groups are likely to have made the transition into tax consolidation, consideration needs to be given to the implications of income tax consolidation on the future activities of corporate groups, such as the significant consequences for corporate groups resulting from the acquisition and disposal of subsidiary members.

While the tax consolidation regime will make it easier for companies in a consolidated group to move assets intragroup and to conduct intragroup transactions, it has also transformed and complicated the M&A taxation issues to be considered by both

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¹ Generally, the transitional period comprised 1 July 2002 to 30 June 2004.
purchasers and vendors when purchasing or disposing of assets or subsidiaries of both consolidated and unconsolidated groups.

While there are a wide range of issues that can arise from M&A transactions, this article focuses on identifying and examining a number of key tax consolidation issues that can arise for the head company of a tax consolidated group when acquiring or disposing of a subsidiary member. The article is not intended to be an exhaustive analysis of every technical issue that may arise during the course of a particular transaction. A number of divestment issues will be addressed, including:

- calculating the membership interests of a subsidiary member exiting the tax consolidated group;
- calculating the membership interests where several subsidiary members exit the tax consolidated group; and
- an examination of Capital Gains Tax (“CGT”) event L5.

Acquisition issues will also be considered, including:

- a consideration of the implications of one tax consolidated group acquiring another tax consolidated group;
- an examination of various tax loss issues;
- considering the impact on Allocable Cost Amount (“ACA”) of deferred consideration (such as earn out clauses) and purchase price refunds; and
- a consideration of the impact of tax consolidation on financing documents.

The legislative framework in relation to tax consolidation remains subject to change. Furthermore, it is expected that tax rulings and tax determinations will be released to provide further guidance on the provisions.
2. DIVESTMENT ISSUES

2.1 Calculating Membership Interests in Leaving Entities

Broadly, a consolidated group consists of the head company, and all of its wholly-owned Australian resident subsidiary members.\(^2\) Where an entity ceases to be eligible to be a subsidiary member of a consolidated group (“the old group”) at a particular time, that entity is referred to as a “leaving entity”.

Where a subsidiary member leaves a consolidated group, Div 711 of the *Income Tax Assessment Act 1997* (Cth) (“ITAA97”)\(^3\) provides statutory rules to determine the tax cost of membership interests held by a consolidated group in a subsidiary member. The group’s cost base of membership interests is basically derived from the tax cost of the assets of the leaving entity at the leaving time reduced by the amount of its liabilities.\(^4\) This aims to preserve the alignment between the costs for membership interests in the entity and its assets.

A subsidiary member leaves the group when:\(^5\)

- all or part of it is sold;
- it is deregistered;
- it ceases to be an Australian resident; or
- it becomes ineligible for membership of the tax consolidated group for any other reason.

It is important to note that only “membership interests” (eg shares in a company) are taken into account.\(^6\) Therefore, granting options or the issue of rights or shares which are debt interests for tax

\(^2\) *Income Tax Assessment Act 1997* (Cth), s 703-10 (“ITAA97”).
\(^3\) ITAA97, s 711-15 (single exit) and s 711-55 (multiple exit).
\(^4\) ITAA97, s 701-15(2).
\(^6\) ITAA97, ss 960-130 and 960-135.
purposes should not result in a subsidiary leaving the consolidated group.

2.2 Tax Attributes

Subsidiary members that leave the group are treated as separate entities for income tax purposes unless, on leaving, they immediately become subsidiary members of another consolidated group.\(^7\)

A tax consolidated group continues to exist even though a subsidiary member (or members) leaves the group (except if the head company ceases to be eligible to be a head company of a consolidated group). The tax attributes that the subsidiary member had when it joined the consolidated group, such as losses and franking credits, remain with the head company of the group.\(^8\) These tax attributes do not transfer to a new purchaser on the sale of a subsidiary member by the head company.

The only exception relates to Controlled Foreign Company (“CFC”) and Foreign Investment Fund (“FIF”) attribution accounts where the sale of the subsidiary results in a transfer of some or all of the CFC’s/FIF’s owned by the consolidated group. The proportion of attribution account surpluses will be transferred to the leaving entity based on the percentage of such investments held.

3. SINGLE LEAVING ENTITY

Broadly, the tax cost setting amount for membership interests of a leaving entity is based on a share of the ACA on exit, which consists of the terminating values of the assets that the leaving entity takes with it, reduced by its liabilities.

The tax consolidation provisions do not prescribe the tax consequences from a disposal of membership interests as such. The tax cost setting amount is merely used as an input to calculate any income tax consequences on disposal of interests in the leaving entity.

\(^7\) Manual, above n 6, B3-5:2.
\(^8\) Ibid.
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by the group. Any gain or loss must be determined for CGT and for revenue account purposes as appropriate under general concepts.

The process for calculating the leaving entity’s ACA is specifically set out in s 711-15(1) of the ITAA97 and requires:

(a) first, working out the old group’s allocable cost amount for the leaving entity in accordance with s 711-20; and

(b) next, if there is more than one class of membership interests in the leaving entity – allocating the allocable cost amount to each class in proportion to the market value of all of the membership interests in the class; and

(c) next, allocating the result under paragraph (a) or (b) to each of the membership interests, or membership interests in the class, by dividing the result by the number of those membership interests …

Section 711-20(1) of the ITAA97 provides that the old group’s allocable cost amount for the leaving entity is calculated as follows:

<p>| Working out the old group’s allocable cost amount for the leaving entity |
|-----------------------------|----------------------------------|----------------------------------|</p>
<table>
<thead>
<tr>
<th>Step</th>
<th>What the step requires</th>
<th>Purpose of the step</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Start with the step 1 amount worked out under s 711-25, which is about the terminating values of assets that the leaving entity takes with it when it ceases to be a subsidiary member.</td>
<td>To ensure that the allocable cost amount includes the cost of the assets.</td>
</tr>
<tr>
<td>2</td>
<td>Add to the result of step 1 the step 2 amount worked out under s 711-35, which is about the value of deductions inherited by the leaving entity that are not reflected in the terminating value of</td>
<td>To ensure that the value of the deductions is reflected in the allocable cost amount.</td>
</tr>
</tbody>
</table>

9 ITAA97, s 701-55.
the assets that the leaving entity takes with it.

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Add to the result of step 2 the step 3 amount worked out under s 711-40, which is about liabilities owed by members of the old group to the leaving entity at the leaving time.</td>
<td>To ensure that the liabilities, which are not recognised while the leaving entity is taken to be part of the head company by subsection 701-1(1), are reflected in the allocable cost amount.</td>
</tr>
<tr>
<td>4</td>
<td>Subtract from the result of step 3 the step 4 amount worked out under s 711-45, which is about: (a) the liabilities that the leaving entity takes with it when it ceases to be a subsidiary member; and (b) membership interests in the leaving entity that are not held by members of the old group.</td>
<td>To ensure that the allocable cost amount is reduced to reflect the liabilities and the market value of the membership interests.</td>
</tr>
<tr>
<td>5</td>
<td>If the amount remaining after step 4 is positive, it is the old group’s allocable cost amount for the leaving entity.</td>
<td>Otherwise the old group’s allocable cost amount is nil.</td>
</tr>
<tr>
<td>6</td>
<td>(Repealed by No 90 of 2002)</td>
<td></td>
</tr>
</tbody>
</table>

### 3.1 Step 1

The use of this step significantly aligns a sale of assets to a sale of shares. The terminating values of assets is calculated in accordance with s 705-30 of the ITAA97. In essence, the liabilities...
terminating value of an asset is its tax value under the respective asset regime.

The term “asset” is not a defined term in the consolidations law. The *Explanatory Memorandum* to the New Business Tax System (Consolidations) Bill (No 1) 2002 (Cth) (“Explanatory Memorandum”) provides that “an asset, for the purposes of the cost setting rules, is anything of economic value which is brought into consolidated group by an entity that becomes a subsidiary member of the group”.\(^{11}\) In *Taxation Ruling* TR 2004/13 the Australian Taxation Office (“ATO”) draws attention to the fact that “the meaning of the word ‘asset’ is found within the commercial or business context that applies where a single entity joins an existing consolidated group … Accordingly, an asset for the purpose of the tax cost setting rule is anything recognised in commerce and business as having economic value to the joining entity at the joining time”.\(^{12}\) Practically this may not pose too much of a problem as the key aspect for Div 711 purposes is not so much to identify each asset that leaves with the leaving entity, but rather to identify those assets that have a terminating value, as it is the latter assets that will increase the old group’s ACA.

It should be noted that in relation to goodwill, s 711-25(2) of the ITAA97 provides that:

If loss of control and ownership of the leaving entity by the head company would decrease the market value of the goodwill associated with assets or businesses of the old group (other than those of the leaving entity), the head company’s cost base of the asset consisting of goodwill that it holds at the leaving time because of its control and ownership of the leaving entity is added to the step 1 amount.

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\(^{11}\) *Explanatory Memorandum* to the New Business Tax System (Consolidations) Bill (No 1) 2002 (Cth) para 5.19 (“Explanatory Memorandum”).

\(^{12}\) Ibid paras 4 and 5.
3.2 Step 2

Step 2 distinguishes between “owned deductions” and “acquired deductions”. The former are included at 100% of the amount, and the latter at 30%.\(^\text{13}\)

Step 2 essentially mirrors step 7 of the entry ACA calculation.

3.3 Step 3

The step 3 amount is:

the total, for all liabilities owed by members of the old group to the leaving entity at the leaving time, of the market values of the corresponding assets of the leaving entity.\(^\text{14}\)

The amount to be added is the market value at the leaving time of the leaving entity’s assets that correspond to the liabilities owed to it by group members at the leaving time. However, where the market value of the corresponding asset held by the leaving entity is greater than its cost, the cost amount is used.\(^\text{15}\)

This element of the ACA is separately identified because, while an entity is a member of a consolidated group, amounts it is owed by other members of the group are not recognised for income tax purposes.

3.4 Step 4

The fourth step in determining the old group’s ACA is to subtract the amount of the leaving entity’s liabilities. In this respect s 711-45(1) of the ITAA97 states:

For the purposes of step 4 in the table in subsection 711-20(1), the step 4 amount is worked out by adding up the amounts of each thing (an accounting liability) that, in accordance with accounting standards, or statements of accounting concepts made by the

\(^\text{13}\) ITAA97, s 711-35(1).
\(^\text{14}\) ITAA97, s 711-40(1).
\(^\text{15}\) ITAA97, s 711-40(2).

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Australian Accounting Standards Board, is a liability of the leaving entity at the leaving time that can or must be identified in the entity’s statement of financial position.

In calculating the amount of liabilities included at step 4, the following adjustments are required:

- an amount is not to be added for an accounting liability that arises because of the leaving entity’s ownership of an asset if, on disposal of the asset, the accounting liability will transfer to the new owner.\(^{16}\) The note to s 711-45(2) of the ITAA97 refers to a mine rehabilitation liability;

- if some or all of an accounting liability will result in a deduction to the leaving entity, the amount to be added for the accounting liability is reduced for the tax effect,\(^{17}\) ie 70% of the liability is included;

- if an accounting liability of the leaving entity is owed to a member of the old group, the amount to be added for the liability is the market value of the corresponding asset of the member (rather than the face value);\(^ {18}\)

- if, for income tax purposes, an accounting liability, or a change in the amount of an accounting liability, (other than one owed to a member of the old group) is taken into account at a later time than is the case in accordance with accounting standards or statements of accounting concepts made by the Australian Accounting Standards Board, the amount to be added for the accounting liability is equal to the payment that would be necessary to discharge the liability just before the leaving time without an amount being included in the assessable income of, or allowable as a deduction to, the head company. An example is accrued

\(^{16}\) ITAA97, s 711-45(2).
\(^{17}\) ITAA97, s 711-45(3).
\(^{18}\) ITAA97, s 711-45(4).
employee leave entitlements or foreign exchange gains and losses;\(^\text{19}\)

- if any membership interest (an employee share interest) in the leaving entity needed to be disregarded under s 703-35 of the ITAA97 in order for the leaving entity to be a wholly-owned subsidiary of the head company at the leaving time, the step 4 amount is increased by the sum of the market values of those interests;\(^\text{20}\) and

- the step 4 amount is increased by the market value of each thing that, in accordance with accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board, is equity in the leaving entity at the leaving time, where the thing is also a debt interest.\(^\text{21}\)

The Explanatory Memorandum states “a specific provision is required to have these debt interests taken into account as liabilities because they are not recognised as liabilities for accounting purposes”.\(^\text{22}\)

3.5 Example – Single Leaving Entity

The following example provides a simple illustration of how the membership interest and capital gain in respect of a leaving entity is calculated.

A head company disposes of a 50% interest (ie 50,000 out of 100,000 shares) in a tax consolidated subsidiary company Sub Co (leaving entity) for $2m. Sub Co’s balance sheet just before it leaves the group is:

\(^{19}\) ITAA97, s 711-45(5).

\(^{20}\) ITAA97, s 711-45(6).

\(^{21}\) ITAA97, s 711-45(7).

\(^{22}\) Explanatory Memorandum, above n 11, para 5.130.
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<table>
<thead>
<tr>
<th></th>
<th>Market Value</th>
<th>Terminating Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$000</td>
<td>$000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Plant &amp; Equip @WDV</td>
<td>1,500</td>
<td>1,600</td>
</tr>
<tr>
<td>Receivables</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>1,400</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(500)</td>
<td></td>
</tr>
<tr>
<td><strong>Net Assets</strong></td>
<td><strong>2,500</strong></td>
<td></td>
</tr>
</tbody>
</table>

1. Calculate tax cost setting amounts for the leaving entity’s membership interests

   **Step A:** Work out ACA (add TVs less liabilities)
   \[=1+1.5+0.5+0.5 – 0.5 = $3m\]

   **Step B:** Allocate ACA to each of the membership interests = $3m/100,000 = $30

2. Calculate CGT gain/loss on disposal

   Capital gain = $2m – (50,000 x $30) = $2m – $1.5m = $0.5m

4. MULTIPLE EXIT

   Where the leaving entity holds membership interests in another subsidiary member of the consolidated group, that subsidiary will also cease to be a member at the leaving time. The cost of the membership interests in each of the leaving subsidiaries must be worked out on a bottom-up basis,\(^\text{23}\) as the membership interests in the lower level entity (which represent an asset of the higher level

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\(^\text{23}\) ITAA97, s 711-55.
entity) must be given a cost which is used in turn to calculate the cost of membership interests in the higher level entity.\textsuperscript{24}

If the head company ceases to be eligible to be a head company of a consolidated group, the group usually also ceases to exist giving rise to a multiple exit scenario.

Importantly, the calculation includes liabilities owed to the leaving entity by any of the other entities that cease to be subsidiary members.\textsuperscript{25}

5. COST BASE TRADE-OFF

As a result of the membership interests being calculated by reference to the terminating value of the leaving entity’s assets, the cost base of shares of a subsidiary may alter on a daily basis as the total assets held by the subsidiary changes (eg trade receivables, stock, etc) or the terminating values of assets change. For example, where the subsidiary owns assets which are depreciated for tax purposes, the greater the amount of depreciation claimed the lower the terminating value is for the depreciable assets included in step 1.

This calculation could therefore give rise to a trade off between maximising the allocation of ACA to depreciable assets compared to non-depreciable assets at formation. This may be particularly evident where a disposal is expected in the short-medium term following formation of the consolidated group or following acquisition of a subsidiary which is expected to be sold.

6. CGT EVENT L5

Where the leaving entity’s ACA after step 4 is a negative amount, the ACA (and therefore the tax cost setting amount of the membership interest) is deemed to be nil.

\textsuperscript{24} ITAA97, s 711-55 and \textit{Explanatory Memorandum} to the New Business Tax System (Consolidation) Bill (No 1) 2004 (Cth) para 5.142.

\textsuperscript{25} ITAA97, s 711-55(3)(a).
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In addition, CGT event L5 arises and the head company is taken to have made a capital gain equal to the negative amount. The time of the event is when the entity ceases to be a subsidiary member of the group.

The head company is liable for 100% of the gain, irrespective of whether the head company has actually disposed of any membership interests in the leaving entity, for example where there is a change in the tax residency of a subsidiary resulting in it being unable to satisfy the requirements of being a subsidiary member of the tax consolidated group. CGT event L5 can apply even if the membership interests are pre-CGT interests.

Companies with assets which have either been largely depreciated or which are internally generated may not be able to support the existing company’s level of liabilities when the company leaves the consolidated group. This is because such assets will have little or no terminating value (ie tax cost base) for the purposes of the exit calculation performed under Div 711. However, where the market value of such assets is higher than their respective terminating value, the existing company may have been able to rely on such a market value to support the level of liabilities (including debt) which the company has reflected in its balance sheet.

The adoption of International Financial Reporting Standards (“IFRS”) in Australia is also relevant to the exit calculation under Div 711. Australian companies will be required to adopt IFRS from 1 July 2005, in the case of entities with a 30 June year end, and 1 January 2005, for entities with a 31 December year end. Depending on the profile of a company, the adoption of IFRS could lead to additional liabilities being included in a company’s balance sheet which will be taken into account when calculating a leaving entity’s ACA under Div 711. Examples of liabilities which may be required to be included in a balance sheet under IRFS include “out of the money” commodity contracts and interest rate swaps as well as defined benefits superannuation funds operated by companies which

26 ITAA97, s 104-520.
are not fully funded (in this case, the unfunded portion would represent a liability). Many of these liabilities would not currently appear on the balance sheet under current Australian Generally Acceptable Accounting Principles.

CGT event L5 operates independently from other CGT events. Accordingly, in situations involving a sale of a subsidiary member, the vendor may have a capital gain arising from the actual disposal of the member of the consolidated group under CGT event A1 as well as a gain under CGT event L5 resulting from the member leaving the consolidated group.

CGT event L5 can also apply in the following circumstances:

a) CGT event L5 on the disposal of multiple entities

CGT event L5 can occur multiple times as the calculation under s 711-20 (which gives rise to CGT event L5) applies on an entity by entity basis.

b) CGT event L5 for Eligible Tier-1 (“ET1”) companies of a Multiple Entry Consolidated (“MEC”) Group

CGT event L5 can also apply to the disposal of an ET1 company of a MEC group despite the fact that the tax cost base of shares for an ET1 company is calculated under Div 719 and not Div 711 (which is required for CGT event L5 to apply). CGT event L5 was amended following its introduction so that the provision would apply to MEC groups and not just consolidated groups. Therefore, CGT event L5 is also a concern in disposals involving ET1 companies which, prima facie, may not have appeared to be the case.

Extreme care needs to be undertaken in dealing with subsidiaries where liabilities exceed the terminating values of the assets. The

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27 ITAA97, s 104-10.
capitalisation of any intra-group debts may be an appropriate strategy in some instances.

6.1 Example – CGT Event L5

Sub Co is the only subsidiary member of a tax consolidated group. The shares in Sub Co are sold by the head company for $1m. Sub Co’s balance sheet just before it leaves the group is:

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
<th>Market Value</th>
<th>Terminating Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000 (cost base)</td>
</tr>
<tr>
<td>Plant &amp; Equip @WDV</td>
<td>1,500</td>
<td>1,600</td>
<td>1,500 (adjustable value)</td>
</tr>
<tr>
<td>Receivables</td>
<td>500</td>
<td>500</td>
<td>500 (cost base)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>2,900</td>
<td>500 (cost base)</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(5,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Assets</td>
<td>(2,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Calculate tax cost setting amounts for the leaving entity’s membership interests

Work out ACA (add TVs less liabilities) = 1 + 1.5 + 0.5 + 0.5 – 5 = ($2m)

Given the result is negative the ACA is nil. More importantly, the head company derives a $2m capital gain.

Given Sub Co is sold for $1m, the nil tax cost setting amount is compared to the capital proceeds of $1m received under the sale.\(^{29}\)

\(^{29}\) This is calculated as the market value of the asset held by the company (ie $6m) less the liabilities of the existing company (ie $5m).
and a capital gain under CGT event A1 of $1m also arises. Therefore, in situations involving a sale of a subsidiary member, the vendor may have a capital gain arising from the actual disposal of the member of the consolidated group under CGT event A1 as well as a CGT event L5 capital gain resulting from the member leaving the consolidated group.

7. TAX LOSSES

From a vendor’s perspective, it is important to consider what impact a transaction may have on the vendor group’s existing tax losses.

If the consolidated group’s tax losses are same business test losses, it is necessary to consider whether the disposal of a business or businesses by the consolidated group by way of the disposal of a subsidiary might result in a failure of the same business test.

8. CGT EVENT J1

CGT event J1 applies if an asset is rolled into a company, and that company subsequently leaves the group. In this circumstance the recipient company may make a capital gain.

With the introduction of tax consolidation, s 104-182 has been inserted which provides:

CGT event J1 does not happen if the recipient company ceases to be a subsidiary member of a consolidated group at the break-up time (whether or not it becomes a subsidiary member of another consolidated group at that time).

Paragraph 13.29 of the Explanatory Memorandum states:

A consequential amendment has been made to the circumstances in which a J1 event occurs under section 104-175 of the ITAA 1997. If the recipient company following a rollover under new Subdivision 126-B ceases to be a subsidiary member of a consolidated group at the break-up time, CGT event J1 does not occur. This is because the

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30 ITAA97, s 104-10.
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cost base provided to the group for its membership interests in the leaving entity under Division 711 of new Part-3-90 is the same as would have been provided if the group had disposed of the assets of the leaving entity directly.

9. TRANSITIONAL MEASURES

In calculating the old group’s ACA, there are a number of potential adjustments that may arise. For example, where the over-depreciated asset rules applied to the subsidiary on formation or entry, then the head entity has an ability to increase the old group’s ACA by the over-depreciation adjustment (s 701-40, Transitional Provisions). The provision requires the head company to provide the subsidiary with a notice prior to the leaving time that the choice has been made to increase the old group’s ACA. The acquiring group then needs to work through the over-depreciation provisions in respect of the acquired subsidiary.

10. ACQUISITION ISSUES

10.1 One Consolidated Group Acquires Another

A consolidated group ceases to exist if:

- the head company becomes a subsidiary member of another consolidated group; or
- the head company ceases to be eligible to be a head company and the first situation does not occur, for example, the head company ceases to exist or becomes a non-resident or the head company joins a MEC group.

Normally, an ACA calculation would be performed for each entity that joins a consolidated group pursuant to Divs 701 and 705 of the ITAA97. However, the rules in relation to the tax cost setting amount in Divs 701 and 705 are modified under Subdiv 705-C of the ITAA97 where a consolidated group is acquired by another consolidated group. Specifically, the head company of the acquired group is treated, with some modification, as a single joining entity. It is the only entity that joins the acquiring group. The subsidiary
members of the acquired group are treated as parts of its head company, with their assets being treated as the head company’s assets, which have their tax costs set at the acquisition time. Intragroup assets, liabilities and membership interests are ignored.\(^{31}\)

Where Subdiv 705-C of the ITAA97 applies, ss 701-15 and 701-50 of the ITAA97 relating to the tax cost setting amounts of membership interests where entities cease to be members of a consolidated group will not apply. In addition, Div 711 of the ITAA97 which calculates the tax cost setting amounts for membership interests in subsidiaries that cease to be members of a consolidated group will also not apply.

An L5 CGT event can only occur where Div 711 applies in relation to the tax cost setting amount for membership interests of subsidiary members leaving a consolidated group. Accordingly, on the basis that Div 711 does not apply, there should be no L5 CGT event as a result of one tax consolidated group joining another.

### 11. RATE OF UTILISATION OF TAX LOSSES

If a head company (former head company) is acquired by another consolidated group and loss bundles are transferred from the former head company to the new head company, an available fraction (“AF”) calculation under s 707-320(1) of the ITAA97 is not undertaken in relation to the previously transferred loss bundles. This is because the transfer of losses will not be at the “initial transfer time” as is required for s 707-320(1) of the ITAA97 to apply. Instead, the AF which applied to loss bundles of the former head company may be adjusted in accordance with the table in s 707-320(2) of the ITAA97.

Under s 707-320(2), an available fraction for a bundle of losses is adjusted by one of the items in the table as follows:

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\(^{31}\) ITAA97, Subdiv 705-C.
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If an event described in an item of the table happens, the available fraction for the bundle is reduced or maintained just after the event by multiplying it by the factor identified in the item:

<table>
<thead>
<tr>
<th>Item</th>
<th>Event</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>One or more losses in the *bundle are transferred for the second or subsequent time</td>
<td>The lesser of 1 and this fraction: Market value of the transferor at the time of the transfer Market value of the transferee at the time of the transfer</td>
</tr>
<tr>
<td>2</td>
<td>At the same time as the losses in the *bundle were most recently transferred, losses in one or more other bundles were transferred from the same transferor to the same transferee, and the losses in the bundle or one of the other bundles had not been transferred before</td>
<td>The result of dividing the lesser (a) the available fraction (apart from this subsection) for the bundle of losses that had not been transferred before; and (b) 1; transferred before by the sum of the available fractions for all the bundles (apart from this item applying to transfers at the time)</td>
</tr>
<tr>
<td>3</td>
<td>The company to which the losses in the *bundle were most recently transferred has transferred to it at a later time losses in one or more other bundles</td>
<td>Total of the available 1 - fractions for the other bundles just after the later time</td>
</tr>
<tr>
<td>4</td>
<td>There is an increase the market value of the company to which the losses in the *bundle were most recently transferred, because of an event described in subsection 707-325(4) (but not covered by subsection 707-325(5))</td>
<td>Market value of the company just before the event transferred, because of an event described in Market value of the company just before the event amount of the increase</td>
</tr>
<tr>
<td>5</td>
<td>The available fractions (apart from this item) for all the *bundles of 1 losses most recently made by the company that most recently made the losses in the bundle total more than 1,000</td>
<td>1. The total</td>
</tr>
</tbody>
</table>

The modification to AF as required by the above table can have some very undesirable effects, as illustrated in the example below.

(2005) 8(1)
11.1 Example

Assume a tax consolidated group (“TC1”) acquired 100% of the shares in another tax consolidated group (“TC2”). Further assume TC2 had $100m of previously transferred carry forward tax losses with an AF of 1 prior to the acquisition by TC1. Calculate the AFs where:

a) TC2 had no tax losses (other than the tax losses previously transferred to it at formation); and

b) TC2 (in addition the tax losses previously transferred to it at formation) has a $1 tax loss.

Assume the market value of TC1 (prior to the acquisition) is negligible.

Under scenario (a) the AF attaching to the $100m of tax losses of TC2 upon the subsequent transfer of the tax losses to TC1 would be 1 under item 1 of the table.

Under scenario (b) the AF attaching to the $100m of tax losses would be 0.5 and the AF attaching to the $1 tax loss would also be 0.5 as a result of the operation of item 2 of the table.

In this circumstance the head company of TC1 may consider cancelling the $1 group loss.

12. TAX LOSS CANCELLATION

The tax consolidation provisions enable the head company to cancel the transfer of a loss. Section 707-145(1) of the ITAA97 states:

The head company of the joined group may choose to cancel the transfer of the loss.\(^{32}\)

However, care needs to be taken in applying this provision. Unfortunately the term “the loss” is not defined.

\(^{32}\) Emphasis added.
TAX CONSOLIDATION: KEY M & A ISSUES

Section 707-140(1) of the ITAA97 states:

To the extent that the loss is transferred under section 707-120 from the joining entity to the head company of the joined group, this Act operates (except so far as the contrary intention appears) for the purposes of income years ending after the transfer as if:

(a) the head company had made the loss for the income year in which the transfer occurs; and

(b) the joining entity had not made the loss for the income year for which the joining entity actually made the loss.\(^{33}\)

The definition of “tax loss” in s 995 of the ITAA97 requires a loss to be determined on the basis of an income year. Arguably, s 707-140 of the ITAA97 may operate to cause the aggregation of the transferred and group losses.

Therefore, where in the year of consolidation the Head Company of a consolidated group has tax losses transferred to it under s 707-120 of the ITAA97 and in the same income year it incurs a current year tax loss (group loss) there is a risk that the aggregate of the previously transferred tax losses and the group loss would together constitute “the loss” that would be transferred on the subsequent acquisition of that group by another consolidated group and it is that aggregated loss that would be cancelled if a choice is made by the “new” head company under s 707-145 of the ITAA97.

The alternate view is that each of the transferred loss and the group loss is a separate “loss” and when that original group becomes part of the second consolidated group (in that same year) it is possible for the “new head company” to separately cancel either the previously transferred tax losses or group losses for the purposes of s 707-145 of the ITAA97.

Given paras 8.71 and 8.72 of the Explanatory Memorandum it would seem that Parliament intended the losses in these circumstances to be able to be dealt with separately and to allow the

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\(^{33}\) Emphasis added.
new head company to choose to cancel either or both of the transferred loss or the group loss.

ATO’s Interpretative Decision 2004/939 specifically addresses this issue. It provides that the transfer of the group loss can be cancelled under subsection 707-145(1) of the ITAA97 without it resulting in the cancellation of the transfer of any of the previously transferred losses.

13. DEFERRED CONSIDERATION AND REFUNDS OF PURCHASE PRICE

The first step in calculating the ACA for an entity joining a consolidated group requires aggregating the CGT cost base for all of the membership interests held in the joining entity\(^{34}\) by members of the consolidated group. If the market value of the membership interests at the time the entity joins the consolidated group is less than their CGT cost base, the amount included under the first step will be the greater of the market value or reduced cost base.\(^{35}\) The cost base of membership interests is determined under s 110-25 and includes incidental amounts paid to acquire the membership interests as well as the amount paid to acquire the membership interests.

A share purchaser agreement may provide for a number of payments after the completion of the transaction, which may be treated as adjustments to the purchase price of the shares. These payments could be additional amounts paid to acquire the shares or amounts paid under warranties or indemnities, which effectively recoup the purchase price. The issue to arise is how these payments should be treated if they are made after the joining time.

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\(^{34}\) ITAA97, s 705-60 sets out the steps to be followed in working out the ACA for the joining entity.

\(^{35}\) Where the market value is less than the CGT cost base, the step 1 amount will be the market value or the reduced cost base. See s 705-65 for further details of how to calculate the cost of membership interests in a joining entity.
13.1 Earn-Out Clauses

Broadly, earn out clauses impose an obligation to pay an amount upon the occurrence of a future event. This will not satisfy the requirement of an amount paid or “required to [be] paid” under s 110-25(2) of the ITAA97. Accordingly, contingent amounts will not, prima facie, be included in the cost base of a membership interest at the time an acquired company enters into the purchaser’s consolidated group.

To resolve this outcome, recent legislative amendments provide that if, after the joining time, money is paid in respect of the acquisition of the membership interest (e.g. under an earn out clause), the payment must be taken into account for the purposes of step 1 of the ACA. Section 705-65(5B), introduced by *Tax Laws Amendment (2004 Measures No 2) Act 2004* (Cth), was granted Royal Assent on 25 June 2004. The section provides:

For the purposes of working out the cost base or reduced cost base of a membership interest under subsection (1), if:

(a) either or both of the following things happen after the joining time:

(i) money paid, or becomes required to be paid, in respect of acquiring the membership interest;

(ii) property is given, or becomes required to be given, in respect of acquiring the membership interest; and

(b) because the thing happened after the joining time, it was not taken into account in working out the first element of the cost base or reduced cost base of the membership interest;

the thing is nevertheless so taken into account, and taken always to have been so taken into account.

As indicated by the Explanatory Memorandum to this amendment, this will ensure that a purchaser who makes a deferred acquisition payment after an entity joins a consolidated group will be

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36 *Taxation Ruling TR 93/15.*
taken to have *always* been able to include the payment in the joining entity’s ACA. Thus, when the obligation to make a payment arises against a purchaser, the purchaser will need to recalculate the joining entity’s ACA and spread this new ACA across the joining entity’s assets, in accordance with the tax cost setting rules.\textsuperscript{37}

### 13.2 Payments Under Warranty of Indemnity

Often the parties to a share sale agreement will include a clause stating that any payments for a breach of warranty or under an indemnity clause will constitute an adjustment to the purchase price of the company acquired.

The wording of s 705-65(5B) requires an adjustment to ACA for “money paid … in respect of acquiring the membership interest”. From the purchaser’s viewpoint, they have *received*, rather than paid, money in respect of acquiring the interest. Therefore, s 705-65(5B) would appear to only provide for a recalculation of ACA for deferred acquisition payments by purchasers, and not recoupments under warranty or indemnity clauses of the share sale agreement.\textsuperscript{38}

Section 110-37(2) would appear to operate to treat the amount of purchase price repaid under a warranty or indemnity clause as never having formed part of the cost base of the shares. This should result in the ACA of the joining entity being amended as the amount of the recoupment should be treated as never having been part of the cost base of the company.

Where the cost base of the membership interest is adjusted (which appears to be the better view), this will result in new tax cost setting amounts being determined for its reset cost base assets and may require the head company to amend any income tax returns which have been lodged in the interim. While amendments to income tax returns due to changes in cost base are not a new event,

\textsuperscript{37} See ITAA97, Subdiv 705-A, especially ss 705-20 to 705-59.

\textsuperscript{38} The Explanatory Memorandum to s 705-65(5B) only discusses deferred acquisition payments by the purchaser and does not consider recoupments such as payments under warranties and indemnities.
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consolidation has created the situation where the tax cost setting amount of a number of assets (and not just for CGT purposes) may need to be re-calculated.

14. FINANCING DOCUMENTATION AND TAX CONSOLIDATION

There may be circumstances where for legal and commercial purposes the financing of part of the tax consolidatable group has been historically kept separate from the remainder of the group. In these circumstances it is essential to ensure that the relevant funding documentation does not pose any restrictions on the formation of a tax consolidated group.

There may be, for example, negative undertakings in the finance documents which prevent the transfer of assets or restrict the indebtedness between certain group members.

In electing to form a tax consolidated group it is essential to review the limitations (if any) that may exist within the relevant financing documents. In certain circumstances the solution to a problem caused by the finance documents may be as simple as seeking approval from the financiers to form a consolidated group.

15. CONCLUSION

The introduction of the tax consolidation regime has changed the critical taxation issues that need to be considered by both purchasers and vendors in M&A transactions. The tax consolidation provisions provide a number of traps for the unwary, several of which are outlined above. As we continue to unravel the mysteries of tax consolidation, it is imperative that all tax practitioners and other interested parties keep abreast of these and other emerging traps and pitfalls.