
The Unthinkable Policy Option? Key Design Issues Under a System of Full Consolidation

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PRÉCIS

En 2010, le ministère des Finances du Canada a lancé un processus de consultation visant à considérer l'établissement éventuel d'un régime officiel d'imposition des groupes de sociétés. La consultation s'est concentrée surtout sur le choix du meilleur type de régime pour le Canada. Les deux principales solutions adoptées dans d'autres pays sont le régime de transfert des pertes et le régime de consolidation intégrale. Il est difficile de faire un choix entre les deux régimes. Néanmoins, il est évident que l'intérêt provincial serait mieux servi par le système de consolidation intégrale, particulièrement en ce qui a trait à la question de la répartition interprovinciale du revenu.

L'objet de cet article est de fournir une analyse comparative détaillée des régimes de consolidation adoptés dans huit pays : l'Australie, la France, l'Italie, le Japon, les Pays-Bas, la Nouvelle-Zélande, l'Espagne et les États-Unis. Ce sont les pays qui, dès la fin de 2009, avaient introduit des régimes de consolidation intégrale touchant à la fois la compensation des pertes à l'intérieur d'un groupe et les transferts d'actifs en franchise d'impôt. L'article fait une comparaison critique des options de politique alternatives en ce qui a trait aux paramètres de conception et aux principaux aspects structurels des huit régimes de consolidation choisis dans le but de trouver un système pouvant servir de modèle ou de base quant à l'élaboration d'un régime canadien. En réponse aux préoccupations touchant l'apparente complexité d'un régime de consolidation, l'article classe les huit régimes au moyen d'un indice de complexité. Cet exercice a pour but de souligner deux aspects de la question : premièrement, les huit régimes représentent un éventail des divers degrés de complexité, permettant de croire qu'un régime de consolidation n'a pas besoin d'être aussi complexe que les modèles australien et américain; et deuxièmement, la complexité d'un régime dépend en grande partie des choix de politique à l'égard des principaux aspects structurels.

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ABSTRACT

In 2010, Canada's Department of Finance initiated a consultation process to consider the possible introduction of a formal corporate group taxation system. A principal focus of the consultation process has been the type of group taxation system that would be best for Canada. The two most common alternatives that have been adopted in other countries are the loss transfer and full consolidation systems. The choice between these two systems is a difficult one. Nevertheless, provincial interest in a full consolidation regime is evident, especially as a means to address the interprovincial allocation issue.

The purpose of this article is to provide an in-depth comparative analysis of the consolidation regimes adopted in eight countries: Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain, and the United States. These are the countries that, by the end of 2009, had introduced full consolidation regimes providing for both intragroup loss offsets and tax-free asset transfers. The article critically compares the alternative policy options with respect to the design features and key structural elements of the eight selected consolidation regimes in an attempt to identify a model regime or template that might serve as a starting point for a Canadian system. In response to concern about the perceived complexity of a consolidation regime, the article ranks the eight consolidation regimes by applying a complexity index. This exercise is designed to highlight two aspects of the issue: first, the eight regimes represent a spectrum of varying degrees of complexity, indicating that a consolidation regime need not be as complex as the Australian and US models; and second, the complexity of a regime depends to a large extent on the policy choices with respect to the key structural elements.

KEYWORDS: COMPARATIVE ANALYSIS ■ CONSOLIDATION ■ CORPORATE TAXES ■ GROUP TAXATION ■ LOSSES

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INTRODUCTION

The Canadian government announced in its 2010 budget that it will consider the introduction of a “formal system of loss transfer or consolidated reporting”¹ (sometimes referred to as “corporate group reporting” or “group taxation”). This announcement was followed by the release of a consultation paper on the taxation of corporate groups in November 2010.² Since that time, a principal focus of the consultation process has been the type of group reporting system that would be best for Canada. There are many systems of group reporting in use around the world, but the two most common are those referred to as “loss transfer” and “full consolidation” systems. The former term includes those systems that treat the members of a corporate group as separate taxpayers filing separate returns but permit losses to be transferred from one member to another. The latter term, as used in this article, refers to a regime under which a group of resident companies is, in general, treated as a single taxpayer and files a single consolidated tax return, allowing both intra-group loss offsets³ and tax-free asset transfers.⁴

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- 1 Canada, Department of Finance, 2010 Budget, Budget Plan, March 4, 2010, at 386. The government suggested, *ibid.*, that the proposal was made in response to “various concerns from the business community and from the provinces regarding the utilization of tax losses within corporate groups,” and that it would focus in particular on whether consolidated reporting could “improve the competitiveness of the tax system for Canadian businesses.”
 - 2 Canada, Department of Finance, *The Taxation of Corporate Groups*, Consultation Paper (Ottawa: Department of Finance, November 2010) (herein referred to as “the consultation paper”).
 - 3 Loss offsets include both non-capital and capital losses. Full consolidation systems also extend consolidated reporting to include other tax attributes, such as tax credits.
 - 4 The term “consolidation” may mean different types of regimes in different contexts. It may be used to include other group taxation regimes, such as group loss relief in the United Kingdom or the *Organschaft* system in Germany: see, for example, the broader definition of “consolidation” in Tony Stolarek, “The Tax Treatment of Consolidated Groups: Managing Major Tax Change,” in Chris Evans and Richard Krever, eds., *Australian Business Tax Reform in Retrospect and Prospect* (Sydney: Thomson Reuters, 2009), 201-22, at footnote 10. The term “consolidation” has even been used to cover virtually all forms of group taxation: for example, see Ernst & Young, *Barometer of Tax Competitiveness for 2009: Comparative Analysis of Tax Systems Within the OECD* (Paris: Ernst & Young, 2009), at 4.

In 1985, when the notion of a formal group taxation system was last broached by the Canadian government, the Department of Finance articulated a clear preference for a group loss transfer system.⁵ The government's current preference was not disclosed, however, in the 2010 consultation paper, nor has any preference been indicated in other announcements.

The private sector appears to favour a group loss transfer system. For example, the consultation briefs submitted by two large accounting firms, Deloitte and PricewaterhouseCoopers, are clear in this regard. Deloitte states:

We recommend the adoption of a group loss transfer system. . . . On the other hand, we believe that a full consolidation system would introduce a level of complexity far beyond what is necessary to achieve the benefits sought.⁶

Similarly, PricewaterhouseCoopers endorses a loss transfer system because

[it] would result in the least disruption to Canada's tax system and it is the system to which taxpayers, in particular, small and medium-sized companies, and the federal and provincial revenue agencies can most easily transition.⁷

In contrast to the federal government's position, there appears to be muted enthusiasm from the provinces for a formal system of group taxation because of its potential impact on provincial tax revenues. Although much of this discussion is taking place in private, an expression of the current concerns of the provinces was provided in Ontario's fall 2010 economic update:

Canada has a system for sharing the Corporate Income Tax base under which each province is entitled to tax the economic activity taking place within its jurisdiction. Any new approach to corporate group taxation must consider the impact on provincial revenues when losses are transferred from one province to offset income from economic activity in another province. The taxation of corporate groups must not distort the principles of interprovincial income allocation and should treat losses in a fair and reasonable manner.⁸

5 Canada, Department of Finance, *A Corporate Loss Transfer System for Canada* (Ottawa: Department of Finance, May 1985).

6 Letter accompanying the brief submitted by Deloitte to the Department of Finance, "The Taxation of Corporate Groups—Deloitte's Comments," April 15, 2011 (www.deloitte.com/view/en_CA/ca/services/tax/eff59db12ad6f210VgnVCM1000001a56f00aRCRD.htm).

7 Letter accompanying the brief submitted by PricewaterhouseCoopers to the Department of Finance, "Taxation of Corporate Groups: Submission to the Department of Finance," April 8, 2011 (www.pwc.com/ca/en/canadian-national-tax-service/publications/2011-04-taxation-corporate-groups-2011-04-en.pdf), at 6.

8 The Honourable Dwight Duncan, minister of finance, *2010 Ontario Economic Outlook and Fiscal Review* (Toronto: Queen's Printer for Ontario, 2010), at 166. Concerns about the effect of such a system on the distribution of corporate tax revenues among the provinces have also been expressed in Alberta, Ministry of Finance, 2011 Budget, February 24, 2011, at 147.

This concern about revenue shifting between provinces was a major reason for the demise of the consultation process in 1985.⁹ At that time, it was suggested that a consolidation regime might be more acceptable to the provinces than a corporate loss transfer regime.¹⁰ The inclusion of a consolidation regime as a policy option in the 2010 consultation paper may have been motivated by provincial interest in such a regime. In fact, such interest is evident in a recent formal response to the consultation paper by the Ontario Ministry of Finance, which signals that province's clear preference for a system of full consolidation over a loss transfer system as a means to address the interprovincial allocation issue:

By treating a corporate group as a single economic unit, a consolidation system would allow loss utilization and minimize the distortions to provincial income allocation created by intra-group transactions and the allocation of third-party financing within the group. . . .

However, a loss transfer system generally does not treat an entire corporate group as a single economic entity and therefore may not adequately address provincial concerns about income allocation.¹¹

Ontario's response also suggests that the widely touted simplicity of a loss transfer system may be overstated, while the complexity of a system of full consolidation is contingent on the type of system chosen—a choice that can be made in a manner that minimizes such concerns.¹²

At a broad conceptual level, there appear to be two possible approaches to full consolidation in the Canadian context. One possibility is a pooling system, under which each consolidated subsidiary remains as a separate entity for income tax purposes. Each consolidated company is still required to file a stand-alone tax computation with the tax authorities, while the tax results of all group members are aggregated at the group level to arrive at the consolidated group's taxable income or loss. Under such a system, it is possible for the provinces to impose tax on individual group members based on their stand-alone tax returns while the federal government could impose tax on the consolidated income of the group. A disadvantage of this approach is a divergence of federal and provincial tax bases, which increases compliance and administrative costs. This may be undesirable in Canada, given the current "highly harmonized" tax system at the federal and provincial levels.¹³

9 Nicholas LePan, "Federal and Provincial Issues in the Corporate Loss Transfer Proposal," in *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 13:1-11.

10 *Ibid.*, at 13:9.

11 Letter accompanying the submission by the Ontario Ministry of Finance to the Department of Finance, "Taxation of Corporate Groups—Response to the Federal Consultation Paper Released November 23, 2010," April 23, 2011, at 6.

12 *Ibid.*, at 8.

13 Consultation paper, *supra* note 2, at 5.

If a consistent tax base is a priority, an obvious alternative approach is to adopt a group's consolidated taxable income as the tax base of the group for both federal and provincial tax purposes.¹⁴ Each province could then be allocated a portion of that tax base according to the existing formulary apportionment rules.¹⁵ The advantage of this option is that it may (on the basis of on the 1985 experience) have some promise as a method of removing the opportunities for corporate groups to shift income between provinces.¹⁶

In response to the federal government's interest in a full consolidation regime, the submissions by Deloitte and PricewaterhouseCoopers, as well as a recent paper by Pantaleo and Johns,¹⁷ have provided some analysis of consolidation regimes around the world. These papers have also tried to determine how such a regime could fit within existing Canadian tax law. The purpose of the present article is to provide a more in-depth analysis of eight specific consolidation regimes around the world: Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain, and the United States.¹⁸ These are the countries that, by the end of 2009, had introduced regimes providing for both intragroup loss offsets and tax-free asset transfers. Although it would be desirable to also consider the application of these regimes to the Canadian context and recommend a specific structure to address provincial concerns, analysis of the eight regimes is a sufficiently complex endeavour that their specific application to the Canadian context is a task best left for future work.

Nonetheless, with the idea that some form of full consolidation system could most readily address provincial revenue concerns, this article compares the design features of the eight selected consolidation regimes in an attempt to identify a model

14 See Ontario, Ministry of Finance, *supra* note 11, at 7: "The federal government and the provinces generally share a harmonized corporate tax base, have uniform interprovincial allocation rules, and many provinces, including Ontario, have harmonized corporate income tax collection. These significant accomplishments contribute to the efficiency of the Canadian tax system and were achieved through partnership between the federal and provincial governments."

15 A similar regime has been suggested by Alexandre Laurin, *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada*, C.D. Howe Institute Commentary no. 284 (Toronto: C.D. Howe Institute, March 2009).

16 For a brief discussion of the issue, see the consultation paper, *supra* note 2, at 6; and Ontario, Ministry of Finance, *supra* note 11, at 5-8. The experience in the United States also suggests that more states have adopted combined reporting in recent years to deal with the interstate income-shifting issue: consultation paper, *supra* note 2, at 32.

17 Nick Pantaleo and Jeffrey C. Johns, "Toward a New System for the Taxation of Corporate Groups in Canada: Has the Time (Finally) Come?" in *Report of Proceedings of the Sixty-Second Tax Conference*, 2010 Conference Report (Toronto: Canadian Tax Foundation) 35:1-38.

18 South Korea introduced a consolidation regime in 2010: see International Bureau of Fiscal Documentation, *Corporate Taxation Database* (Amsterdam: IBFD) (www.ibfd.org), search under "Country Analysis"—"Republic of Korea." Since little information is yet available on the detailed rules and actual implementation of the regime, it is not analyzed in detail in this article.

regime that might provide a template as a starting point for the Canadian context.¹⁹ In an effort to provide a broader context for the more limited country comparison, the next part of the article provides a brief overview of group taxation regimes, ranging from loss transfer systems to full consolidation systems. The overview is followed by a discussion of the key structural elements of the consolidation regimes of the eight selected countries. This in turn is followed by a discussion of the possible elements of a model consolidation regime, based on an assessment of the eight regimes. As a response to the concern regarding the perceived complexity of a consolidation regime, the eight consolidation regimes are then ranked by applying a complexity index. This exercise is designed to highlight two aspects of the issue: first, the eight regimes represent a spectrum of varying degrees of complexity, indicating that consolidation regimes need not be as complex as the Australian and US models; and second, the complexity of a regime depends to a large extent on the policy choices with respect to the key structural elements.

OVERVIEW OF GROUP TAXATION REGIMES

The group taxation regimes in different countries often differ substantially, thus presenting a challenge to the construction of a systematic analysis. It has been observed that it is “difficult to establish an exact ‘family tree’ of the group taxation regimes around the world. Lines are hard to draw. Exceptions abound.”²⁰ Nevertheless, the following overview aims to illustrate the different forms of group taxation regimes.²¹ The regimes are classified according to the extent to which a single entity concept is applied in respect of two key tax attributes that a group taxation regime normally covers: intragroup loss offsets and intragroup asset transfers.

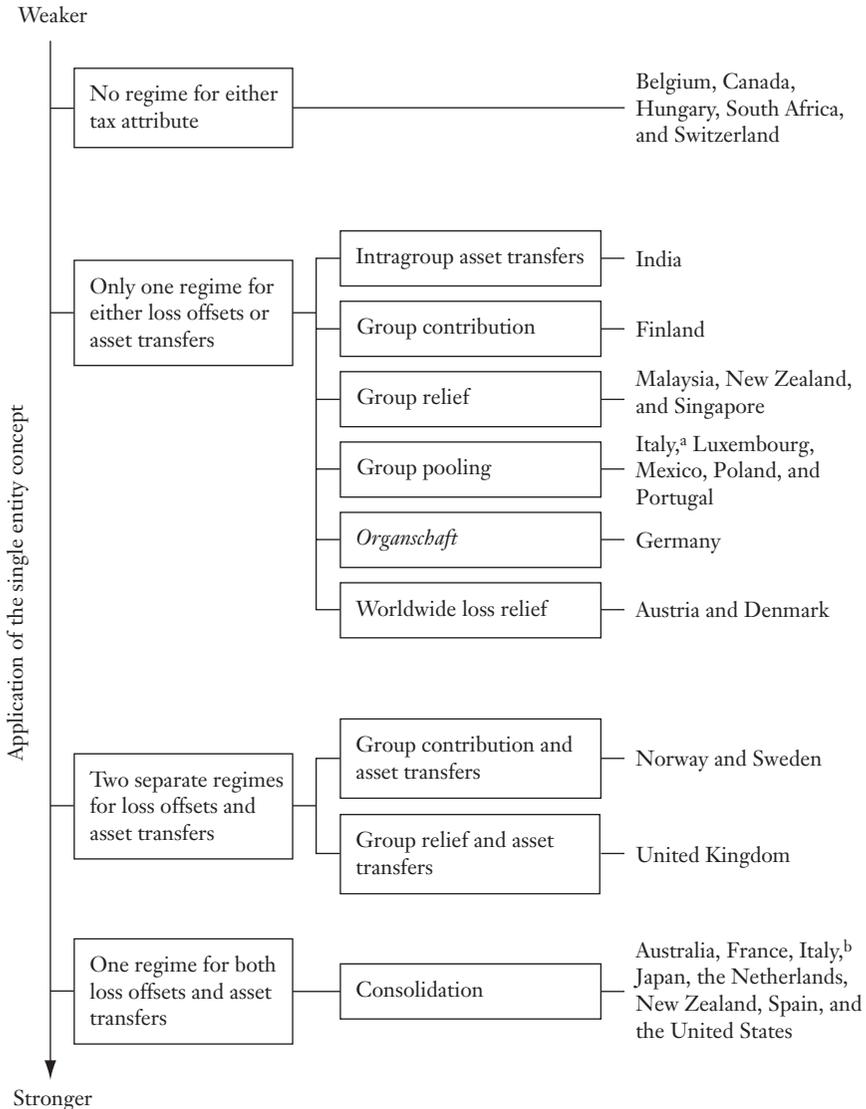
The group taxation regimes classified according to these two tax attributes are summarized in figure 1.

19 Although the eight consolidation regimes have been described elsewhere in considerable depth, very little comparative analysis has been done. See, in this respect, Antony Ting, “Policy and Membership Requirements for Consolidation: A Comparison Between Australia, New Zealand and the US” [2005] no. 3 *British Tax Review* 311-34. For a comparison of the consolidation regimes in Australia and the United States, and the treatment of corporate losses in Canada, see Maureen Donnelly and Allister Young, “Policy Options for Tax Loss Treatment: How Does Canada Compare?” (2002) 50:2 *Canadian Tax Journal* 429-88, at 449-70.

20 Yoshihiro Masui, “General Report,” in International Fiscal Association (IFA), *Group Taxation*, Cahiers de droit fiscal international, vol. 89b (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Utigevers, 2004), 21-67, at 29.

21 The overview is not intended to be exhaustive and does not cover all group taxation regimes in every country. It is based primarily on Masui’s report, *ibid.*, supplemented and updated by information from various sources, including in particular the *Corporate Taxation Database*, *supra* note 18, search under “Country Analysis.” Another IFA report also provides some valuable information on the treatment of losses in a corporate group: International Fiscal Association, *Tax Treatment of Corporate Losses*, Cahiers de droit fiscal international, vol. 83a (The Hague: Kluwer Law International, 1998).

FIGURE 1 Group Taxation Regimes Allowing Intragroup Loss Offsets and/or Intragroup Asset Transfers



^a Since 2008.

^b Before 2008.

Sources: Yoshihiro Masui, “General Report,” in International Fiscal Association (IFA), *Group Taxation*, Cahiers de droit fiscal international, vol. 89b (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 2004), 21-67, at 29; International Bureau of Fiscal Documentation, *Corporate Taxation Database* (Amsterdam: IBFD) (www.ibfd.org).

Some countries (Belgium, Canada, Hungary, South Africa, and Switzerland) do not have a specific regime allowing either intragroup loss offsets or asset transfers. Corporate groups in these countries often have to resort to complicated tax-planning structures to achieve similar tax outcomes; however, such planning is uncertain in practice and subject to challenge by tax authorities.²² For instance, in Canada, despite the generally accommodating attitude of the tax authorities, the tax structures to achieve intragroup loss offsets are often not only complex, but also uncertain in terms of outcome.²³

Many countries have at least one regime catering for one or both of these tax attributes. The group taxation regimes, other than consolidation regimes, that allow intragroup loss offsets are described below.

Group Relief

Malaysia, New Zealand, Singapore, and the United Kingdom²⁴ have a group relief regime under which, in general, losses may be transferred within a group of resident companies.²⁵ For example, in the United Kingdom, if a parent company owns at least 75 percent of the shares of a subsidiary, trading losses can be surrendered from one company to the other.²⁶ Even if the shareholding is less than 100 percent, the whole amount of the losses can be transferred.²⁷

22 For a general discussion of the common planning techniques, see Masui, *supra* note 20, at 47-51.

23 Laurin, *supra* note 15, at 5-7. See also Maureen Donnelly and Allister W. Young, "Group Relief for Canadian Corporate Taxpayers—At Last?" (2011) 59:2 *Canadian Tax Journal* 239-63.

24 The UK group relief regime was introduced in 1967 to replace the 1953 provisions relating to subvention payments (under which an intragroup loss offset was effectively allowed by permitting a profit-making group member to make a deductible payment to another loss-making member). The group relief regime was regarded "as a concession to those who would like to see full grouping, with a single group assessment. . . . It was a half-way house, in which the group companies could make early use of each other's losses without . . . needing to make actual payments to each other": D. de M. Carey, "Company Bran-Tub 1967" (July-August 1967) *British Tax Review* 239-44, at 239.

25 Since 2006, the scope of the UK group relief regime in general has been extended to cover non-resident subsidiaries resident in the European Economic Area (EEA) under certain circumstances: *Corporate Taxation Database*, *supra* note 18, search under "Country Analysis"—"United Kingdom," at paragraph 8.1. For a discussion of the UK position on EEA losses, see John Tiley, *Revenue Law*, 6th ed. (Oxford: Hart Publishing, 2008), at 959. In contrast, in Australia, the scope of group relief has been substantially restricted since the introduction of a consolidation regime in 2002. In particular, group relief is now available only if one of the parties involved is an Australian branch of a foreign bank: Income Tax Assessment Act 1997 (ITAA 1997), subdivisions 170-A and 170-B.

26 Income and Corporation Taxes Act 1988 (UK), 1988, c. 1, section 402. The surrender of trading losses is also allowed between two 75 percent subsidiaries of a parent company. For a detailed discussion of the UK group loss relief regime, see, for example, Tiley, *supra* note 25, section 49.6.

27 Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis*, 3d ed. (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2010), at 400.

In contrast to the general policy of restricting the group loss relief regime to resident groups in the above countries, Austria and Denmark have extended their group loss relief regimes to cover losses from non-resident subsidiaries.

Group Contribution

Finland, Norway, and Sweden have a group contribution regime, under which a profit-making group member can make a contribution to a loss-making member within a group of resident companies. The contribution is deductible for the former and taxable to the latter, thus effectively achieving an intragroup loss offset. There is no requirement to effect a transfer of cash or property, and the contribution can be booked as an intragroup loan.²⁸

Group Pooling

Countries with a group pooling regime include Italy (since 2008),²⁹ Luxembourg, Mexico,³⁰ Poland, and Portugal. Under this regime, a group of resident companies is defined to be a taxable unit and computes its taxable income or loss by aggregating individual results of each group member. An intragroup loss offset is thus achieved. The major difference between this regime and a full consolidation system is that group pooling does not allow tax-free intragroup asset transfers. The group pooling regime is therefore not as comprehensive as a consolidation regime.

Organschaft

Under Germany's *Organschaft* regime,³¹ a parent company and its subsidiary can elect to have the taxable income or loss of the subsidiary transferred to the parent

28 Masui, supra note 20, at 30; and Dunja Edvinsson, "New Rules Seek To Make Group Contribution Regime EU Law Compliant" (2010) 50:7 *European Taxation* 329-32, at 329.

29 Italy introduced a domestic consolidation regime in 2004, allowing both intragroup loss offsets and tax-free asset transfers. However, intragroup asset transfers were abolished in 2008, thus changing the system to a group pooling regime.

30 In Mexico, beginning in 1991, non-resident subsidiaries could also participate in group pooling: Aage Michelsen, "General Report," in *Tax Treatment of Corporate Losses*, supra note 21, 21-69, at 57-58. However, few (if any) taxpayers took up the option, owing to onerous requirements, and it was subsequently removed: Mario Calderón Danel, "Mexico," in *Tax Treatment of Corporate Losses*, ibid., 629-51, at 645-46.

31 For a brief discussion of the regime in Germany, see Ault and Arnold, supra note 27, at 401-2; and Simon Patrick Link, "Germany," in Guglielmo Maisto, ed., *International and EC Tax Aspects of Groups of Companies*, EC and International Tax Law Series vol. 4 (Amsterdam: International Bureau of Fiscal Documentation, 2008), 301-25, at 314-19. Before 2005, Austria also had an *Organschaft* regime. It was replaced by a new group taxation regime (*Unternehmensgruppe*) in response to criticisms of the *Organschaft*—in particular, the inability to offset cross-border losses: Gerald Gahleitner and Stefan Ratzinger, "Austria: International Group Taxation—An Overview of Austria's New Tax Incentive" (2005) 45:11 *European Taxation* 509-14, at 510.

company, thus achieving an intragroup loss offset at the parent company level. A profit-and-loss pooling agreement, which must have a minimum term of five years, is required between the parent and the subsidiary. Under the regime, a subsidiary remains as a separate entity for tax purposes and is required to file a tax return reporting a taxable income of nil. The taxable income or loss of the subsidiary is, in general, calculated on a separate entity basis and intragroup transactions (including intragroup asset transfers) are not eliminated.³²

Organschaft applies to not only income tax, but also trade tax and value-added tax.³³ Furthermore, it pools both taxable income and losses of subsidiaries. It is therefore regarded as representing a stronger application of the single entity concept than the group taxation regimes described above.

Regimes allowing intragroup loss offsets are more common than those allowing intragroup asset transfers. In the 2004 Congress report of the International Fiscal Association (IFA), of the 20 countries that reported at least one regime for either of the tax attributes, 19 had an intragroup loss offset regime while only 12 had an intragroup asset transfer regime.³⁴ A survey of the countries in December 2009 reveals no material change in this pattern.³⁵ Most countries have the same regimes as in 2004. The exceptions noted include:

- Austria, which had an *Organschaft* regime in 2004, replaced it with an *Unternehmensgruppe* regime in 2005, allowing cross-border loss offsets;
- Poland, which was not included in the 2004 report, has a group pooling regime;
- Malaysia, which was not included in the 2004 report, has a group relief regime; and
- South Korea, which had no regime for either of the two tax attributes in 2004, introduced a consolidation regime in 2010.

In figure 1, 11 countries allow both intragroup loss offsets and tax-free intragroup asset transfers. Eight of them—Australia, France, Italy,³⁶ Japan, the Netherlands, New Zealand, Spain, and the United States—implement a consolidation regime to deal comprehensively with both tax attributes. These are the countries selected for comparison in this article. Only three countries—Norway, Sweden, and the United Kingdom—have separate regimes catering for the two tax attributes.

32 An unusual feature of the *Organschaft* regime is that pre-grouping losses of a subsidiary are suspended. They are not available to the parent company, but can be used by the subsidiary after it leaves the regime: Link, *supra* note 31, at 317.

33 *Corporate Taxation Database*, *supra* note 18, search under “Country Analysis”—“Germany,” at paragraph 8.1.

34 Masui, *supra* note 20, at 33-34.

35 The survey was done on December 10, 2009 on the IBFD databases: see note 21 for details.

36 See *supra* note 29.

DESIGN FEATURES OF CONSOLIDATION REGIMES

As a particular form of group taxation regime, consolidation regimes require the articulation of the following key structural elements:

- application of the single entity concept;
- definition of an eligible corporate group and mandatory versus elective application of the regime;
- treatment of preconsolidation losses;
- treatment of group losses on exit;
- treatment of assets on entry, during consolidation, and on exit; and
- treatment of intragroup shareholdings on entry, during consolidation, and on exit.

These structural elements are discussed in turn below with reference to their presence in the consolidation regimes of the eight countries.

Application of the Single Entity Concept

The consolidation regimes of the eight selected countries generally treat corporate groups as one single entity. However, they demonstrate some variation in the extent to which this single entity concept is applied. In particular, there appear to be three different applications of the concept: (1) pooling, (2) attribution, and (3) absorption.

Pooling

The pooling system is the predominant application of the single entity concept in the eight countries; indeed, six of them—all except Australia and the Netherlands—apply this system.³⁷ The parent company and its subsidiaries in a consolidated group are treated, to a large extent, as separate entities for income tax purposes, with the taxable income or loss of each group member being computed on an individual basis. The separate entity results are then aggregated at the group level—often adjusted for intragroup transactions—to arrive at consolidated taxable income or loss.

The major advantage of this approach is its simplicity. Most of the existing tax rules for companies are founded on the traditional separate entity doctrine, according to which each company is treated as a separate taxpayer. The rules can therefore be applied comfortably to consolidated group members under a pooling system that, for the most part, preserves this separate entity treatment. The interactions between the consolidation regime and other income tax regimes are also simpler,

37 General Tax Code (GTC), France, articles 223A and 223B; Income Tax Code (ITC), Italy, articles 118 and 121; Corporation Tax Act (CTA), Japan, article 4-2; Income Tax Act 2007 (ITA 2007), New Zealand, sections FM 3(1) and (2); Corporate Income Tax Law (CITL), Spain, section 65(1); and Internal Revenue Code (IRC), United States, IRC Reg. sections 1.1502-11(a) and 1.1502-13.

since the former embraces to a large extent the separate entity doctrine that is the fundamental underlying principle of the latter.

A related policy issue with respect to the pooling system is whether the individual tax computations of a consolidated group member should be prepared on a stand-alone or a group basis. For example, an expenditure of a subsidiary may be regarded as capital in nature on a stand-alone basis and thus not deductible. However, if the item is examined on a group basis, so that facts and circumstances of other group members are taken into consideration, the expenditure may be judged to have a revenue character and thus be currently deductible.

Five of the six countries with a pooling system (all except New Zealand) adopt the stand-alone basis. That is, each subsidiary prepares its tax computation on a stand-alone basis before aggregation at the group level. Taxability and deductibility of various items are generally determined as if the subsidiary were a stand-alone unconsolidated company. There are exceptions to the general rule, but the stand-alone basis is the predominant approach.

In contrast, in New Zealand, each company in the group prepares its tax computation on a group basis.³⁸ When calculating the taxable income of a group member for consolidation purposes, measures are in place to ensure that a consolidated group is generally liable to income tax as if it were a single company. Thus, income derived by a group member—which would be non-taxable on a stand-alone basis—is treated as taxable if the income would be taxable to the consolidated group if the group were a company. Similar rules apply to expenditures.

In practice, the stand-alone basis implies lower compliance costs than the group basis. The individual tax computation of a consolidated company can be prepared as if the company had not consolidated. Ordinary tax rules for companies can be applied, avoiding reassessment of the taxability and deductibility of each income and expense item of a consolidated member in light of the facts and circumstances of other group members.

Attribution

The Netherlands is the only country that has adopted the attribution option referred to as “fiscal unity.”³⁹ Assets, liabilities, and activities of consolidated subsidiaries are attributed to the parent company. In other words, income and expenses of the subsidiaries are deemed to be those of the parent company, thus achieving the aggregation of taxable income and losses of the group members. One important feature of this option is that the subsidiaries continue to be treated as separate entities for income tax purposes, an approach that has proved to be especially important in the application of tax treaties.⁴⁰

38 ITA 2007 sections FM 9, 11, and 12.

39 Corporate Income Tax Law of 1969 (CITL 1969), article 15(1).

40 Rudolf J. de Vries, “Netherlands,” in *Group Taxation*, supra note 20, 461-84, at 467. Before 2003, the Netherlands adopted an absorption model under which a consolidated subsidiary was

Absorption

Australia is currently the only country that applies the absorption option.⁴¹ Under this single entity concept, known as the “single entity rule” (SER), consolidated subsidiaries are deemed to have become divisions of the parent company and to have ceased to exist as individual companies for income tax purposes.⁴² Assets of subsidiaries are deemed to be held directly by the parent company. As a result, unlike the treatment in most other consolidation regimes, intragroup asset transfers within a consolidated group are completely ignored. The transfers not only have no immediate tax implications, but also do not require the parties to trace asset movements, keep a record of any deferred gain or loss, or recapture the gain or loss when either the transferor or the transferee leaves the group. Moreover, preconsolidation losses of a joining subsidiary are transferred to and can be used by the parent company, without the need to compute the subsidiary’s stand-alone taxable income every year.⁴³

As described below, the price to pay for these apparent advantages is high. Problematic and highly complex rules, known as the “tax-cost-setting” (TCS) rules, are required to adjust the cost bases of assets and shares in a joining subsidiary.⁴⁴ The rules on preconsolidation losses are also complex and problematic.⁴⁵ Another problem associated with the SER is the difficult interactions it creates between the consolidation regime and other parts of the income tax system based on the separate entity doctrine. The Australian experience suggests that application of the SER renders the application of other tax regimes to consolidated groups more difficult.

Definition of an Eligible Corporate Group and Mandatory Versus Elective Application of the Regime

Consolidation regimes tend to be restricted to resident companies under common control. The restriction to resident companies reflects the political reality that extending general residence taxing rights to non-resident companies is problematic. Extending consolidation to non-resident entities also raises revenue and anti-avoidance concerns. Therefore, all of the eight consolidation regimes considered

treated as having been “absorbed” into the parent company. However, the exact meaning of “absorption” was controversial, especially with respect to whether the subsidiary was still eligible for treaty benefits. The tax law was amended in 2003 to replace the absorption model with the current attribution model, in order to remove the treaty issue.

41 The discussion of Australia’s consolidation regime in this article is based on the more detailed analysis in Antony Ting, “Australia’s Consolidation Regime: A Road of No Return?” [2010] no. 2 *British Tax Review* 162-93.

42 ITAA 1997 section 701.1.

43 The use rate of the transferred losses is subject to the “available fraction” rules, which are discussed below under the heading “Treatment of Preconsolidation Losses.”

44 See the discussion below under the headings “Treatment of Assets—On Entry” and “Treatment of Intragroup Shareholdings—On Exit,” respectively.

45 See the discussion of these rules below under the heading “Treatment of Preconsolidation Losses.”

here are, in general, restricted to resident company groups under common control.⁴⁶ Unincorporated entities are, in general, excluded from consolidation. The Australian regime is an exception to this general rule; it allows trusts and partnerships to be included as members of a consolidated group.⁴⁷ As well, all of the four EU countries extend the scope of consolidation to cover permanent establishments of non-resident companies.⁴⁸ This policy represents a response to the EU non-discrimination rules and to certain decisions of the European Court of Justice on the application of those rules.⁴⁹

Most countries specifically exclude certain entities from consolidation. Besides non-residents, the most common exclusion is for companies that are not subject to the normal corporate income tax rates—for example, those subject to a reduced tax rate or exempt from tax.⁵⁰ Companies in bankruptcy and liquidation are also often excluded from a consolidated group.⁵¹ Both New Zealand and the United States have specific restrictions on companies that are taxed as flowthrough entities. In particular, New Zealand only allows such companies (known as “qualifying companies”) to form a consolidated group with each other.⁵² Flowthrough entities in the United States (for example, S corporations) are not eligible to join any consolidated group.⁵³

46 Exceptions to this residence requirement are rare in group taxation regimes. For instance, France and Italy permit worldwide group pooling, but it has very limited use in practice. For a brief discussion, see *Corporate Taxation Database*, supra note 18, search under “Country Analysis”—“France” and “Italy.”

47 ITAA 1997 sections 703.15(2), table item 2, and 719.10(1)(b). Some countries do allow consolidation of certain unincorporated entities that are taxed as corporations—for example, limited partnerships in Italy, New Zealand, and Spain (as well as Australia). An analysis of the issues relating to the inclusion of unincorporated entities in a consolidated group is beyond the scope of this article. For further discussion, see Ting, supra note 19, at 324-25.

48 For a brief survey of the EU countries that allow permanent establishments in their grouping regimes, see Marco Adda, “Can a Permanent Establishment Be a ‘Legitimate Heir’ in a Domestic Consolidated Tax Regime?” (2008) 48:5 *European Taxation* 238-44, at 239-40. See also Masui, supra note 20, at 53-55 and 58-62.

49 For example, since 2003, the Netherlands has allowed a permanent establishment of a non-resident company to be either the head entity or a subsidiary member of a consolidated group: CITL 1969 article 15(4). Also see de Vries, supra note 40, at 475.

50 Countries that have this exclusion include Australia (ITAA 1997 section 703.15(2)), Italy (ITC article 126(1)), Japan (CTA article 4-2), New Zealand (ITA 2007 section FM 31(1)(c)), Spain (CITL section 67(4)), and the United States (IRC sections 1504(b)(1) and (2)). The exclusion covers companies that are subject to specific tax regimes, such as insurance companies and special investment entities.

51 Countries that exclude these companies include Italy (ITC article 126(2)), Japan (CTA article 4-2), and Spain (CITL section 67(4)(b)).

52 ITA 2007 section FM 31(2)(a). Mining companies are subject to similar restrictions: ITA 2007 section FM 31(2)(b). The United States has similar rules for insurance companies: IRC section 1504(c).

53 IRC section 1504(b)(8).

In practice, it is not easy to provide a simple and effective definition of common control. A bright-line definition—for example, specification of a minimum percentage of voting rights—may be simple, but may not be effective. Control can be established by various means, such as options and convertible securities, control over the composition of the board of directors or key executives, or special shareholders' agreements.⁵⁴ A more general definition—for example, de facto control—may be more effective in capturing a control relationship, but is not easy to administer, being “too uncertain and unpredictable.”⁵⁵ Most countries adopt a bright-line option based on share ownership, but protect it from abuse with supplementary tests or anti-avoidance provisions.

With respect to the ownership threshold, the comparative analysis of the eight countries reveals two different specifications: (1) substantially 100 percent and (2) substantially less than 100 percent. Five of the eight countries—Australia, France, Japan, the Netherlands, and New Zealand—use a substantially 100 percent ownership standard.⁵⁶ Specifically, France and the Netherlands have a 95 percent threshold; the other three countries, 100 percent. The threshold in the Netherlands was 100 percent before 2003. The 95 percent threshold is intended to accommodate employee share schemes or small shareholdings that the parent company fails to purchase in an acquisition.

A high ownership threshold can be justified on a number of bases. Perhaps most importantly, a subsidiary under the control of a parent company should be treated in a similar manner as a branch of the parent. Realization of this consistency of treatment requires that a parent company must wholly own the subsidiary, with no allowance for minority interests. In other words, the threshold should be 100 percent.⁵⁷ Moreover, since loss offset among group members is likely to have an adverse impact on revenue, governments may try to minimize the impact by restricting access to the regime through the application of a higher threshold. For example, the Dutch government has been reluctant to lower the 95 percent threshold because of revenue concerns.⁵⁸ Furthermore, the presence of a minority interest introduces complexity into consolidation regimes. For this reason, during the design phase of the Australian

54 For a detailed analysis of the definition of control in different regimes, see Antony Ting, “Definition of ‘Control’ Under the Consolidation and Controlled Foreign Company Regimes: A Comparison Between Australia, New Zealand and the United States” (2006) 12:1 *New Zealand Journal of Taxation Law and Policy* 37-60.

55 Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78 (Toronto: Canadian Tax Foundation, 1986), at 417.

56 ITAA 1997 section 703.15(2) (Australia), GTC article 223A (France), CTA article 4-2 (Japan), CITL 1969 article 15(1) (the Netherlands), and ITA 2007 section FM 35(1) (New Zealand).

57 Many countries allow a small percentage to be owned by employees through employee share schemes. This policy is pragmatic and reasonable, since this kind of holding in general would not significantly affect the control of the parent company over the subsidiary.

58 De Vries, *supra* note 40, at 471.

consolidation regime, US officials specifically warned their Australian counterparts not to allow minority interests in subsidiaries as the United States does.⁵⁹

Interestingly, it seems that corporate groups in practice do not have major objections to the use of a high ownership threshold to determine eligibility for consolidated treatment. Given the significant benefit of loss offsets and tax-free asset transfers, it is reasonable to expect a strict ownership requirement to screen for eligible group members. Furthermore, in practice, most subsidiaries of corporate groups are wholly owned for commercial reasons.⁶⁰ A high threshold therefore does not pose a significant obstacle to consolidation.

Nonetheless, three of the eight countries use an ownership threshold substantially lower than 100 percent: Italy, 50 percent; Spain, 75 percent; and the United States, 80 percent.⁶¹ The unusually low threshold in Italy may be due to historical reasons.⁶² Before the consolidation regime was introduced, Italy had an “implicit” group taxation regime, known as the “excess imputation credit surrender” regime. In broad terms, the regime allowed intragroup loss utilization by surrendering excess tax credit of a loss company to profitable related companies. The ownership threshold under this regime was 50 percent, possibly (at least in part) accounting for the use of the same low threshold in the consolidation regime.

In Spain, the ownership threshold has fluctuated.⁶³ Initially set at 50 percent when the consolidation regime was introduced in 1977, the threshold was subsequently increased to 90 percent in 1982, and then reduced to 75 percent in 2002. The ownership threshold under the US consolidation regime has also fluctuated.⁶⁴ When the regime was first introduced in 1917, it required that the parent company own “substantially all” of the shares of another company.⁶⁵ The threshold was

59 Geoffrey Lehmann, “An Assessment of Australia’s Tax Consolidation Regime,” in Geoffrey Lehmann, ed., *Business Tax Reform: Meet the Critics*, Australian Tax Research Foundation Conference Series no. 24 (Sydney: Australian Tax Research Foundation, 2007), at 277.

60 Statistics on corporate groups in Canada show that between 2005 and 2008, on average about 85 percent of the corporate groups contained corporations with 100 percent ownership: consultation paper, supra note 2, at 27. Similarly, in Australia, it was found that over 90 percent of subsidiaries in listed corporate groups were wholly owned subsidiaries: Ian M. Ramsay and G.P. Stapledon, “Corporate Groups in Australia” (2001) 29:1 *Australian Business Law Review* 7-32.

61 ITC articles 117 and 120 (Italy), CITL section 67(2)(b) (Spain), and IRC section 1504(a)(1)(B)(ii) (United States).

62 Massimo Giaconia, “Italy,” in *Group Taxation*, supra note 20, 369-91, at 375-76.

63 María Amparo Grau Ruiz, “Spain,” in *Group Taxation*, *ibid.*, 609-32, at 615; and José Ignacio García Muniozgueren, “Spain: New Corporate Tax Measures for 2002” (2002) 42:3 *European Taxation* 138-40, at 139.

64 For a detailed discussion of the historical development of the ownership requirement in the United States, see Kevin M. Hennessey, Richard Yates, James Banks, and Patricia Pellervo, *The Consolidated Tax Return: Principles, Practice, Planning*, 6th ed. (New York: RIA) (looseleaf), chapter 1.

65 The 1917 regime was mandatory and basically an anti-avoidance measure. Consequently, “substantially all” did not mean a fixed percentage; instead, ownership was determined on the basis of the facts in each particular case: *ibid.*, at paragraph 1.04[2][a].

changed to 95 percent of voting stock in 1924, and was again amended in 1942 to require ownership of 95 percent of the voting power of all classes of shares and 95 percent of non-voting shares. The threshold was then reduced to 80 percent in 1954 as a means to allow more companies to consolidate. The major problem with this lower threshold is the presence of minority interests in subsidiaries (as discussed above). The US experience strongly suggests that the presence of a significant minority interest should be avoided.⁶⁶

The ownership threshold under each of the eight consolidation regimes is applied on the basis of some specification of share ownership. At one extreme, Australia and Spain adopt a formalistic approach and apply the specified threshold primarily on the basis of legal ownership. The absence of constructive ownership rules that account for third-party arrangements affecting voting rights and economic exposure otherwise associated with share ownership provides substantial potential for abuse.⁶⁷

In contrast, other countries have more robust ownership requirements in the sense that arrangements affecting economic ownership of shares and the ability to exercise voting rights are relevant. France's ownership threshold requires 95 percent holdings in both share capital and voting rights in the subsidiary.⁶⁸ The Netherlands' ownership threshold requires 95 percent ownership in both share capital and "rights to profits,"⁶⁹ while Italy's 50 percent ownership requirement applies to all three factors of share capital, voting rights, and rights to profits.⁷⁰ Japan protects its share capital threshold by a specific anti-avoidance provision targeting abuse of its consolidation regime.⁷¹

The voting right factor is designed to define a control relationship between the parent company and its subsidiaries. In addition to France and Italy, New Zealand⁷²

66 Lehmann, *supra* note 59, at 277.

67 For example, in Australia, a wholly owned subsidiary may escape consolidation treatment if a third party holds some of its non-voting preference shares, even though the subsidiary is fully controlled by the parent company. This violates the "all-in" principle of the Australian consolidation regime. Alternatively, even if a parent company holds all the shares in a subsidiary, the latter may be effectively controlled by a third party that holds options over all the shares in the subsidiary. In that case, the parent company may still consolidate with the subsidiary, even though the latter is in substance controlled by another party. In contrast, both New Zealand and the United States have special provisions to deal with options and other financial instruments in their consolidation regimes.

68 GTC article 223A. See also Nicolas Message, "France," in *International and EC Tax Aspects of Groups of Companies*, *supra* note 31, 277-99, at 283.

69 CITL 1969 article 15(1). See also de Vries, *supra* note 40, at 469; and Johann Müller, *The Netherlands in International Tax Planning* (Amsterdam: International Bureau of Fiscal Documentation, 2005), at 248.

70 ITC articles 117 and 120; Italian Civil Code, articles 2346 and 2359.

71 CTA article 132-3.

72 ITA 2007 section IC 4.

and the United States⁷³ also adopt this factor in their ownership requirements. While France and Italy adopt the voting right factor in conjunction with the share capital factor, New Zealand and the United States do not stipulate share capital in their ownership requirements. Instead, they base their ownership tests primarily on voting rights, supplemented by share value as an anti-avoidance measure.

All of the eight selected countries allow corporate groups to elect to consolidate; in fact, none of these consolidation regimes is mandatory. However, the eight countries are divided on the issue of whether the election to consolidate is revocable. Three countries—the Netherlands,⁷⁴ New Zealand,⁷⁵ and Spain⁷⁶—allow a group to revoke the election. Four countries—France, Italy, Japan, and the United States—do not, in general, allow revocation.⁷⁷ The election to consolidate in Japan and the United States is for an indefinite term. In contrast, the relatively short term of an election in France (five years) and in Italy (three years) represents a less rigorous anti-avoidance policy objective. The remaining country, Australia, does not have a consistent policy on this issue. An election to consolidate is irrevocable for domestically owned groups⁷⁸ but effectively revocable for foreign-owned groups.⁷⁹ The divergent policies among the eight countries on this key structural element illustrate the difficult compromises that governments have to make between competing policy objectives. The policy choice between revocable and irrevocable elections depends on the tradeoff between anti-avoidance (which would suggest an irrevocable election) and flexibility (which would suggest that the election be revocable).

Given the associated benefits, most eligible corporate groups elect consolidated treatment. A notable exception is small and medium-sized enterprises, which seem to have a tendency not to elect consolidated treatment because of perceived compliance costs.⁸⁰ The availability of consolidated treatment on an elective basis for eligible

73 IRC section 1504(a)(1)(B)(ii).

74 CITL 1969 article 15(6). An anti-avoidance provision prevents a subsidiary from joining and leaving a consolidated group in the same year: CITL 1969 article 15(7).

75 ITA 2007 section FM 37. New Zealand's rules of election to consolidate are very flexible. They not only allow a group to elect to consolidate, but also allow a group member to elect to leave a consolidated group. Therefore, it is unnecessary for the law to stipulate whether the choice to consolidate is revocable or not.

76 CITL section 70(5).

77 GTC article 223A (France), ITC article 117(3) (Italy), CTA article 4-5(3) (Japan), and IRC Reg. section 1.1502-75(a)(2) (United States).

78 ITAA 1997 section 703.50.

79 ITAA 1997 sections 719.60 and 719.80.

80 For example, in Australia, more than 90 percent of large corporate groups (that is, having a group turnover of more than A\$1 billion) have elected to consolidate, while less than 30 percent of small corporate groups (having a group turnover of less than A\$10 million) have formed a consolidated group: Australia, The Board of Taxation, *Post-Implementation Review into Certain Aspects of the Consolidation Regime*, Discussion Paper (Canberra: Commonwealth of Australia, 2009) (www.taxboard.gov.au/content/reviews_and_consultations/aspects_of_the_consolidation_regime/discussion_paper/consolidation_regime_discussion_paper.pdf), at 54.

corporate groups is contrary to the apparent preference among Canada's provinces to have such a regime apply on a mandatory basis. It appears that the reason for this preference is to ensure that corporate groups that meet the requirements for consolidated treatment cannot escape application of the regime and engage in interprovincial income shifting.⁸¹

The more common issue of electivity under the consolidation regimes of the eight selected countries concerns the inclusion of all or only some of the otherwise eligible members in a consolidated group. Indeed, inclusion of otherwise eligible companies within a consolidated group may be elective or mandatory. The comparative analysis of the eight countries reveals no predominant policy on this structural element. Four countries—France,⁸² Italy,⁸³ the Netherlands,⁸⁴ and New Zealand⁸⁵—allow cherry-picking of subsidiaries. Three countries—Japan, Spain, and the United States—impose the all-in rule.⁸⁶ Australia does not have a consistent policy in this respect. It imposes the all-in rule for domestically owned consolidated groups, but allows cherry-picking of subgroups owned by foreign parent companies.⁸⁷

It is difficult to determine which approach is better. The diverse policy choices among the eight countries again reflect the difficult compromises that governments have to make between competing policy objectives. On the one hand, the all-in rule serves an anti-avoidance objective by insisting that, where the election to consolidate is made, all eligible members of the corporate group must join the consolidated group. On the other hand, allowing cherry-picking provides flexibility of treatment.

81 See, for example, Ontario, Ministry of Finance, *supra* note 11, at 7.

82 Frank Le Mentec, "French Tax Group Regimes," in *The European Union and Group Relief: How Will the Marks & Spencer Case Impact?* BNA International Special Report (London: BNA International, 2006), at 3. This flexible policy has been in place since the consolidation regime was introduced in 1988: Pierre Knoepfler and Jack Anderson, "France: Towards a Real Group Tax Harmonization" (1988) 28:6 *European Taxation* 171-77, at 172.

83 Giaconia, *supra* note 62, at 379.

84 The basic building block of a consolidated group in the Netherlands is defined to be between *two* companies, a parent and its subsidiary: CITL 1969 article 15.

85 Any *two or more* eligible companies of a wholly owned group may elect to form a consolidated group: ITA 2007 section FM 35(1).

86 CTA article 4-2 (Japan), CITL section 67(1) (Spain), and IRC Reg. sections 1.1502-75(a) and (e) (United States).

87 Australia's all-in policy for domestically owned groups is achieved quite indirectly by the combination of several provisions. ITAA 1997 section 703.10 defines a "consolidatable group" as consisting of the head company and *all* the subsidiary members of the group. Section 703.5(1)(a) in turn defines a "consolidated group" as coming into existence upon the election by the head company to consolidate the consolidatable group. New subsidiary members acquired by an existing consolidated group must also be included in the consolidation pursuant to section 703.5(3). The contrasting policy for foreign-owned groups, known as "MEC" (multiple entry consolidated) groups, is contained in section 719.5.

Treatment of Preconsolidation Losses

On entry of a company into a consolidated group, the treatment of preconsolidation losses incurred by the company must be determined.⁸⁸ The comparative analysis reveals three alternative treatments of such losses: (1) quarantine, (2) transfer to the parent, and (3) cancellation.⁸⁹

Quarantine

Under the quarantine approach, preconsolidation losses incurred by a joining subsidiary are quarantined and are available for offset only against profits generated by that subsidiary. The policy rationale for quarantine is that since the preconsolidation losses were incurred when the subsidiary was treated as a separate taxpayer, those losses should remain with the subsidiary and be available only for offset against its future taxable income. A prerequisite for this policy is that the subsidiary maintains its separate identity for income tax purposes during consolidation. In six of the eight countries—all except Australia and Japan—preconsolidation losses of a joining subsidiary are quarantined.⁹⁰ All of these six countries except the Netherlands adopt the pooling system, which is a logical companion of the quarantine policy.

A related issue is whether the preconsolidation losses should be applied before or after aggregation of the group members' taxable income and losses. The six countries that adopt the quarantine approach are divided between two different versions of its application: offset before aggregation and offset after aggregation. Three countries—France, Italy, and New Zealand—adopt the offset before aggregation option. Under this option, preconsolidation losses of a subsidiary are applied first to offset taxable income of the company. Remaining taxable income (if any) is then pooled with the results of other group members to arrive at the group's consolidated taxable income or loss.

The advantage of this policy option is its simplicity: the preconsolidation losses are determined and carried forward on the basis of the general rules applicable to

88 The amount involved is often substantial. In Canada, the balances of unutilized non-capital losses and capital losses in 2008 were \$206 billion and \$78 billion, respectively: consultation paper, *supra* note 2, at 23. Similarly, the Australian government estimated that the amount of carryforward losses in entities before the introduction of the consolidation regime was in the order of A\$66 billion: Review of Business Taxation, *A Platform for Consultation: Building on a Strong Foundation* (Canberra: Commonwealth of Australia, 1999), vol. 2, at 561.

89 Theoretically, another alternative policy is to suspend preconsolidation losses of a subsidiary during consolidation, and revert them back to the company when it leaves the consolidated group. However, in practice, none of the eight countries adopt this policy, perhaps because of the undesirable deferral of loss utilization, and the possibility of either loss expiry (unless losses can be carried forward indefinitely in a country) or unusable losses if the subsidiary never leaves the group. Germany is a rare exception among group taxation regimes in adopting the suspension policy: Link, *supra* note 31, at 317.

90 GTC article 223I (France), ITC article 118(2) (Italy), CITL 1969 articles 15ae(1)(a) and 15ah (the Netherlands), ITA 2007 sections ID 2(2) and 3 (New Zealand), CITL section 74(2) (Spain), and IRC Reg. 1.1502-21(c)(1)(i) (United States).

company losses. This option may also have implications in countries that impose a time limit on the carryover of losses. As compared with the alternative approach, offset before aggregation provides a faster rate of use of preconsolidation losses, thus reducing the risk of loss expiry—though this may not be a significant issue if the loss carryforward period is long.

The Netherlands, Spain, and the United States adopt the reverse order under an offset-after-aggregation approach. Preconsolidation losses of a subsidiary are available for offset only after the taxable income of the company is aggregated with other group members' results. This approach is relatively complex. Experience of the three countries suggests that the apportionment rules allocating the group's net taxable income to a particular subsidiary tend to be complicated.⁹¹ Another potential problem is the risk of loss expiry. Preconsolidation losses can be used only if the group as a whole has net taxable income. All three of the countries adopting this policy option have loss carryforward time limits; however, the carryforward period is relatively long.⁹² It thus appears that the risk of loss expiry is not a major concern to policy makers in these countries.

Transfer to the Parent

Under the second of the three alternative treatments, preconsolidation losses of a subsidiary are transferred to the parent company upon consolidation. The policy is premised on a strong single entity concept, under which subsidiaries are deemed to have ceased to exist as separate entities for income tax purposes. When their preconsolidation losses are transferred to the parent company, they are available for offset against the consolidated group's taxable income.

Australia is the only country that has adopted this approach. Under its strong single entity rule (SER), subsidiaries are deemed to have ceased to exist during consolidation. This deemed "disappearance" of subsidiaries means that the quarantine approach is not an option, since it typically restricts the loss utilization rate by allowing offset of preconsolidation losses only against taxable income generated by the same subsidiary. Moreover, the SER assumes that the deemed disappearance of subsidiaries during consolidation means that it is impossible to calculate a subsidiary's taxable income on a stand-alone basis.⁹³

91 For instance, in the Netherlands the allocation of the group profit attributable to a particular subsidiary is subject to a set of complex profit-split rules. For a detailed discussion of the rules, see Müller, *supra* note 69, at 263-68. In the United States, the allocation is subject to the highly complex "separate return limitation year" rules. For a detailed discussion of the rules, see, for example, Hennessey et al., *supra* note 64, section 8.05.

92 The time limits are 9 years in the Netherlands, 15 years in Spain, and 20 years in the United States.

93 *A Platform for Consultation*, *supra* note 88, at 563. It is doubtful that this assumption is correct. Experience in other countries that adopt the quarantine policy strongly suggests that in practice it is still possible to compute a subsidiary's profit and loss on a stand-alone basis during consolidation.

Australian policy makers nonetheless faced an important constraint in the design of the rules on preconsolidation losses. Before the consolidation regime was introduced in 2002, Australia had a group loss regime, which, in broad terms, allowed intragroup loss transfers among wholly owned resident companies.⁹⁴ This placed considerable pressure on policy makers to come up with a model that would be at least as attractive as the existing regime. The pressure was intensified by the fact that most companies would be denied access to the former group loss relief regime after the introduction of the consolidation regime.⁹⁵ Australia's solution was to allow the transfer of preconsolidation losses of subsidiaries to the parent company upon consolidation,⁹⁶ and to provide that the transfer is not reversed when the subsidiary leaves the group.

The policy of transferring preconsolidation losses to a parent company presented a serious problem to the government: unrestricted utilization of such transferred losses would have a significant revenue impact.⁹⁷ The response was to adopt an invented concept, the available fraction (AF).⁹⁸ In broad terms, preconsolidation losses of a joining subsidiary are assigned an AF that is calculated as the ratio of the market value of the subsidiary to that of the consolidated group on entry. The maximum amount of the losses that the parent company may use in a year is equal to the product of the AF and the group's consolidated profits for that year.

The Australian government claims that the objective of the AF rules is to reflect the loss use rate that would apply if the subsidiary had not joined the consolidated group. However, the questionable use of market value as a proxy for the actual tax positions of a company, and the failure to adjust the market valuations on a regular basis, make the AF a very rough proxy. Nevertheless, if one accepts that the most important objective of the AF rules is to restrict the use rate of preconsolidation losses, their mechanical operation arguably serves that purpose well. This is especially so given that the AFs of a group can never be adjusted upward under adjustment events.⁹⁹

94 ITAA 1997 division 170. Upon the introduction of the consolidation regime, the scope of the group loss relief regime was substantially curtailed; currently, it is applicable only to foreign bank groups with Australian branches and subsidiaries.

95 New Zealand faced a similar constraint in the design of its consolidation regime but came up with a more flexible and taxpayer-friendly approach, in which consolidation and group loss relief regimes coexist.

96 ITAA 1997 section 707.120. The transfer is subject to a modified continuity-of-ownership test and a same business test. A detailed discussion of these tests is beyond the scope of this article.

97 At the time, it was estimated that there was a "large store of past losses in entities . . . approximately \$44.6 billion revenue losses and \$21.7 billion capital losses": *A Platform for Consultation*, supra note 88, at 561. To put the numbers into perspective, the aggregate taxable income of companies in the 1999-2000 income year was \$129 billion: Australian Tax Office, *Tax Statistics 1999-2000* (Canberra: Commonwealth of Australia, 2002).

98 ITAA 1997 division 707.

99 This is clearly the government's intention: Australia, Treasury Department, *New Business Tax System (Consolidation) and Other Measures Bill (No. 1) 2002: Explanatory Memorandum* (Canberra: Commonwealth of Australia, 2002), at paragraph 8.5.

It may be more accurate to describe the AF rules as simply a rough and arbitrary measure to allocate a group's taxable income to individual group members for the purpose of controlling the use rates of preconsolidation losses.

Ironically, another advantage of the AF rules is a result of the arbitrary nature of the AF. In contrast to countries that have adopted a quarantine policy, specific anti-avoidance provisions are not required in Australia to prevent abuses of the loss offset rules. Italy and the Netherlands, for example, have found it necessary to enact provisions to prevent acceleration of the use of preconsolidation losses by an intra-group transfer of assets with hidden reserves.¹⁰⁰ This kind of provision is unnecessary under the AF model since the utilization rate is not dependent on a subsidiary's individual taxable income.

Even so, it is doubtful whether this advantage is sufficient to justify the problematic AF rules, the outcome of which is detached from the actual circumstances of a company. As noted above, the AF of preconsolidation losses of a subsidiary is determined on entry, on the basis of the prevailing market values of the company and the group. The value of the AF determined at that point in time is not subject to regular revaluation, even though the market values of the company and the group most likely would change over time. Even if the subsidiary successfully turns around and makes a substantial profit during consolidation, the transferred losses are still subject to the old AF limit fixed at the joining time. The outcome is therefore very different from that under the more common quarantine policy. The method of calculating the AF also implies that the outcome would be very different if the subsidiary had not joined a consolidated corporate group. Finally, the heavy reliance on market valuations of subsidiaries and the group implies high compliance costs for taxpayers and monitoring costs for the Australian Taxation Office (ATO).

Cancellation

In Japan, generally preconsolidation losses of a subsidiary are cancelled upon entry into a consolidated group.¹⁰¹ This harsh policy is driven primarily by tax-avoidance concerns. In fact, the government did not appear to be too enthusiastic about introducing a consolidation regime. This reluctance is implicit in other aspects of the regime, including the deemed disposal of certain assets at market value at joining time, and a 2 percent consolidation surcharge in addition to the normal corporate tax rate (imposed for the first two years following the introduction of the regime).

The cancellation approach is simple, avoiding the need for complex rules to control the use rate of preconsolidation losses. However, the tax outcome for an unconsolidated company with unused losses is very different once it joins a consolidated group. To avoid such discontinuity in tax treatment, the other countries allow the offset of preconsolidation losses of a subsidiary at a rate approximating that which would apply if the company had not consolidated.

100 ITC article 123(2) (Italy), and CITL 1969 article 15ae(2) (the Netherlands).

101 CTA article 81-9(1).

The cancellation of preconsolidation losses of joining subsidiaries has been a major disincentive to consolidation for corporate groups in Japan that would qualify to elect consolidated treatment. It is therefore not surprising that the Japanese government has recently relaxed the rules under its 2010 tax reform. Effective April 1, 2010, preconsolidation losses of a joining subsidiary are not cancelled but are subject to quarantine provided that, among other things, the subsidiary has been wholly owned by the parent company for five years before the joining time.¹⁰²

Treatment of Group Losses on Exit

The most significant advantage of consolidation is the ability to offset taxable income and losses among consolidated group members. All of the eight countries allow intragroup offset of losses incurred by group members during consolidation. However, the treatment of group losses on exit (that is, when a subsidiary leaves a consolidated group) is more varied. There are two main policy approaches to this design issue: (1) stay with the group and (2) apportionment.

Under the stay-with-the-group approach, group losses stay with the consolidated group even if a leaving subsidiary has contributed to those losses. This option is simple to operate since there is no need for complex allocation rules to apportion the consolidated group losses to a leaving subsidiary. Five countries have adopted this option—Australia, France, Italy, the Netherlands, and New Zealand.¹⁰³ However, Italy and the Netherlands provide an option to apply for apportionment of the group's consolidated losses to a leaving subsidiary. This apportionment option increases the complexity of the regime.

In Japan, Spain, and the United States, a group's consolidated losses are allocated to a leaving subsidiary.¹⁰⁴ This option requires complex allocation rules to apportion the consolidated group's losses to the leaving subsidiary.

Treatment of Assets

On Entry

The tax-free transfer of assets among consolidated group members is another significant advantage of consolidation. Tax policy makers must decide, however, as a separate issue, how to treat the assets of a company on entry into a consolidated group. The comparative analysis of the eight selected countries reveals, broadly, three alternative approaches to the treatment of assets (other than intragroup

102 *Corporate Taxation Database*, supra note 18, search under “Country Analysis”—“Japan”—“Corporate Taxation,” at paragraph 8.2; and Ernst & Young, “Japan” (May 2010) *APAC Tax Matters* 14-15, at 15.

103 ITAA 1997 section 707.410 (Australia), GTC article 223E (France), ITC article 118(1) (Italy), CITL 1969 articles 15af(1)(b) and (2) (the Netherlands), and ITA 2007 section ID 1(1) (New Zealand).

104 CTA article 57(6) (Japan), CITL section 81(1)(b) (Spain), and IRC Reg. section 1.1502-21(b)(2)(i) (United States).

shares)¹⁰⁵ on entry: (1) rollover treatment, (2) mark-to-market treatment, and (3) cost base reset.

ROLLOVER TREATMENT

Under the rollover approach, preconsolidation tax attributes are rolled over to the consolidated group, and assets of a joining subsidiary are treated as owned by the consolidated group at the original cost bases. The whole amount of gain or loss on disposal—including the amount attributable to the preconsolidation period—is attributed to the group. Six of the eight countries (excluding Australia and Japan) have adopted this approach, with no immediate tax consequences for assets of subsidiaries on entry to a consolidated corporate group.¹⁰⁶

MARK-TO-MARKET TREATMENT

Under the mark-to-market approach, assets are deemed to have been passed to the consolidated group at their respective market values. Unrealized gains or losses on assets owned by a subsidiary before entry are recognized immediately on entry. Presumably because of valuation issues, and the effect of immediate taxation on the attractiveness of a consolidation regime, Japan is the only country that has adopted the mark-to-market approach applicable to fixed assets, land, securities held as capital assets, and monetary assets held by a joining subsidiary.¹⁰⁷ The Netherlands adopts a general policy of rollover except for intragroup shares and receivables, which are marked to market on entry.¹⁰⁸

COST BASE RESET

Australia is the only country that has adopted an “asset-based” approach to the treatment of the assets of a joining subsidiary. Adoption of this approach was driven primarily by a determination to deal with the dual cost base issue—that is, the recognition of the same economic gain or loss more than once in a corporate group because of multiple levels of ownership.¹⁰⁹ Because this approach is new and unusual, and possibly unfamiliar to most readers, it is analyzed in more detail here.

105 Treatment of intragroup shares is discussed separately below.

106 The rollover policy on assets in subsidiaries is often the consequence of a pooling system, under which the subsidiaries remain, to a large extent, separate entities for income tax purposes. Their assets thus attract no immediate tax consequences upon consolidation. The Netherlands provides for an exception to this general rule: see the discussion below under “Mark-to-Market Treatment.”

107 CTA article 61-11. The deemed sale rule is subject to a number of exceptions, including assets of the parent company and of subsidiaries owned by the parent company for more than five years.

108 CITL 1969 articles 15ab(1) and (6). This exception is primarily anti-avoidance in nature: Müller, *supra* note 69, at 253.

109 ITAA 1997 division 705. The government’s determination to use the consolidation regime to deal with the dual cost base issue was evident in the legislation design process: see *A Platform for Consultation*, *supra* note 88, at paragraphs 25.5 and 25.6. See also Graeme S. Cooper, “A Few

Unlike most European countries, Australia does not have a comprehensive domestic participation exemption (PEX) regime for corporate equity. The dual cost base issue therefore represents a serious challenge to the tax system, including double taxation of the same economic gain, double deduction of the same economic loss, and value shifting among group members. The government believed that the introduction of a consolidation regime provided a valuable opportunity to deal with these problems by adopting the SER and effectively collapsing multiple levels of ownership in a corporate group into one single level. In particular, all subsidiaries are deemed to have become divisions of the parent company, and their assets are deemed to be owned directly by the parent. Because multiple levels of ownership are collapsed into one, the dual cost base issue becomes a non-issue within a consolidated group.¹¹⁰

The adoption of the SER, however, raises an important issue: What should be the cost bases of subsidiaries' assets that are now deemed to be owned directly by the parent company? As noted earlier, since intragroup asset transfers are ignored completely for income tax purposes, there is no need to trace intragroup asset movements during consolidation, to keep track of any deferred gain or loss on those transfers, or to recapture the gain or loss when either the transferor or the transferee leaves the group. The government apparently believed that the more common rollover policy was incompatible with its determination to collapse multiple levels of ownership in a consolidated group into one.

This determination to deal with the dual cost base issue comes at a high compliance and administrative price. Among other things, the preconsolidation cost bases of shares in a subsidiary become irrelevant, since the company may carry very different assets when it later leaves the group. The cost base of shares of a leaving subsidiary therefore has to be reconstructed. The government considered two policy options to reconstruct the cost bases of shares in a leaving subsidiary: the entity-based model¹¹¹ and the asset-based model.¹¹² Under the latter, upon consolidation, the cost base of shares in a subsidiary is pushed down to the underlying assets. Preconsolidation cost bases of assets in general are erased and permanently replaced by the reset cost bases. On exit from the group, the share cost base is reconstructed by pushing up the cost bases of assets that the company takes away from the group.

Observations on Managing the Taxation of Corporate Groups—The Australian Experience” (2011) 59:2 *Canadian Tax Journal* 265-94.

110 However, consolidation can deal with the dual cost base issue only in relation to corporate groups that elect to consolidate. The tax law still requires other specific provisions to deal with the issue for non-consolidated groups. In contrast, a comprehensive participation exemption would be a more comprehensive solution for all corporate groups.

111 This is basically the model in the US consolidation regime. See the discussion below under the heading “Treatment of Intragroup Shareholdings—On Exit.”

112 *A Platform for Consultation*, supra note 88, at 572-78.

A somewhat bitter irony is that Australia chose its asset-based approach in order to avoid the compliance and administrative costs of tracing intragroup asset transfers under an entity-based approach such as that in the United States, described below.¹¹³ In fact, as noted earlier, the decision to adopt the asset-based approach was influenced by the US experience with the entity-based approach; in particular, US tax officials apparently warned their Australian counterparts that the entity-based approach requires complex and ongoing equity tax basis adjustments for intragroup asset transfers during consolidation.¹¹⁴ However, the Australian approach is hardly a clear improvement in terms of simplicity. The asset-based model includes a complex set of rules—the TCS, or tax-cost-setting, rules—that are designed to achieve the pushdown of share cost bases to the underlying assets. Under the TCS rules, a subsidiary's liabilities (identified and measured under accounting rules) are added to the cost bases of shares in the company, and adjustments are made for certain profits and losses of the company, to arrive at an amount known as the “allocable cost amount” (ACA).¹¹⁵ The ACA is then generally allocated to the assets in the subsidiary according to their respective market values on entry.¹¹⁶ In other words, the cost bases of many assets are “reset” on entry, with the reset cost base replacing the “real” cost base and remaining permanently with the asset, even if the subsidiary subsequently leaves the group.¹¹⁷

The reset cost base of an asset may be higher or lower than the original cost base. In practice, the creativity of taxpayers and their advisers is more likely to produce a

113 Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable*, Report: Overview, Recommendations, Estimated Impacts (Canberra: Commonwealth of Australia, 1999), at 528. For a brief description of the US entity-based model, see Yariv Brauner, “United States” in *International and EC Tax Aspects of Groups of Companies*, supra note 31, 503-34, at 524-25.

114 Lehmann, supra note 59, at 277.

115 ITAA 1997 section 705.60.

116 ITAA 1997 section 705.35(1)(c). Certain assets (such as Australian currency and receivables)—known as “retained cost base assets”—retain their cost bases: ITAA 1997 section 705.25. The total amount of these retained cost bases is subtracted from the ACA before the balance is allocated to the remaining assets (known as “reset cost base assets”): ITAA 1997 section 705.35(1)(b).

117 A detailed discussion of the highly technical and complex TCS calculations is beyond the scope of this article. Nevertheless, the problems become obvious if one looks at the end product—that is, the reset cost base of an asset. Ironically, the ATO's *Consolidation Reference Manual*—which is intended to help taxpayers to understand how the consolidation regime works—provides a telling example illustrating the problems with the TCS rules: Australian Taxation Office, *Consolidation Reference Manual: Taxing Wholly-Owned Corporate Groups as Single Entities* (Canberra: Commonwealth of Australia, 2008), example in section C2-2-110. In the example, a subsidiary had a piece of land whose cost base and market value both were and remained \$100. At the joining time, after 16 pages of TCS calculations, the cost base of the land was reset to \$74. The implication is that if the consolidated group sold the land for its market value of \$100 (which is equal to its original cost base), the group would be taxed on an artificial gain of \$26.

stepped-up, instead of a stepped-down, reset cost base. The TCS rules thus provide fertile ground for taxpayers' ingenuity.

The policy of allowing a stepped-up cost base is unique among the eight countries. In fact, the result of this policy under the TCS rules is surprisingly generous. The rules effectively permit conversion of part of share acquisition costs into depreciable cost bases, with the extent of the conversion depending on the relative amount of depreciable assets of the subsidiary involved, their market values, and also the aggressiveness of taxpayers taking advantage of the rules. The stepped-up basis can also reduce gain on future disposal of capital assets.

Finally, as in the case of the AF rules discussed above, the heavy reliance on market valuation of assets at the joining time also implies high compliance costs for taxpayers and policing costs for tax authorities.

During Consolidation

Under the single entity concept, an intragroup asset transfer during consolidation should have no immediate tax consequences for the group. That is, the transfer should be treated as if it were a transfer between divisions of a company. Among the eight countries, three approaches are used to address this structural element: (1) rollover treatment, (2) non-recognition of a transfer, and (3) realization treatment.

The rollover approach is the predominant choice among the eight countries; six of them (excluding Australia and Italy) have adopted this option.¹¹⁸ Under the rollover approach, any gain or loss on intragroup asset transfers is deferred, and the deferred gain or loss is, in general, recaptured when either the transferor or the transferee leaves the consolidated group.

As discussed earlier, the SER adopted in Australia dictates that all assets of subsidiaries be considered assets of the parent company during consolidation. Intragroup asset transfers are therefore completely ignored. The advantages of this treatment over the rollover approach have been described above: there is no need to trace the movement of assets within a consolidated group, to keep a record of any deferred gain or loss, or to recapture the gain or loss when either the transferor or the transferee leaves the group. However, the benefit comes at a high price in terms of the complex and problematic TCS rules.

Italy originally allowed rollover treatment when its consolidation regime was introduced in 2004. However, because of avoidance concerns, the policy was abolished in 2008, and intragroup asset transfers within a consolidated group are now subject to realization treatment.¹¹⁹

118 GTC article 223F (France), CTA article 81-10 (Japan), ITA 2007 sections FM 8 and 10 (New Zealand), CITL section 72 (Spain), and IRC Reg. section 1.1502-13(a)(2) (United States).

119 ITC article 121. See also Fabrizio Bendotti, "Italy," in *International and EC Tax Aspects of Groups of Companies*, supra note 31, 327-62, at footnote 7.

On Exit

On the exit of a company from a consolidated group, policy makers must decide how to treat the assets and associated tax attributes that go with the leaving subsidiary. The tax attributes may be a mixture of preconsolidation tax attributes (for example, gains accrued during the preconsolidation period) and tax attributes generated during consolidation (for example, gains accrued during consolidation). To some extent, the approach to the treatment of assets on exit is dictated by the treatment of intra-group asset transfers during consolidation. The comparative analysis of the eight countries reveals three approaches to this structural element: (1) recapture treatment, (2) inheritance of reset cost bases, and (3) non-recognition treatment.

Where a country adopts rollover treatment for intragroup asset transfers, the deferred gain is, in general, recaptured when either the transferor or the transferee leaves the consolidated group. Six of the eight selected countries (excluding Australia and Italy) have adopted this realization approach.¹²⁰ However, there are some subtle differences. In three of the six countries (France, Spain, and the United States), recapture is triggered if either the transferor or the transferee of the previous asset transfer leaves the consolidated group. In the Netherlands, recapture is triggered by the exit of the transferor or the transferee only if the previous intra-group asset transfer is regarded as tax-driven.¹²¹ Recapture is triggered in New Zealand when the transferee leaves the group, while only the departure of the transferor triggers recapture in Japan. Triggering of realization treatment on the exit of the transferor appears to be based on the premise that, in the absence of the rollover, the deferred gain or loss would have been taxed to the transferor. Alternatively, a country may recapture deferred gain or loss upon the departure of the transferee so as to prevent the transferee from taking an asset with hidden reserves away from the group tax-free.

Under the unique asset-based model in Australia, a leaving subsidiary inherits the cost bases of assets—including the reset cost bases created under the TCS rules—that it takes away from the consolidated group.¹²² No immediate taxation arises on exit.

In Italy, since intragroup asset transfers during consolidation are subject to realization treatment, there are no additional tax consequences for assets that a subsidiary takes with it on leaving the group.

Treatment of Intragroup Shareholdings

On Entry

Intragroup shareholdings give rise to the dual cost base issue noted above. Most modern corporate tax systems address, in varying degrees, the double recognition

120 GTC article 223F (France), CTA article 61-13 (Japan), CITL 1969 article 15ai(1) (the Netherlands), ITA 2007 section FM 21(2) (New Zealand), CITL section 73(2) (Spain), and IRC Reg. section 1.1502-13(a)(5) (United States).

121 For a brief discussion of the rules, see Müller, *supra* note 69, at 270 and 274-77.

122 This is one of the implications of the “exit history” rule: ITAA 1997 section 701.40.

of gain or loss associated with such shareholdings.¹²³ One comprehensive approach is the PEX (participation exemption) regime used by many European countries. By exempting dividends and gains derived from shares in a subsidiary, as well as denying the recognition of losses, such a regime effectively removes one of the two levels of taxation associated with intragroup shareholdings. In other words, it deals directly with the primary cause of the issue and comprehensively resolves it.¹²⁴ Countries without a general PEX regime have chosen to adopt other, and often more complicated, policies to deal with the dual cost base issue in the context of their consolidation regimes. As described above, Australia collapses multiple levels of ownership in a corporate group. The United States adopts an entity-based model under which adjustments to the cost base of shares are made continuously during consolidation to remove duplication of income or losses.

On entry into a corporate group, the comparative analysis reveals three alternative approaches to the treatment of intragroup shareholdings: (1) rollover treatment, (2) mark-to-market treatment, and (3) deemed elimination. The preferred option tends to be a function of a country's general approach to the dual cost base issue.

Six of the eight countries—France, Italy, Japan, Spain, New Zealand, and the United States—have adopted rollover treatment for intragroup shares on entry into a consolidated group, consistent with rollover treatment of the assets of a joining subsidiary.¹²⁵ The Netherlands is the only country that does not extend its general rollover policy for assets to intragroup shares; instead, such shares are marked to market on entry.¹²⁶ This approach was apparently adopted to prevent an otherwise taxable gain on the shares from escaping taxation through consolidation.¹²⁷

Under Australia's asset-based model, shares in subsidiaries held by the parent company are deemed to have ceased to exist. On the exit of a company, the cost base of the shares in the leaving subsidiary must be reconstituted under the TCS rules.¹²⁸

123 See, for example, Ault and Arnold, *supra* note 27, at 358-62. Attempts to deal with the issue in the context of unrealized gains or losses in assets have proved to be particularly complex. For example, see ITAA 1997 subdivisions 165-CC and 165-CD for the Australian rules dealing with the multiplication of losses.

124 Another advantage of the PEX regime is that it is generally applicable to both consolidated and unconsolidated groups. It is also applicable equally to resident and non-resident shareholders. In other words, it provides a general and neutral solution to intracorporate shareholdings. In contrast, other solutions, such as the asset-based model in Australia, do not apply outside consolidation regimes. Of course, the PEX regime has its drawbacks. The general exemption policy tends to attract tax avoidance. Specific anti-avoidance provisions are often necessary to protect the regime from abuse.

125 Rollover treatment is again a logical consequence of the pooling system, under which the tax attributes of shares in a subsidiary are maintained at the joining time.

126 CITL 1969 article 15ab(1).

127 Müller, *supra* note 69, at 253.

128 See the discussion below under the heading "On Exit."

During Consolidation

Under a strong application of the single entity concept, intragroup share transfers should have no tax implications, consistent with the treatment of divisions of a single company. This policy is, in fact, followed by a majority of the eight countries, though some countries adopt a different approach, primarily to deal with the dual cost base issue. Nonetheless, in all eight countries, there is no immediate taxation of intragroup share transfers during consolidation.

Four countries—France, Japan, Spain, and the United States—have adopted rollover treatment.¹²⁹ While each group member accounts for the gain or loss on the intragroup transfer in its own tax computation, the transfer is neutralized at the group level when the parent company prepares the consolidated tax computation. This is the same approach that applies to an intragroup transfer of non-share assets during consolidation. In all of these four countries except Japan, the deferred gain or loss is recaptured when either the transferor or the transferee leaves the consolidated group. In France and Spain, the recaptured gain or loss may qualify for exemption under the PEX regime. In Japan, recapture is triggered only by the departure of the transferor.

Italy and the Netherlands rely on their general PEX regimes to exempt intragroup share transfers. In both countries, the PEX regime applies to companies in general, whether or not they are members of a consolidated group.¹³⁰ In most cases, intragroup share transfer will be eligible for exemption since the ownership threshold requirements under consolidation are often stricter than those under the PEX regime. An advantage of this approach is its simplicity, since additional provisions are not required in the consolidation regime to deal with intragroup share transfers. The PEX regime also applies consistently throughout the consolidation cycle, covering entry, the consolidation period, and exit. A possible drawback of applying the regime to intragroup share transfers is that it may be less beneficial than non-recognition treatment (for example, in France and Spain). This is so if the PEX regime exempts only, say, 95 percent of the gain, thus leaving the remaining 5 percent to be taxed at the transfer time.

In Australia, as discussed above, intragroup shares in subsidiaries are deemed to have ceased to exist during consolidation. This fiction dictates that there be no tax implications for intragroup share transfers, since they are deemed not to have occurred. But again, this approach requires application of the TCS rules to reconstruct the cost base of shares in a leaving subsidiary.

The absence of a general tax on capital gains in New Zealand means a “no taxation” outcome for intragroup share transfers. In the rare cases where shares in a subsidiary are held as revenue assets (receivables), an intragroup transfer of these

129 GTC article 223F (France), CTA article 61-13 (Japan), CITL section 72 (Spain), and IRC Reg. section 1.1502-13(a)(2) (United States).

130 ITC article 87 (Italy) and CITL 1969 article 13 (the Netherlands).

assets is subject to rollover treatment consistent with the treatment of intragroup asset transfers.¹³¹

On Exit

On the exit of a company from a consolidated group, tax attributes that have been deferred during consolidation have to be addressed, with intragroup shareholdings presenting the troublesome dual cost base issue. The approaches of the eight countries to this structural element of their consolidation regimes are diverse, especially among the countries that do not have a comprehensive PEX regime for domestic corporate groups. In particular, the comparative analysis reveals two broad approaches: (1) application of the PEX regime and (2) realization treatment.

All of the four European countries enjoy the benefit of an existing PEX regime, with gain or loss on a disposal of shares in a leaving subsidiary generally being eligible for exemption.¹³² New Zealand again enjoys the luxury of the general policy of not taxing capital gains. Disposal of shares in a leaving subsidiary therefore does not have any tax implications, unless the shares are held as revenue assets. In that case, New Zealand recaptures any deferred gain or loss on the shares.¹³³ There is no specific provision to adjust the cost bases of the shares, probably because it is rare for shares in a consolidated subsidiary to be held as revenue assets.

Australia, Japan, and the United States, lacking the benefit of a general PEX regime for domestic corporate groups, all impose taxation on the disposal of shares in a leaving subsidiary. However, each of the three countries adopts a different approach to the determination of the cost bases of the shares in the subsidiary—though with the same objective of dealing with the dual cost base issue.

In Australia, the shares in a leaving subsidiary, which are deemed to have disappeared during consolidation, spring back to life and are assigned a cost base that is reconstituted from the cost bases—including reset cost bases created under the TCS rules on entry—of the underlying assets that the subsidiary takes away from the consolidated group.¹³⁴ As discussed earlier, the disadvantages of this asset-based model are the complex and problematic TCS rules and the failure of the model to provide a comprehensive solution to the dual cost base issue. In particular, double taxation is still possible if a subsidiary leaves a consolidated group and takes with it assets with hidden reserves. Owing to the arbitrariness of the TCS rules, artificial gain or loss can be created and even duplicated at leaving time, since the cost bases of shares in a leaving subsidiary are reconstituted on the basis of the reset cost bases of assets in the subsidiary. The heavy reliance on market valuation of assets

131 ITA section FM 15.

132 GTC article 219 (France), ITC article 87 (Italy), CITC 1969 article 13 (the Netherlands), and CITC section 30 (Spain).

133 ITA article FM 15.

134 ITAA 1997 division 711.

under the TCS rules implies high compliance costs for taxpayers and monitoring costs for the tax authorities, and creates avoidance opportunities.

In the United States, under the entity-based model, the cost bases of intragroup shares are adjusted continuously during consolidation. The model provides for “investment adjustments” under which the cost bases of shares in a subsidiary are adjusted for various items, including distributions, profits, and losses of the subsidiary.¹³⁵ For example, assume that a parent company (P) acquires a subsidiary (S) for \$100 and then forms a consolidated group.¹³⁶ If S has taxable income of \$10, that amount is included in the group’s consolidated taxable income and is subject to tax at the group level. The investment adjustment rules adjust the cost base of S’s shares to \$110. If P subsequently sells S, the \$10 of taxable income is not taxed again. The rules are complex and impose high compliance costs. They require continuous adjustments throughout consolidation,¹³⁷ and the rules have to be applied on a bottom-up approach if multiple levels of shareholdings are involved.¹³⁸ Furthermore, if a company has more than one class of shares, the adjustment rules are even more complicated.¹³⁹

In Japan, the cost bases of shares in a leaving subsidiary are adjusted at the leaving time, reflecting in general the net change in retained profits of the company.¹⁴⁰ Although arguably less precise, the Japanese approach is much simpler than the approaches in Australia and the United States.

A MODEL CONSOLIDATION REGIME?

The different approaches to the major structural elements of consolidation regimes in the eight countries are summarized in table 1, with the countries arranged from left to right according to the extent of the application of the single entity concept (weakest to strongest).

The preceding discussion has indicated that, among the eight countries, Australia stands out as having adopted the strongest version of the single entity concept, and this is borne out by its position at the far right of the table. Under the Australian

135 The investment adjustment rules, contained in IRC Reg. section 1.1502-32, are complex, and a detailed discussion of their application is beyond the scope of this article. For more information about the rules, see, for example, Hennessey et al., *supra* note 64, chapter 13.

136 The scenario described here is based on the example provided in IRC Reg. section 1.1502-32(a)(1).

137 In particular, the adjustments have to be made “as of the close of each consolidated return year, and as of any other time . . . if a determination at that time is necessary to determine a tax liability of any person”: IRC Reg. section 1.1502-32(b)(1).

138 IRC Reg. section 1.1502-32(a)(3)(iii).

139 IRC Reg. section 1.1502-32(c).

140 See Fumihiko Komamiya, “Japan,” in *Group Taxation*, *supra* note 20, 393-405, at 397; and Japan, Ministry of Finance Tax Bureau, *Comprehensive Handbook of Japanese Taxes 2006* (Tokyo: Ministry of Finance, 2006), at 82; and Yuji Gomi and Tasuku Honjo, eds., *2007 Corporation Tax Act of Japan* (Tokyo: Sozei Shiroyokan, 2007), at 457-58.

TABLE 1 Major Structural Elements of Consolidation Regimes in the Eight Countries

Design feature	Italy	France	Japan	United States	Spain	New Zealand	Netherlands	Australia	Model regime
Single entity concept	Pooling	Pooling	Pooling	Pooling	Pooling	Pooling	Attribution	Absorption	Pooling
Ownership requirement									
Threshold	<<100%	≈100%	≈100%	<<100%	<<100%	≈100%	≈100%	≈100%	≈100%
Factors	SC + VR + PR	SC + VR	SC ^a	VR + Value	SC	VR ^b	SC + PR	SC	VR and/or SC with protections
Election to consolidate: revocable?	No (3-year term)	No (5-year term)	No	No	Yes	Yes	Yes	Yes/No	Indecisive
All-in rule	No	No	Yes	Yes	Yes	No	No	Yes/No	Indecisive
Preconsolidation losses	Quarantine	Quarantine	Cancel ^c	Quarantine	Quarantine	Quarantine	Quarantine	Transfer	Quarantine
Group losses (on exit)	Stay + option to allocate	Stay	Allocate	Allocate	Allocate	Stay	Stay + option to allocate	Stay	Indecisive
Assets (except shares)									
On entry	Rollover	Rollover	Mark-to-market	Rollover	Rollover	Rollover	Rollover	Cost base reset	Rollover
Intragroup transfer	Immediate taxation	Rollover	Rollover	Rollover	Rollover	na (rollover if taxable asset)	Rollover	Deemed no transfer	Rollover

(Table 1 is concluded on the next page.)

TABLE 1 Concluded

Design feature	Italy	France	Japan	United States	Spain	New Zealand	Netherlands	Australia	Model regime
<i>Assets (except shares) (continued)</i>									
On exit	na	Recapture	Recapture	Recapture	Recapture	na (recapture if taxable asset)	Rollover ^d	Inherit reset cost base	Recapture
<i>Intragroup shares</i>									
On entry	Rollover	Rollover	Mark-to-market	Rollover	Rollover	Rollover	Mark-to-market	Deemed ceased to exist	Rollover
Intragroup transfer	PEX	Rollover	Rollover	Rollover	Rollover	na (rollover if revenue asset)	PEX	No tax implication	Indecisive
On exit	PEX	PEX	Taxable: based on adjusted cost base	Taxable: based on adjusted cost base	PEX	na (recapture if revenue asset)	PEX	Taxable: based on reconstituted cost base	Indecisive

<<100% = Substantially less than 100%.

≈100% = Substantially 100%.

SC = Share capital.

VR = Voting rights.

PR = Profit rights.

PEX = Participation exemption.

^a Protected by anti-avoidance provision.

^b Protected by value factor in certain circumstances.

^c Effective October 1, 2010, quarantine if the joining subsidiary satisfies certain restrictive conditions.

^d Recapture if previous transfer is regarded as tax-driven.

regime, subsidiaries are not only deemed to have become divisions of the parent company, but also deemed to have ceased to exist for income tax purposes. Multiple levels of ownership in a corporate group are collapsed into one, and intragroup shareholdings are deemed to have vanished during consolidation. The implications of these propositions are significant. The original cost bases of underlying assets and shares in the subsidiaries are erased and lost forever on entering consolidation.

The Netherlands comes second with its attribution concept, under which assets, liabilities, and activities of subsidiaries are attributed to the parent company, but the subsidiaries are still regarded as existing separate entities during consolidation. Among the six remaining countries, all of which adopt the pooling system, New Zealand stands out with its general policy of determining the taxability and deductibility of various items for each individual group member on a group basis.

Among the remaining five countries, France and Italy allow cherry-picking of subsidiaries to join consolidation, which arguably is contrary to the principle that a corporate group should be treated as a single entity. They therefore represent a weaker application of the concept than that in the other three countries. Italy deviates significantly from the single entity concept by imposing immediate taxation on intragroup asset transfers during consolidation, and is therefore regarded as having the weakest application of the concept among the eight countries.

The remaining three countries—Japan, Spain, and the United States—are more difficult to rank since they do not exhibit significant differences in the extent of their application of the single entity concept. Their positions in the table take the following features into consideration:

- Japan has adopted the unique approach of cancelling preconsolidation losses of a company on entry into a consolidated corporate group, which arguably is not supported by the single entity concept.
- For Spain and the United States, the only major difference lies with the treatment of intragroup shareholdings. Spain relies on its general PEX regime to address the dual cost base issue, while the United States applies its unique entity-based model, under which the cost bases of shares in a subsidiary are adjusted continuously during consolidation.

Is it possible to identify a model consolidation regime from the approaches of the eight selected countries? The discussion so far suggests that a consolidation regime is often the product of compromises between competing policy objectives and constraints. Nevertheless, it is worthwhile to attempt to identify a model regime representing the best practice in a “clean slate” scenario. In fact, comparative analysis of the eight countries reveals convergence around the best practice with respect to many structural elements. A pooling system is preferred to other versions of the single entity concept in terms of simplicity. Interaction between the consolidation regime and other parts of the income tax system is easier since the pooling system preserves, to a large extent, the separate identity of a subsidiary, and thus operates under a similar conceptual framework as the separate entity doctrine. Australia’s

experience with its asset-based model demonstrates that a strong single entity concept can be very complex and problematic to operate in practice.

The comparative analysis of the ownership requirements suggests that the ownership threshold should be substantially 100 percent, thereby avoiding the complicating presence of minority interests. In respect of the factors in the ownership threshold, the concept of common control suggests that voting rights should be one factor. A shareholding requirement without some form of constructive ownership rule is simple to apply in practice, but prone to abuse.

With respect to the treatment of preconsolidation losses, the quarantine approach is the apparent preference. The irreversible transfer of the losses to the parent company in Australia proves to be very problematic. The potential revenue impact is so substantial that the Australian government has had to adopt an arbitrary regime to limit the use rate of the transferred losses. The heavy reliance on market valuation of subsidiaries and the consolidated group not only implies high compliance costs for taxpayers and monitoring costs for tax authorities, but also provides avoidance opportunities. Japan's cancellation approach is harsh and has severely diminished the attractiveness of its consolidation regime.

The rollover and recapture policy—being the most common approach to deal with the assets of a joining subsidiary—is the preferred approach, presumably because of its simplicity. Australia's asset-based model provides a tax-friendly environment for corporate groups during consolidation. However, the problems and complexity at the transition times (on entry and on exit of a company) are a high price to pay. Italy's elimination of rollover treatment in 2008, just four years after the introduction of its consolidation regime, illustrates the difficult compromise between competing objectives.

The comparative analysis of the other structural elements fails to reveal clearly preferred approaches. The all-in rule is a classic example of the difficult compromise between competing policy objectives. On the one hand, the rule should be implemented as an anti-avoidance measure. On the other hand, some countries believe that an all-in rule would render their consolidation regime less attractive. The decision on whether or not to adopt the all-in rule depends on the relative weight that policy makers place on these objectives. The diverse treatment of group losses on exit illustrates a similar problem.

The approach to intragroup shareholdings is perhaps the most difficult structural element. The associated dual cost base issue has troubled policy makers for decades. The solution depends to a large extent on whether a comprehensive PEX regime exists for domestic corporate groups. If so, the answer is straightforward. New Zealand achieves an outcome similar to participation exemption treatment owing to the absence of a general taxation regime for capital gains. Other countries without a comprehensive PEX regime do not have this luxury. Australia, Japan, and the United States have to incorporate often complex rules into their consolidated regimes to deal with the dual cost base issue. The fact that each of the three countries has adopted a different approach to this issue is telling.

THE COMPLEXITY INDEX—COMPARISON OF THE EIGHT CONSOLIDATION REGIMES

One of the major concerns regarding the introduction of a full consolidation regime in Canada is the perceived complexity of such a regime. Australia and the United States are the two examples commonly cited to substantiate this concern. However, the comparative study of the eight countries set out above suggests that a consolidation regime need not necessarily be as complex as those regimes. In fact, the other six regimes appear to be much simpler than the Australian and US models. The study further suggests that the complexity of a consolidation regime depends to a large extent on the policy choices that a country makes with respect to the key structural elements of the regime.

To illustrate the relative complexity of the eight consolidation regimes, a complexity index can be constructed, with a complexity score being assigned to each regime. The ranking of the eight regimes is presented in table 2. Some critics may argue that the score assigned to a regime is arbitrary and perhaps subjective. However, it is important to bear in mind that the index serves primarily to highlight the *relative* complexity of the eight regimes. The relative magnitude of a score does not imply a proportional level of complexity. For example, if a regime has a complexity score of 40, this does not necessarily mean that it is twice as complex as a regime with a score of 20. Instead, these two scores simply indicate that the first regime is more complex than the second.

The complexity score of a consolidation regime is the outcome of a two-step procedure. The first step is to identify the key structural elements in the design of a regime that significantly affect its complexity. These elements include

1. application of the single entity concept,
2. the treatment of preconsolidation losses,
3. the treatment of group losses on exit,
4. the treatment of assets, and
5. the treatment of intragroup shares.

The second step is to assign a score to each of the alternative policy options for each design feature or structural element. The most complex policy option receives a score of 10 and the simplest option a score of 0. The option with complexity in between the two extremes has a score of 5. For example, with respect to the application of the single entity concept, Australia's absorption model has a score of 10 since it is the most complex policy option, especially with respect to the complicated interactions between the consolidation regime and the other parts of the tax system. The pooling system adopted in six of the other countries is relatively the simplest option and gets a score of 0. The Netherlands' attribution system scores 5 since, in terms of complexity, it falls between these two extremes.

The result of this exercise is presented in table 2, with the eight countries ranked according to their aggregated complexity scores.

TABLE 2 Complexity of Consolidation Regimes in the Eight Countries

Design feature	New Zealand	France	Italy	Japan	Netherlands	Spain	United States	Australia
Single entity concept	0	0	0	0	5 (attribution)	0	0	10 (absorption)
Preconsolidation losses	0	0	0	0	5 (quarantine + offset after aggregation)	5 (quarantine + offset after aggregation)	5 (quarantine + offset after aggregation)	10 (transfer to parent)
Group losses on exit	0	0	5 (stay + option to allocate)	10 (allocate)	5 (stay + option to allocate)	10 (allocate)	10 (allocate)	0
Assets	0	5 (rollover and recapture)	5 (rollover and recapture)	5 (rollover and recapture)	0	5 (rollover and recapture)	5 (rollover and recapture)	10 (reset cost bases)
Intragroup shares	0	0	0	0	0	0	10 (entity-based model)	10 (reconstituted cost bases)
Complexity index	0	5	10	15	15	20	30	40

The table shows that on the basis of the respective scores, the Australian and US regimes are the most complex. This is consistent with the common perception. New Zealand scores a perfect 0, suggesting that it is the simplest regime among the eight countries. However, one important qualification, noted previously, is that New Zealand enjoys the rare luxury of the absence of a general tax on capital gains. This particular feature of its tax system removes most of the pressure on its policies with respect to the treatment of assets and intragroup shares.

CONCLUSION

The choice between a system of full consolidation and a group loss relief regime is a difficult one. It often represents a tradeoff between conflicting policy objectives as well as constraints imposed by the existing tax system. Nevertheless, Canada should consider a consolidation regime for the following reasons:

- First, a consolidation regime is more comprehensive than other group taxation regimes, allowing both intragroup loss offsets and intragroup asset transfers.
- Second, intragroup transactions other than asset transfers are generally ignored within a consolidated group, a feature that can constrain interprovincial income-shifting opportunities between consolidated group members.
- Third, although a consolidation regime tends to be more complex than other group taxation regimes, the fact that an increasing number of countries have adopted consolidation in recent years suggests that many governments prefer this type of regime over other group taxation regimes, and that they believe that the complexity involved is justified.
- Fourth, some countries that already had other group taxation regimes have decided to introduce a consolidation regime.
- Finally, a system of full consolidation may provide an elegant solution to the troublesome issue of interprovincial allocation of the corporate group tax base.

The comparative analysis suggests that a stronger application of the single entity concept in a consolidation regime does not necessarily imply a better regime on policy grounds. Australia has adopted the world's first asset-based model, which represents the strongest application of the single entity concept among the eight countries. Its single entity rule dictates the fiction that, after consolidation, only one company remains—the parent company. Australia's consolidation regime offers some distinct attractions, including the ability to completely ignore intragroup asset transfers within a consolidated group. However, the price to pay for the advantages is high, especially at the transition points when a company enters or exits the consolidated group. The TCS rules are complex and can generate artificial gain or loss, which can even be duplicated at the time a company leaves the group. The rules on preconsolidation losses can also produce arbitrary and anomalous results. Both sets of rules rely heavily on market valuations of assets and companies, implying high compliance and policing costs, and creating avoidance opportunities. Another problem

with the strong application of the single entity concept is the difficult interaction between the consolidation regime and other parts of the income tax system. Most regimes in the tax law are designed to operate under the traditional separate entity doctrine, which by definition contradicts the single entity concept. Experience suggests that the stronger the application of the single entity concept, the more difficult the interactions tend to be.

For a majority of the key structural elements of a consolidation regime, the comparative analysis points quite clearly to a predominant policy option in the eight countries. The pooling system is adopted in all of the eight countries except Australia and the Netherlands. Preconsolidation losses are quarantined in all of the eight countries except Australia and Japan. All of the eight countries except Australia and Italy adopt the rollover and recapture policy for assets on entry and exit, and for intragroup asset transfers. The comparative analysis suggests that the ownership threshold should be substantially 100 percent in order to avoid minority interest problems.

For the other key structural elements, the eight countries exhibit considerable variations and reveal no clear preferred design choice. The all-in rule and the treatment of group losses on exit are examples of the difficult compromises that policy makers have to make. The approach to intragroup shareholdings is perhaps the most difficult choice. It depends, to a large extent, on the presence (or absence) of a general PEX regime dealing with the dual cost base issue.

Experience suggests that once a consolidation regime is introduced, major structural changes are unlikely. Businesses enjoy the benefits of intragroup loss offsets and tax-free asset transfers under the consolidation regime. Repeal of the regime is therefore likely to be politically unacceptable. Fine-tuning is often the only feasible approach in practice. Therefore, it is important for Canada, if it decides to introduce a consolidation regime, to get the legislation right when it is first introduced. The comparative analysis of the eight consolidation regimes presented in this article attempts to shed some light on the structural design choices.