ARTICLES

THE IMPACT OF THE CONSOLIDATION REGIME ON PROJECT FINANCE IN AUSTRALIA

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The new income tax consolidation regime is one of the most radical and complex tax measures that have been introduced in recent years. The introduction and operation of the regime has implications for all companies that operate in a group structure. Although changes to taxation law have always had a significant impact on project financing, and financing in general, consolidation is likely to raise particular issues for financiers advancing project finance to special purpose vehicles (SPVs) which are, or are likely to become, part of a consolidated group. This is largely due to the new risks that the regime introduces for financiers and borrowers, particularly as a result of the introduction of joint and several liability for the members of a consolidated group where a parent company defaults in meeting its income tax obligations.

AN OVERVIEW OF THE CONSOLIDATION REGIME

Under the consolidation regime,[1] groups of Australian resident companies, trusts or partnerships that are wholly owned by a common parent company, may elect to "consolidate". Once an election to consolidate has been made, the group is then treated as a single entity for income tax purposes and each of the wholly owned subsidiaries of the parent company are effectively "treated as a division or a branch [of the parent company] for the purposes of the Australian [income] tax system".[2]

The parent company has a primary obligation to meet the income tax liabilities of the consolidated group. It is able to lodge a single income tax return and is able to meet the income tax liabilities for the entire group by way of a single payment, rather than each member of the group being required to lodge an individual income tax return to meet individual income tax liabilities.

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1 *New Business Tax System (Consolidation) Act (No. 1) 2002* (Cth); *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002* (Cth); *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* (Cth); *New Business Tax System (Consolidation and Other Measures) Act 2003* (Cth); *Taxation Laws Amendment Act (No. 5) 2003* (Cth); *Taxation Laws Amendment Act (No. 6) 2003* (Cth); *Taxation Laws Amendment Act (No. 8) 2003* (Cth).

2 Tony Cooper, "Consolidations" (Paper presented at the Taxation Institute of Australia, International Tax Master Class, New South Wales Division, 31 August 2000) 3. See also Commonwealth of Australia *Consolidation Reference Manual* (28 May 2003) B0-2, B0-3; *Income Tax Assessment Act 1997* section 701-1.

The assets and liabilities of each of the subsidiary companies are regarded as being the assets and liabilities of the parent company. All transactions within the group, including transactions involved in restructuring of group assets and companies, are ignored for income tax purposes.

On entering into a consolidated regime, the parent company is also taken to have inherited the tax history of its wholly owned subsidiaries.[3] Provided that certain eligibility requirements are fulfilled, the tax losses of members of the consolidated group are regarded as being tax losses of the parent company. The franking credits of the members of the group are also pooled in the parent company and are able to be utilised by the entire group. As a result, the group is able to prepare a single set of tax accounts dealing with carry forward losses and franking credits for the whole group.

The Consolidation Reference Manual released by the Australian Tax Office (ATO) gives the example of a subsidiary, perhaps an SPV, incurring borrowing expenses and subsequently joining a consolidated group. In that event, by way of example, the parent company is likely to be entitled to a deduction for any previously undeducted borrowing costs of the subsidiary as if the parent company had actually incurred the expenditure itself.[4]

Perhaps most significantly for the project finance industry, each member in the group is regarded as being jointly and severally liable for the income tax liability of the entire group where there is a default by the parent company in meeting the group's income tax obligations.

The fact that a group is consolidated does not however affect the legal and statutory obligations of each of the individual members of that group for the purposes of other legislation, such as the *Corporations Act 2001* or for the purposes of the goods and services tax or fringe benefits tax.

The decision to elect to consolidate is optional but irrevocable. One commentator has noted however that there is in fact "a de facto mandatory requirement to consolidate due to the ... repeal of the various current group concessions".[5] This comment stems from the fact that part of the consolidations legislation provides that the existing grouping rules in relation to the transfer of group losses,[6] capital gains tax (CGT) asset rollovers,[7] and intercorporate rebates for unfranked dividends[8] ceased to be available to corporate groups from 1 July 2003, unless those groups elect to consolidate.

As a result, if members of a corporate group intend to transfer assets, pay unfranked dividends between members without adverse tax consequences or utilise tax losses against the income of other group members, the group must elect to be subject to the new consolidations regime. For example, "[w]ithout consolidation, all intra-group transactions may give rise to taxable events as

3 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B0-2, B0-4; *Income Tax Assessment Act 1997* section 701-5.
4 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B0-2, B0-4.
5 Ross Doherty, "Consolidation of Entity Groups" (Paper presented the Taxation Institute of Australia New Business Taxation One Day Conference, 15 February 2000) at 8.
6 *Income Tax Assessment Act 1997* Subdivision 170A.
7 For example *Income Tax Assessment Act 1997* Subdivision 126-B.
8 *Income Tax Assessment Act 1936* section 46.

there will be no ability to offset taxable income in one member entity of a group with the tax losses of another".[9]

There will also be adverse consequences for companies who do not elect to consolidate but wish to transfer excess foreign tax credits between companies that are part of the same wholly owned group.[10]

Groups can elect to become subject to the consolidations regime for the 2002/2003 financial year at any time until they lodge their first consolidated income tax return.

Where a group has elected to consolidate prior to 30 June 2004 there are two methods available to determine the new tax values for the assets of the various subsidiaries in the consolidated group. Consolidated groups can either elect to retain the existing tax values for the assets of each subsidiary or can reset the asset values according to cost setting rules. The ability to retain the existing tax values of the assets of each subsidiary is a transitional provision that will not be available for groups that commence consolidation after 30 June 2004. Where a consolidated group wishes to reset its asset values or where the group elects to consolidate after 30 June 2004, the tax cost of each asset of a subsidiary will be based on a share of the "allocable cost amount" of that subsidiary.[11] The rules that govern the calculation and setting of the ACA are complex and will often result in significant implementation costs. The legislation, so far as it applies to the setting of the tax costs of assets of companies entering into the regime, is beyond the scope of this paper.

Given that the transitional rules for determining asset values ceased to be available from 1 July 2004 it is likely that most groups that are eligible to consolidate will elect to have a start date for consolidation on or before 30 June 2004.

ELIGIBILITY REQUIREMENTS FOR CONSOLIDATION

A group which is eligible to consolidate can consist of as few as two eligible entities, however if a group does elect to consolidate, all eligible, wholly owned members of that group must be included in the consolidated group in accordance with a "one in all in"[12] principle.

A parent company or a member of a consolidated group can be any Australian resident[13] company that has at least some of its taxable income taxed at the general Australian company tax rate.

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9 C J Getz and Deborah van Horn, "Tax Consolidation: Ralph's Corporate Tax Panacea" (2000) 3 *The Tax Specialist* 170, 171.

10 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B1-1, B1-7.

11 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B2-2, B2-3.

12 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B1-1, B1-1.

13 The statutory definition of an Australian resident (contained in *Income Tax Assessment Act 1997* section 995-1 and *Income Tax Assessment Act 1936* section 6(1)) will include a company that is incorporated in Australia or a company that is not incorporated in Australia but carries on business in Australia and has either its central management and control in Australia or has its voting power controlled by shareholders who are residents of Australia. As a result the consolidations regime can potentially apply to companies that, for example, carry on business in Australia and have their central management and control in Australia. A discussion as to whether or not a company has its central management and control in Australia can be found in the case of *Esquire Nominees Ltd v FC of T* (1973) 129 CLR 177. Where a company qualifies as an Australian resident because it carries on a business in Australia and because its central management and control is in Australia, it may nonetheless be precluded from becoming part of a

The parent company cannot be a subsidiary member of a consolidated group or a group that is eligible to consolidate and cannot be an entity that is specifically excluded[14] from being part of a consolidated group.

In order for a subsidiary to be a member of a consolidated group, "all of the membership interests in it …[must be] beneficially owned by the head company, other wholly owned subsidiaries of the head company or a combination of both".[15] The term "membership interests" is defined by reference to section 960-135 of the *Income Tax Assessment Act 1997*. The ATO has indicated in the Consolidations Reference Manual[16] that generally a membership interest in a company is an interest held by a member or a stockholder in the company.

The Consolidation Reference Manual notes that "[a]n entity will not be a member of another entity if the only reason it would be a member is that it holds interests or rights in another entity that are debt interests".[17] A debt interest is defined by reference to subdivision 974-B of the *Income Tax Assessment Act 1997*. Effectively debt interests are disregarded when determining whether an entity is a wholly owned subsidiary of another entity. The Consolidation Reference Manual gives the example of a compulsorily redeemable preference share held by a financier as being a debt interest and therefore disregarded when determining whether that entity is a wholly-owned subsidiary of another entity in order to allow those entities to consolidate.[18]

Non-share equity interests such as convertible notes, which generally do not fall within the definition of a debt interest,[19] will also be disregarded in determining the ownership of company for the purposes of the consolidation regime. Nonetheless, the author is aware of at least one SPV that has been unable to be part of a consolidated group because of the terms of the particular convertible notes issued by that SPV to a non-group entity. In the past the issue of convertible notes has been a fairly standard feature of a number of project financings. Companies will need to be wary of the fact that the terms of some convertible notes may mean that those convertible notes constitute a 'membership interest' that will, where issued to a non-group entity, preclude that SPV being part of a consolidated group.

Where a subsidiary has issued shares under an employee share scheme, that subsidiary can still be part of a consolidated group provided that employees under the share scheme hold no more than 1% of its ordinary shares.

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consolidated group if it is also regarded as a resident of another country with its central management controlled in another country. Such companies are referred to as prescribed dual resident companies and are specifically excluded from the operations of the consolidation regime.

14 Such entities include income tax exempt entities (*Income Tax Assessment Act 1997* section 703-20(2), table item 1), credit unions (*Income Tax Assessment Act 1997* section 703-20(2), table item 2 and 3), pooled development funds (*Income Tax Assessment Act 1997* section 703-20(2), table item 5) and film licensed investment companies (*Income Tax Assessment Act 1997* section 703-20(2), table item 6).

15 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B1-1, B1-2.

16 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B1-1, B1-3.

17 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) C1-1, C1-17.

18 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) C1-1, C1-13.

19 As defined in *Income Tax Assessment Act 1997* subdivision 974-B.

The consolidations regime can also potentially apply where a non-resident company directly owns a number of Australian resident subsidiaries. In that situation, one of the subsidiaries can be nominated as the notional parent company of the group.[20] Alternatively, corporate groups with a foreign parent company may decide to utilise CGT rollover relief for asset transfers between non-resident entities and between non-resident entities and their Australian parent entities[21] to re-organise their Australian interests under a common Australian parent company.

For a MEC group, which has an ultimate holding company which is a non-resident, there is likely to be some tension between how the consolidated group is treated in Australia for income tax purposes and how that group of companies is treated under the tax laws of its ultimate holding company's home jurisdiction.[22] One commentator has correctly pointed out that "[t]he Business Tax Reform consolidation proposals will create a fiction for the purposes of Australian tax law. Where this fiction is not adopted by the tax rules of another jurisdiction then there is a potential for a mismatch that cross-border investors must manage along with other tax risks".[23] There may be other cross-border issues that will arise where an Australian resident subsidiary, which is part of a consolidated group, carries on business in a foreign country.

BACKGROUND TO THE CONSOLIDATION REGIME

The concept of a consolidations regime in Australia first received wide scale recognition in the July 1999 Ralph Review of Business Taxation Report, entitled "A Tax System Redesigned" (the Ralph Report).[24] The implementation of a consolidations regime is not however unique to Australia.

The United States has had a consolidated income tax regime since the 1950s. In the United States a consolidated income tax return can be filed by an "affiliated group" of companies. An affiliated group of companies must have a common parent that holds at least 80% of the voting power of all classes of stock of the subsidiary members.[25] One of the key differences between the United States system of consolidation and the Australian system of consolidation is that there is a requirement in the United States that a consolidated tax return only be filed if each of the companies which are to be included within the affiliated group, consent to the filing of the consolidated return.[26] In Australia the parent company makes the election to consolidate and the eligible subsidiary members are automatically a part of that consolidated group. This has implications for creditors of an SPV where those creditors may not be aware that the parent company has elected to consolidate.

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20 Such a group is known as a "Multiple Entry Consolidated" (MEC) group.
21 Getz and van Horn, op cit n 9, at 172.
22 Cooper, op cit n 2, at 9-10.
23 Ibid at 14.
24 Commonwealth of Australia, *A Tax System Redesigned: Report of the Review of Business Taxation* (1999).
25 Howard E Abrams and Richard L Doernberg, *Essentials of United States Taxation* (1999) 2-299-2-300.
26 Ibid at 2-301.

In France, a group of companies must have a common parent entity that holds at least 95% of each of the members of the group, in order to consolidate for income tax purposes.[27]

New Zealand has operated with a consolidation regime from 1 April 1993.[28] The New Zealand regime requires 66% common ownership in order to enable a group of companies to consolidate.

Similarly, Germany has for a number of years operated within a consolidation regime known as Organschaft.[29] The consolidations regime in Germany allows for a group to be consolidated where the parent company owns greater than a 50% interest in a subsidiary. The regime in Germany is perhaps one of the more liberal consolidation regimes and also allows that "shareholders with no controlling interest …[are], by virtue of a partnership agreement, able to form a majority interest for corporate Organschaft purposes and …[can] form a so called 'multi parent' Organschaft".[30]

The consolidation regime in Mexico also allows consolidation where a parent entity holds 50% of the voting shares in the group members.[31]

One of the notable absences from the list of countries that have implemented a consolidated income tax regime is the United Kingdom. The United Kingdom does not have a consolidation regime[32] but allows for the transfer of corporate tax attributes between group members that are 75% owned by the same head entity.[33]

One of the key distinguishing features between the consolidation regimes in the United States, France, New Zealand, Germany and Mexico and the consolidation regime that is being introduced in Australia is the fact that in those other countries, the consolidation regime can be regarded as truly optional. Whilst the consolidation regime in Australia is touted as being optional, as discussed above, it is to some extent mandatory for group companies if they wish to access the longstanding grouping provisions which have otherwise been repealed from 1 July 2003.

PARTICULAR IMPACTS FOR THE PROJECT FINANCE INDUSTRY

Whilst the implementation of the consolidations regime will have consequences for all companies that are part of a group structure, there are particular effects in the area of project finance. The most significant risks to a financier who has lent money to a member of a consolidated group,

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27 *Mergers and Acquisitions in France: Acquisitions and Disposals* (undated) Ernst & Young <http://www.ey.com\global\content.nsf\uk\tax_-_tax_news_-_tax_features_-_02_06_dc_-_Mas_in_France> at 11 January 2004.

28 David Williams, "A background to the new consolidation regime – How Did We End Up Here?" (Paper presented at Taxation Institute of Australia Conference (Venue unknown) (15 February 2001) at 5.

29 *Proposed radical changes to German tax law will affect UK multi nationals with German investments* (date unknown)Ernst & Young <http://www.ey.com\global\content\.nsf\uk\it_-_alerts_-_02_10_dc_-_germany_tax_law_changes> at 11 January 2204.

30 Ibid. See also the discussion in Peter Harris, "Corporate Tax: The Australia System's Curious Peculiarities" (1998) 1 *The Tax Specialist* 178, 179.

31 Peter Harris, "Corporate Tax: The Australia System's Curious Peculiarities" (1998) 1 *The Tax Specialist* 178, 179.

32 Ibid.

33 Ibid.

comes during the period of time once a group has entered the consolidations regime and has commenced operation as a consolidated group.

Obviously the consolidations regime will only affect financing arrangements where the borrowing vehicle is a vehicle to which the consolidations regime would apply. For example, the consolidations regime will not affect financing extended to joint ventures unless the borrowings of the joint venture are in reality a borrowing by each of the joint venture SPVs.

A number of the effects of the consolidation regime in the area of project finance are as a direct consequence of the nature of project finance. Project finance is generally regarded as:

> "a financing of a particular economic unit in which a financier is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of an economic unit as collateral for a loan." [34]

The very basis of project finance requires that a financier is able to analyse the risks with respect to a defined project and that a borrower is largely able to limit the financier's recourse to that defined project. Practically this is often achieved by extending finance to an SPV which only holds assets related to the particular project. "As a consequence, unrelated, non-project risk is segregated from the project financed."[35]

This segregation or quarantining of risk in an SPV is in many ways in conflict with the basic tenets of the consolidation regime. For example, the consolidations regime in effect deems that an SPV is a division or branch of the parent company, regards the assets and liabilities of that SPV as being the assets and liabilities of the parent company and of most concern, may result in the SPV being jointly and severally liable for the income tax liabilities of the entire consolidated group.

The potential for an SPV to become liable for the income tax debt of the consolidated group is "a potentially substantial liability over which neither the borrower nor lender may have any control".[36] Structuring which, in the past, was based on the acquisition of "particular assets in a separate legal entity in the hope that doing so … [might] provide a better tax outcome, or at least a clearer tax outcome than that which would have been obtained if the same assets were held in a single entity…"[37] will also require reassessment as a result of the introduction of the consolidations regime.

There is also the potential for the operation of the consolidation regime to result in an SPV defaulting under existing borrowing covenants. As a result, financiers and borrowers will need to review their current financing arrangements and in particular will need to review covenants that will be affected by a change in the net assets of the SPV, the insolvency of the parent company due to insufficient tax funding arrangements within the group or the creation of a contingent liability for the SPV by virtue of the operation of the joint and several liability provisions.

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34 P Nevitt, *Project Financing* (4th ed, 1983) at 3.

35 Scott L Hoffman, *The Law and Business of International Project Finance* (2nd ed, 2001) at 126.

36 Martin Irwin, Thomas McAuliffe and Blair Day, "Consolidation Rules: Implications for Borrowers and Lenders" (2002) 51 *Weekly Tax Bulletin* 2122, 2122.

37 Grant Cathro, "Tax Sharing Agreements" (Paper presented at Taxation Institution of Australia (Victoria Division) Consolidations Seminar, November 2002) at 1.

JOINT AND SEVERAL LIABILITY OF GROUP MEMBERS

Under the consolidation regime the parent company is primarily liable to meet the group's income tax liabilities.[38] Such liabilities will include "Pay As You Go" instalments, franking deficit tax, general interest charges and administrative penalties related to income tax. If however the parent company defaults in meeting those liabilities, and where the ATO has been unsuccessful or is likely to be unsuccessful in recovering those unpaid group liabilities from the parent company, the ATO may seek recovery from subsidiary members of the group.[39] If that occurs, all of the companies which are members of the group, are prima facie jointly and severally liable to meet the group's entire income tax liability[40] within 14 days of the members being provided with a notice of the liability by the Commissioner of Taxation.

It seems likely that in the event of default by the parent company, the Commissioner will give written notice to the most asset rich or solvent subsidiaries of the group, in order to recover the income tax owed in relation to the entire group. Many SPVs that have been extended project finance on the basis of the value of the assets held by that SPV and on the basis of projected cash flows for that SPV are likely to be attractive to the Commissioner for similar reasons.

The requirement for the joint and several liability provisions seems to stem from the fact that prior to the introduction of the consolidation regime the ATO could take action against each individual subsidiary for that subsidiary's individual income tax debts. Following consolidation, and without joint and several liability, the ATO would only be able to take action against the parent company for payment of the entire group's income tax liabilities.[41]

A member of a consolidated group is only jointly and severally liable for the group's tax liabilities to the extent that those tax liabilities were incurred while that member was a member of the consolidated group and to the extent that the member's liability is not limited under a valid Tax Sharing Agreement (TSA).[42]

TAX SHARING AGREEMENTS

A TSA attempts to cap the liability of a subsidiary to an agreed allocation of the total liability, in the event that the parent company defaults in relation to its income tax obligations. Effectively, the "allocation of a tax liability under a valid TSA overrides the statutory joint and several liability rule".[43] As a result, it is likely that a significant proportion of groups that elect to consolidate will look to enter into a TSA. It is also likely that the "parties who would be most concerned to see the Tax Sharing Agreement in place are those who are external to the group and who may be affected by the presence of joint and several liability".[44]

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38 *Income Tax Assessment Act 1997* section 721-10 and 721-15.

39 Commonwealth of Australia *Consolidation Reference Manual* (28 May 2003) B3-4, B3-4-2.

40 *Income Tax Assessment Act 1997* section 721-15(1).

41 Cathro, "Tax Sharing Agreements", op cit n 37, 1.

42 Commonwealth of Australia *Consolidation Reference Manual* (28 May 2003) B0-2, B0-2-5; *Income Tax Assessment Act 1997* section 721-15(3).

43 Irwin, McAuliffe and Day, op cit n 36, at 2122.

44 Cathro, "Tax Sharing Agreements", op cit n 37, at 7.

In order for a subsidiary to rely on a TSA, the subsidiary must be a party to a TSA that:

(a) is in place before the due date for payment of the relevant income tax liability;

(b) allows an amount to be determined for each TSA contributing member in respect of the group liability;

(c) provides a reasonable allocation of the total amount of the group liability between the parent company and the contributing members;

(d) complies with any requirements set out in the regulations; [45]

(e) has not been entered into as part of an arrangement to prejudice recovery of the relevant liability by the ATO; and

(f) is in the "approved form"[46].[47]

In the author's experience most financiers, particularly in the context of project finance, are now concerned to ensure that a valid TSA is in place where they have extended finance to a subsidiary that is part of or is eligible to be part of a consolidated group. Indeed creditors of any company that is to become party to a TSA should be concerned to examine the terms of the TSA. However, "[i]n practice, any third party dealing with a consolidated group … will not find it easy to be certain that what is produced to it as a TSA will in fact be valid."[48]

Financiers have often sought to minimise tax risk by requiring borrowers to obtain a private binding ruling from the ATO with respect to certain tax arrangements. Unfortunately for both borrowers and financiers, the ATO have indicated that they are not prepared to give private binding rulings with respect to whether or not a TSA is valid.

Inevitably there will be case law regarding what constitutes a valid TSA. However until such cases are brought and decided, borrowers and financiers will need to rely on the scant guidelines issued by the ATO[49] and provided for in the legislation.

In order to be valid, a TSA also needs to be provided to the Commissioner within 14 days of a request by the Commissioner to the parent company.[50] Where "an unpaid group liability is not covered by a [valid] TSA or if the TSA is not provided to the Tax Office when required, contributing members are jointly and severally liable for the liability".[51] Even where the parent company does provide the Commissioner with a copy of the TSA within 14 days of receiving a notice to do so, it will not necessarily mean that the Commissioner will regard the TSA as valid

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45 Currently, there are no relevant regulations in place.

46 The ATO has not provided an approved form for a TSA, despite the reference in *Income Tax Assessment Act 1997* subsection 721-25(3) to the requirement to provide the Commissioner with a copy of the TSA in the "approved form".

47 Commonwealth of Australia *Consolidation Reference Manual* (28 May 2003) B3-4, B3-4- 2; *Income Tax Assessment Act 1997* section 721-25.

48 Grant Cathro, "Consolidation – Contractual Issues Arising for Buyers and Sellers of Companies" (2003) 6 *The Tax Specialist* 1.

49 Refer to Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003).

50 *Income Tax Assessment Act 1997* section 721-15(5).

51 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B3-4, B3-4-2.

and "it will not estop the Commissioner from taking action to recover a liability if the view is subsequently taken that no valid TSA was in place at the time the liability arose".[52]

There is an understandable tension between the interests of the ATO, which will potentially have resort to the assets of all of the subsidiaries of a consolidated group, and the interests of a project financier whose recourse might be limited to the assets of a particular SPV.[53] Although the ATO will rank as an unsecured creditor, behind a project financier who is likely to be a secured creditor, there remain a number of issues of which project financiers and borrowers alike need to be aware.

DETERMINING A REASONABLE ALLOCATION OF THE GROUP LIABILITY

One of the key difficulties in dealing with TSAs is in determining whether the contribution amounts for each of the subsidiary members is a reasonable allocation of the total group liability.[54] Some commentators have suggested that "an inappropriate allocation of a liability to even *one* member can invalidate the TSA in respect of that liability for *all* members of the group".[55] Where a consolidated group has used an SPV to obtain project finance, financiers will also want to be assured that the group's TSA accurately apportions the tax liabilities of the group such that the SPV does not assume more than its fair share of the group's tax liabilities.

The ATO has suggested that a reasonable allocation might be achieved by way of reference to a breakdown of the group accounting profit for the preceding or current income year or might be based on the ability of each member to pay the liability. The concept of a reasonable allocation being based on each member's ability to pay, should be a concern to financiers who are likely to have advanced funds to asset-rich companies which could well be regarded by the ATO or the group as being able to meet the relevant liability. It should also be a concern to financiers and borrowers that the ATO has recognised that "[t]he ultimate determination of what is a 'reasonable allocation' will … rest with the courts'[56] and '[w]hile it may be unlikely that such a challenge will occur where an entity remains within a corporate group, there is certainly a real possibility that challenges may arise where entities have been sold, or where entities have become insolvent and their affairs have been placed into the hands of the banks, an administrator or liquidator".[57]

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52 Anna Maria Carey, "Implications of special leave application in *Linter* decision to consolidated groups and some guidance on tax sharing agreements" (2003) 28 *Weekly Tax Bulletin* 1166, 1166.

53 Outside of the project finance arena, this is even more likely to be the case where a financier has been involved in negative pledge lending or hybrid financing structures that involve financing on a negative pledge basis. Particularly for negative pledge lending (where lending is often not supported by security) financiers will need to be alert to the fact that because they are unsecured they will rank equally with the ATO where joint and several liability has been triggered due to a default by the parent company. It is arguable whether a financier under a negative pledge lending would necessarily rank first in time, particularly where the ATO's claim is in relation to an amended assessment that might pre-date the date on which the negative pledge lending was entered into.

54 *Income Tax Assessment Act 1997* section 721-25(1)(c).

55 Jane Trethewey and Stephen Barkoczy, "Dealing with Tax-Related Liabilities and Tax-Sharing Agreements under the Consolidations Regime" (2003) *Keeping Good Companies* 429, 431. See also paragraph 35.4.21 of *ATO Receivables Policy* (2003) Australian tax Office <http://law.ato.gov.au/atolaw/view.htm?locid=rmp/rp0001> at 11 January 2004.

56 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) C9-7-110, C9-7-110-5.

57 Cathro, "Tax Sharing Agreements", op cit n 37, at 6.

The temptation for a financier involved in the negotiation of a TSA for a group to which the financier has made funds available, might be for the financier to stipulate that the borrower's contribution under the TSA be limited to nothing or to a lower percentage than might otherwise be the case. This approach is problematic. If the attempt to limit a borrower's liability results in the TSA not containing a reasonable allocation for the liability, the TSA may be invalid and as a result the SPV may be jointly and severally liable for the entire group's income tax liability.

Even where the allocation of liability is reasonable at the time the TSA is entered into, financiers and borrowers will need to be alive to the fact that it may be necessary to enter into a new TSA or to amend a TSA if there are changes in the structure of the group due to the entry or exit of subsidiary members, or as a result of changes to an individual subsidiary's operations. It is foreseeable that where an SPV does not yet generate any profit, it might not be required to contribute to any group liability. However where the circumstances of the SPV changed such that at a future point in time the SPV began to make a profit, the TSA would need to be amended to ensure that the allocation under the TSA remained reasonable.[58]

An assessment of whether the TSA represents a reasonable allocation of liability will necessarily depend on an assessment of the composition of the group, the profitability of members of the group and other variables which the financier might not be privy to or might not be in the best position to assess. Such an assessment may also, as a practical matter, be difficult for a project financier to obtain, particularly where "…sponsors do not wish to disclose all of the tax affairs of the group to scrutiny by financiers".[59]

Where the sponsors have been unwilling for a financier to analyse the financial position of the group in order to determine whether an allocation of liability under a TSA is reasonable or in some cases as a result of that further due diligence, a financier may look for credit support or further warranties and indemnities from the parent company. The author is aware of financiers who have demanded further security from the sponsors of a project in order to protect themselves from what they view as unacceptable uncertainty with respect to TSAs and the consolidation regime in general. At least one commentator has noted that a "way to manage the risk for corporate lending may be for lenders to consider insisting on guarantees from, at least, the operational entities of a corporate group (rather than just a holding company), so that they have direct access to the main assets of the group's business".[60] This recourse to the assets of other group members would seem to be the antithesis of a borrower's objectives when entering into project finance or other forms of limited recourse finance.

Irwin, McAuliffe and Day have suggested that "[f]or limited recourse financings, in addition to requiring an appropriate TSA, lenders ought to seek to negotiate appropriate undertakings in events of default to ensure that they have adequate information in order to assess the risks of a liability arising and to protect their position if a liability is crystallised".[61]

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58 Irwin, McAuliffe and Day, op cit n 36, at 2122.

59 Peter Doyle, *Project Finance: Issues for Project Sponsors and Project Contract Counter Parties* (2003) Mallesons Stephen Jacques < http://www.mallesons.com/publications/publications.htm> at 9 October 2003, 28.

60 Irwin, McAuliffe and Day, op cit n 36, at 2122.

61 Ibid.

Financiers should also be concerned to ensure that all members of the consolidated group, not just those members of the group who are liable to contribute in the event of a default by the parent company, have entered into the TSA. "There is a real risk that a failure to ensure that all subsidiaries which have substantial assets, or substantial income, are parties to the Tax Sharing Agreement, may mean that the allocation made by that Agreement is not a reasonable allocation."[62] As a result the relevant SPV could become jointly and severally liable for the entire group's income tax liability.

In addition to requiring that members of a consolidated group enter into a TSA, many financiers have also begun to stipulate that groups to which they have advanced finance, enter into funding agreements. Basically, such funding agreements will dictate the method by which each of the subsidiaries of a parent company will provide the parent company with sufficient funds to enable it to meet the income tax liability for the entire group. Whilst the ATO does not require a group to enter into a funding agreement, it will be prudent for most consolidated groups to do so.

ARRANGEMENTS TO PREJUDICE RECOVERY BY THE ATO

Given the overriding uncertainty as to how TSAs will be interpreted, some commentators have suggested that the only foolproof way to avoid joint and several liability is to "de-group" a borrower from the consolidated group.[63] The apparent rationale behind this is to ensure that those companies are not eligible to be part of the consolidated group and as such to exclude them from any potential liability under the consolidations regime.

Such an arrangement may have adverse implications for the remaining members of the consolidated group. The terms of section 721-25(2) of *Income Tax Assessment Act 1997* suggest that a group liability might not be covered by a TSA if the TSA was entered into as part of an arrangement (such as an arrangement to dispose of a 1% interest in an asset rich member of the group) which was entered into to prejudice the recovery of some or all of a group liability by the ATO. Companies which carry out restructures that might, for whatever reason, result in the disposal of a minimal interest in an asset rich member of a consolidated group or a group which is eligible to consolidate need to be careful that they do not, by doing so, potentially invalidate a TSA that will apply to the rest of the group.

Even if it is possible to de-group an SPV from the consolidated group, a lender will nonetheless be exposed to any amended assessments that are issued with respect to any period for which the SPV was part of a consolidated group. "The consequence of this rule is that a lender may be exposed to a circumstance where it has lent to a borrower on the basis that it had no residual tax liability from its previous consolidated group, only to find that such a liability arises (for instance, because an amended assessment has been issued in respect of the borrower's previous group) after the loan has been made and the loan documents negotiated."[64]

62 Cathro, "Tax Sharing Agreements", op cit n 37, at 11.
63 Irwin, McAuliffe and Day, op cit n 36, at 2122.
64 Ibid.

EXERCISING SECURITY OVER A MEMBER OF A CONSOLIDATED GROUP

The fact that the joint and several liability of a subsidiary of a consolidated group continues to exist (in respect of tax liabilities for income years in which the subsidiary was a member) even though that subsidiary might no longer be a member of the group,[65] raises some new challenges for financiers wishing to exercise their security over the shares of such companies. Even financiers who have exercised their security over shares in an SPV prior to 1 July 2004 should be aware of the potential application of the consolidations regime where the group to which that SPV was a part, later elects to become consolidated.

In order for a subsidiary to cleanly exit from a consolidated group, that subsidiary must cease to be a member of the consolidated group prior to the relevant due date for payment and must have paid to the head company a suitable contribution towards the group liability or an amount which is equal to a reasonable estimate of the subsidiary's liability.[66] A clean exit will not possible where the liability has already fallen due or where an amended assessment has been received, relating to a period during which the subsidiary was a member of the consolidated group.[67]

Similarly, a subsidiary will not be able to achieve "a clean exit if there is no TSA, if the TSA is not valid … or if the Target was not a party to the TSA".[68] Where a financier takes security over the shares of an SPV, the financier should be concerned to ensure that there is a valid TSA such that if the financier were to exercise that security, the SPV could achieve a clean exit from the consolidated group. Although the "scope of the … [SPV's] liability to contribute after … [exit] can be circumscribed, … [it] must be circumscribed in an appropriate manner, if the purchaser [, financier or liquidator] is to avoid the risk of disagreement with the ATO".[69] If an SPV is unable to be cleanly exited from a consolidated group it will be of limited value when it comes to selling the SPV to a third party to recoup some of the financier's loss.

One area of concern where an SPV is to exit a consolidated group, is the fact that an otherwise valid TSA might be regarded as invalid where the parent company fails to provide the TSA to the Commissioner within the required timeframe. A subsidiary which has exited the consolidated group as part of the clear exit provisions in section 721-35 *Income Tax Assessment Act 1997* will be able to "provide the ATO with a TSA in order to demonstrate to the Commissioner that they have satisfied the requirements of the 'clear exit' provisions".[70] Interestingly, the Treasury has indicated that such a provision will only benefit the exiting member and will not alter the liability

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65 This is largely due to section 204 of the *Income Tax Assessment Act 1997,* which provides that liability for taxes that are the subject of an amended assessment is regarded as having arisen when the original assessment was due and payable.

66 *Income Tax Assessment Act 1997* section 721-35.

67 Cathro, "Consolidation – Contractual Issues Arising for Buyers and Sellers of Companies", op cit n 48, at 10.

68 Ibid.

69 Cathro, "Consolidation – Contractual Issues Arising for Buyers and Sellers of Companies", op cit n 48, at 19.

70 Commonwealth of Australia, Treasury Papers, "Collection and Recovery Rules", released 4 December 2003, 3.

of the continuing members of the consolidated group, which will "continue to be jointly and severally liable for the group's income tax liabilities".[71]

Even where there is a valid TSA, the fact that a subsidiary member has met its income tax funding obligations to the parent company or has paid the amount that would be payable under the TSA, "will not reduce the subsidiary member's liability *to the ATO* [emphasis added] under the TSA.[72] In other words, a subsidiary member may have to pay a second time, if the head company defaults".[73] As a result, there is the potential for the SPV to retain a contingent liability to the ATO long after a financier has initially exercised its security to take control of the SPV.

Under the New Zealand consolidation regime, there is the ability to apply to the Commissioner for a determination that only certain companies in the group will be jointly and severally liable for the income tax liability of the group for a particular year. In order to receive a predetermination, the applicant must show the Commissioner that granting the application will not significantly prejudice the ability for the Commissioner to recover the full income tax liability.[74] Such a determination allows the member to make a clean exit from the group and ensures that a purchaser or a financier exercising security over that member can feel comfortable that the relevant member will not be jointly and severally liable for the income tax liability of the group. The ability to apply for a predetermination and the resulting certainty from obtaining such a predetermination is an element sadly lacking in the Australian consolidation regime.

A financier would also be prudent to "seek some assurance that the head company … has paid all group liabilities which fell due for payment in the past".[75] It may be possible for an indemnity to be introduced into existing financing arrangements such that the parent company or other group companies indemnify the financier with respect to group liabilities that fell due for payment prior to the financier exercising its security over the shares of an SPV. Financiers will also need to consider whether security should be taken over the parent company or another asset or subsidiary of the group to secure that indemnity.

Obviously SPVs and their sponsors will not welcome any such erosion of limited recourse. Financiers however are likely to regard such security as vital in order to ensure the indemnity is met, and to ensure the financier ranks ahead of the ATO in the event that the group becomes insolvent subsequent to the financier exercising its security over the SPV.

A financier would also need to analyse the potential exposure of an SPV over which it will exercise security, to amended assessments issued in the future for a period in which the SPV was part of the consolidated group. Practically, this will require that the financier have access to the tax records of the group, which is likely to be an unwelcome imposition on most borrowers. As a

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71 Commonwealth of Australia, Treasury Papers, "Collection and Recovery Rules", released 4 December 2003, 4.

72 Commonwealth of Australia, *Consolidation Reference Manual* (28 May 2003) B3-4, B3-4-2.

73 *Corporate Governance Alert, July 2003* (2003) Mallesons Stephen Jacques < http://www.mallesons.com/publications/publications.htm> at 10 October 2003.

74 Andrew Sinclair, "Entity Taxation and Consolidation" (Paper presented at the Blue Series Seminar, New South Wales Division of the Taxation Institute of Australia, 27 April 2000).

75 Cathro, "Consolidation – Contractual Issues Arising for Buyers and Sellers of Companies", op cit n 48, at 10.

result, it would be prudent for financiers to consider altering existing finance documents to include warranties or obligations for the parent company to provide the financier with ongoing access to the tax records of the SPV and where necessary, the income tax records of the entire group. This would enable a financier that has exercised its security over an SPV to, where necessary, "complete consolidated tax returns, negotiate with the ATO and deal with any objection and appeal procedure".[76]

In the past project financiers have sought to take security over the shares in an SPV by way of a mortgage debenture. This has given "the project financier the option, when security is enforced, of either selling the project assets or selling the ownership interests in the project vehicle. This [has been] … relevant where, for example, the project vehicle has accrued tax losses".[77] Financiers will now need to be mindful of that fact that if a subsidiary which is part of a consolidated group leaves the group, the losses and franking credits in relation to that subsidiary remain with the group.[78] Irwin, McAuliffe and Day have suggested that lenders might deal with this by insisting "that either a borrower be paid cash for the value of any tax losses it generates or, where the sponsor has a high credit rating, an undertaking be given by the sponsor to contribute to the borrower's funds equal to the value of the utilised tax losses if the project fails".[79]

The general uncertainty for financiers wishing to exercise security over the shares of an SPV that is part of a consolidated group may mean that financiers will look to exercising their security over the assets of the SPV rather than exercising their security over the shares in the SPV, despite the greatly increased stamp duty liability.

THE IMPACT OF THE REGIME ON EXISTING BORROWING COVENANTS AND EVENTS OF DEFAULT

The introduction of the consolidation regime necessitates a review of existing borrowing covenants, financial ratios and events of default to determine whether those provisions remain appropriate in the context of an SPV that operates within a consolidated group. Financiers will also need to ensure that existing protections in financing documents will be sufficient to deal with the new tax risks inherent in the consolidations regime.

Project finance is essentially "based on the ability of the project to generate sufficient cashflows to repay … debt".[80] As a consequence, any event that may impact on the cash flows of a project will be relevant in determining whether a project is viable. In the event that a TSA is found to be invalid, the cash flows of the project may be adversely affected when the SPV becomes jointly and severally liable for the income tax debts of the consolidated group. In that scenario, it is also highly likely that the financial ratios that are an integral part of project financing, will be affected. In particular the project life cover ratio and the loan life cover ratio, which are based on projected cash flows might well be affected. Importantly, any change in financial ratios is likely to have the potential to trigger pre-payment events or events of default under financing documentation.

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76 Cathro, "Consolidation – Contractual Issues Arising for Buyers and Sellers of Companies", op cit n 48, at 19.

77 Doyle, op cit n 59, at 28.

78 Frank Betkowski, "Accounting for the Tax Consolidation System" (2003) 7 *Tax Specialist* 39, 40.

79 Irwin, McAuliffe and Day, op cit n 36, at 2122.

80 Hoffman, op cit n 35, at 154.

The implementation of the consolidations regime will also alter the way in which assets and liabilities are recognised in the accounts of members of a consolidated group. Lenders will need to be aware and cautious of the fact that the net asset position of an SPV may change as a result of the implementation of the consolidation regime. Similarly, the composition of an SPV's statement of financial position in terms of the division of value between tangible and intangible assets may also change as a result of the regime. Profits, before and after tax, may also be impacted by the consolidation regime.[81] Here again, consolidation is likely to affect financial ratios on which borrowing covenants are likely to be based [82] and may potentially trigger adverse consequences under borrowing covenants and events of default under loan and security documentation. Financiers and borrowers will also need to be aware of clauses in some finance documentation that can require that the borrower prepare amended models and assumptions where there is a change in taxation law.[83]

Financiers and borrowers also need to consider whether there will be a breach of any undertakings in existing documentation in relation to the transfer of tax losses. In many financing arrangements there are prohibitions on SPVs transferring tax losses other than as directed by the financier. Under the consolidations regime there will be a statutory 'transfer' of tax losses from a subsidiary to the parent company when that parent company elects to consolidate. Here again, this may trigger default under the relevant provisions.

Negative covenants regarding maximum aggregate debt levels for SPVs will also need to be monitored in light of the contingent liability that may exist if a TSA is found to be invalid. "If a subsidiary member … becomes jointly and severally liable for group liabilities as a result of failure by the head company to meet its obligations by the due date, it (the subsidiary member) can find itself inadvertently in breach of such banking contracts."[84] Such potential defaults will provide further impetus for SPVs to ensure that there is a valid TSA in place to limit the potential for the SPV to be jointly and severally liable for the entire group's income tax liability.

SPVs will also be concerned to ensure there is a valid TSA in place to limit the potential that the subsidiary might, as a result of being jointly and severally liable for the entire group's income tax liability, become insolvent. Here again such events are likely to result in the SPV breaching covenants within their existing financing arrangements and is also likely to open up the directors of the company to liability under the *Corporations Act 2001* in relation to trading whilst insolvent (among other things).

There is the possibility that under consolidation a parent company could have a group tax liability that was in excess of the parent company's assets. Directors of parent companies will need to be aware of this issue and should consider whether allowing the parent company to have a group tax liability in excess of its assets might conflict with their obligations to the company. In addition, the author is aware of at least one set of financing documents which includes as an event of default, breaches by the directors of the SPV or the parent company of their duties under the

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[81] Betkowski, op cit n 78, at 53.

[82] *Corporate Governance Alert, July 2003*, op cit n 73, page 3 of 6.

[83] Irwin, McAuliffe and Day, op cit n 36, at 2122.

[84] Marina Raulings and Andrew Cameron, "Tax Sharing Agreements – Be Alert and Alarmed" (2003) 38 *Taxation in Australia* 319, 320.

Corporations Act 2001. Where that particular event of default is contained in existing financing documents, directors would need to ensure that before the parent company elects to consolidate, it first enters into funding arrangements with the intended members of the group.[85]

Any actual failure by the SPV's head company to meet its income tax liabilities may also trigger either an event of default or a pre-payment event for the SPV. The author is aware of a number of events of default in the existing financing arrangements in the mining industry which may well be triggered by a failure by the parent company, as the sponsor, to meet its income tax liabilities under the consolidations regime.

Financiers and borrowers will also need to be aware that the election by a parent company to consolidate might also potentially trigger a material adverse event clause under existing financing documentation. Such clauses are often subjective and are expressed to be "in the financier's opinion". Borrowers will need to feel comfortable that financiers will not regard the group's election to consolidate as such an event.

Material adverse event clauses might also be triggered where an SPV fails to notify a financier that the SPV intends to enter into a TSA and such action is regarded by a financier as prejudicing their existing rights under existing financing documentation. Even if the financier was aware of the intention to enter into a TSA, the author is aware of at least one instance where a financier refused to be involved in the process of negotiating a TSA because the financier failed to recognise the effect that an invalid TSA might have on the SPV.

The author is also aware of other instances where financiers have requested amendments to finance documentation to stipulate that financiers must be provided with a copy of any notice received by the parent company with respect to a TSA within one day of the notice being received by the head company. The author is aware of a number of financiers who are negotiating with borrowers to amend finance documentation so that the failure by the parent company to comply with a notice from the Commissioner to produce the TSA, will be a accelerated payment event under the financing documents for the SPV. Requests for such amendments to existing finance documentation indicate how seriously financiers are approaching the potential additional risks that have been introduced as a result of the consolidations regime.

CONCLUSION

There are clearly new risks to a financier and to an SPV as a result of the introduction of joint and several liability for the members of a consolidated group where a parent company defaults in meeting its income tax obligations. It remains to be seen whether attempts to circumscribe that potential liability by entering into TSAs will be effective. Even where a TSA is in place there is likely to be some additional risk that a financier may not be in the best position to assess or manage. Financiers are likely to require that the borrower or the sponsors shoulder any additional tax risk that results.

Similar issues and uncertainty will arise where the financier wishes to exercise their security over an SPV that is part of a consolidated group. Once again, additional protections for financiers are likely to find their way into financing documentation to help deal with that uncertainty. There may

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[85] See discussion in *Corporate Governance Alert, July* 2003, op cit n 73, page 3 of 6.

also be a move away from financiers exercising security over the shares of an SPV and a move towards exercising security over the assets of an SPV to minimise the effect of the consolidation regime.

Financiers and borrowers will need to undertake a detailed review, and in many cases will need to negotiate amendments to existing financial agreements to ensure that the consolidations regime will not cause unintentional breaches of financial covenants. Financiers are also likely to seek additional protections and clarity with respect to the impact of the consolidations regime on SPVs from borrowers.

It is clear that the introduction of the consolidation regime introduces an additional element of complexity and uncertainty into the project finance industry. In those circumstances it seems inevitable that financiers will be keen to distance themselves from any additional tax risk and will seek to obtain greater comfort and security from borrowers and the consolidated groups of which those borrowers are a part. For borrowers who have entered project finance arrangements in the hope of limiting recourse to the relevant SPV, this is likely to be an unwelcome development.