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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

FINANCIAL SECTOR LEGISLATION AMENDMENT (RESTRUCTURES) BILL 2007

EXPLANATORY MEMORANDUM

(Circulated by the authority of the Treasurer,
the Hon Peter Costello, MP)

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Glossary

1.1 The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	**Definition**
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulatory Authority
ASIC	Australian Securities and Investments Commission
Bill	Financial Sector Legislation Amendment (Restructures) Bill 2007
Corporations Act	*Corporations Act 2001*
Court	Means a court with jurisdiction in respect of Chapter 5 of the *Corporations Act 2001*, namely the Federal Court or a Supreme Court of a State or Territory
FSTBA	*Financial Sector (Transfers of Business) Act 1999*
NOHC	Non-operating holding company
NOHC structure	A non-operating holding company is the ultimate holding entity of the group in Australia
Operating body	An ADI, general insurer or life insurance company
Wallis Review	*Financial System Inquiry*, March 1997

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Outline

2.1 The Financial Sector Legislation Amendment (Restructures) Bill 2007 (the Bill) seeks to facilitate the adoption of a non-operating holding company (NOHC) as the ultimate holding company of a financial group in Australia (NOHC structure). It will provide financial groups with greater flexibility in choosing a corporate structure to manage their risk exposures and comply with prudential requirements, without unnecessarily constraining their business efficiency and competitiveness.

2.2 In March 1997, the *Financial System Inquiry* (Wallis Review) recommended that subject to a financial group meeting prudential requirements, the prudential regulator should permit the adoption of a NOHC structure. The Review concluded that to protect against creditors of one entity seeking to pursue the other entities of a group, legal separation structured around a NOHC is the best method of quarantining the assets and liabilities of the various entities in the group. Such a structure also relieves other entities of a group of any formal obligation to support a distressed affiliate.

2.3 A NOHC structure can offer a financial group greater operational flexibility while, at the same time, provide for more efficient and effective means of meeting prudential requirements by allowing the appropriate allocation of risk between prudentially and non-prudentially regulated businesses of a group. This can be achieved by organising different types of activities into separate business lines. This type of structure can assist efforts aimed at quarantining risks in the various parts of a financial group by, for example, separating the risks of a group's entrepreneurial private investment activities from its insurance and banking operations.

2.4 In September 1997, the Australian Government announced its response to the Wallis Review. As part of the response, the Australian Government agreed to facilitate the establishment of non-operating holding companies to encourage new entry and greater competition in the financial sector. The Government's decision to facilitate the establishment of non-operating holding companies was subject to prudential requirements being met.

2.5 To implement the Government's decision, the *Banking Act 1959* was amended and provisions were included in the *Financial Sector (Shareholdings) Act 1998* to allow financial groups containing authorised deposit-taking institutions (ADIs) to be established with a NOHC as the parent entity.

2.6 To date, no major Australian financial group containing an ADI has chosen to adopt a NOHC structure. This has been the result of a number of other regulatory and tax provisions that have impeded Australian financial groups from moving to a NOHC structure.

2.7 Consistent with the Government's decision to facilitate the establishment of NOHCs, this Bill will remove the regulatory impediments to the adoption of a NOHC structure. The impediments identified arise under particular requirements of the *Corporations Act 2001* (Corporations Act) and income tax law.

2.8 The Bill will provide the Minister with the power to grant relief from these specific requirements of the Corporations Act. To grant relief, the Minister will issue a restructure instrument that specifies the statutory provisions and the entities of a company group (and any persons involved in complying with a requirement) for which the relief applies.

2.9 The relief provided by the Minister will only relate to the specific provisions of the Corporations Act as set out in the restructure instrument. It will not relieve an entity from having to meet its other obligations under the Corporations Act, associated regulations and other relevant legislation.

2.10 The Bill will also provide the Minister with the power to approve the issue of associated internal transfer certificates by the Australian Prudential Regulatory Authority (APRA). An internal transfer certificate will provide for the transfer of assets and liabilities between two entities of the company group being restructured and, thereby, facilitate the rearrangement of different types of activities into separate business lines. This will allow a group containing ADIs to separate its banking and non-banking businesses.

Taxation aspects

2.11 Schedule 2 to this Bill amends the consolidation membership rules and the capital gains tax provisions in the *Income Tax Assessment Act 1997* to remove tax impediments that prevent financial groups containing ADIs from restructuring.

Date of effect: The measure applies from 1 July 2007.

Proposal announced: The measure was announced on 8 May 2007 in the 2007-08 Budget.

Financial Impact

2.12 Minimal.

Compliance Cost Impact

2.13 Negligible.

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Introduction

Clause 1: Short title

3.1 This Act may be cited as the *Financial Sector Legislation Amendment (Restructures) Act 2007*.

Clause 2: Commencement

3.2 This Act commences on the day on which it receives the Royal Assent.

Clause 3: Schedules

3.3 Schedule 1 and 3 (excluding consequential amendments to the *Income Tax Assessment Act 1997* in Schedule 3) will commence on the day on which this Act receives the Royal Assent. Schedule 2 and consequential amendments to the *Income Tax Assessment Act 1997* in Schedule 3 will commence on 1 July 2007.

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Schedule 1 — Restructure relief: corporations law aspects

4.1 Schedule 1 to this Bill extends the coverage of the *Financial Sector (Transfers of Business) Act 1999* (FSTBA) to the restructure of financial groups involving the creation of a NOHC as the ultimate holding company of the group in Australia. It will be applicable to the restructure of a financial group that has an ADI, general insurer or life insurance company as the ultimate holding company of the group in Australia, and where that ultimate holding company will be replaced by a NOHC. This Bill will facilitate the adoption of a NOHC structure by providing the Minister with the power to grant financial entities relief from specific statutory requirements under the Corporations Act that currently impede such restructures. Any relief granted will be specified in a restructure instrument.

The Minister will also be provided with the power to approve the issue of associated internal transfer certificates, which provide for the transfer of specified assets and liabilities between two related bodies of a financial group, by the Australian Prudential Regulatory Authority (APRA).

The arrangement will allow APRA to work through the details of the rearrangement with the financial group so as to assist APRA to efficiently satisfy prudential requirements. This will provide financial groups with an efficient mechanism to separate their activities into separate business lines. The appropriate allocation of risk between prudentially and non-prudentially regulated businesses can assist a financial group in more efficiently and effectively meeting its prudential requirements.

Financial Sector (Transfers of Business) Act 1999

Definitions

4.2 Items 1 to 14 provide additional and amended definitions required for the extended scope of the FSTBA.

Key Changes

4.3 Items 8 and 14 extend the existing scope of coverage of 'receiving and transferring body' to include a body corporate receiving or transferring assets or liabilities under an internal transfer certificate.

4.4 Item 9 defines the group of companies that would be considered to form the financial group and, thus, be eligible for an internal transfer certificate as part of a restructure incorporating a NOHC structure. A subsidiary has the same meaning as defined in the Corporations Act.

Part 4A — Restructures

Division 1 — Outline of Part

4.5 Section 36A provides a brief outline of the effect of the Part.

Division 2 — Restructure Approvals

4.6 A written application can be made to the Minister by a financial group headed by an ADI, general insurer or life insurance company that intends to enter into a scheme of arrangement under section 411 of the Corporations Act, to restructure the group to incorporate a NOHC as the ultimate holding company of the group in Australia.

4.7 Such an arrangement would transfer existing ordinary shareholders in the operating body to become ordinary shareholders in the NOHC. This would occur through a cancellation or transfer of shares in the operating body and an issue of identical shares by the NOHC. However, this does not limit the scope of the arrangement to provide for the other matters such as the transfer of assets and liabilities.

4.8 A scheme of arrangement will ensure shareholders of the operating body heading a financial group are given the right to vote on any proposal to adopt a NOHC structure.

4.9 An application can be made for the approval of a restructure instrument and the issue of associated internal transfer certificates. It is also possible to make an application for a restructure instrument alone.

4.10 In conjunction with the approval of a restructure instrument, the Minister can provide approval for the issue of any internal transfer certificate by APRA. The content and detail of these certificates will be determined by APRA in conjunction with the operating body.

4.11 The application must be in the specified form and be accompanied by the required information. The form of the application and the information required is prescribed in the transfer rules issued by APRA under section 46(1) of the FSTBA. Transfer rules are disallowed instruments.

4.12 The NOHC must be authorised by APRA in order to be the ultimate holding company for a financial group containing an ADI or general insurer in Australia.

4.13 The Minister will approve an application if he is satisfied that the restructure would improve the operating body's ability to meet its prudential requirements as administered by APRA. This provision does not infer that an operating body be in breach or in non-compliance with prudential requirements, to seek approval for a restructure. However, it must be demonstrated to the Minister that, as a result of the restructure, the operating body would be in a better position to meet relevant prudential requirements. In examining the application, the Minister will also consider the interests of depositors/policy owners of the operating body, the interests of the financial sector, and any other matters appropriate in making a decision.

4.14 In the event that the Minister does not approve an application, the Minister will provide relevant parties with a written statement setting out the reasons for the refusal. The Minister may refuse an application on the grounds that he is not satisfied that the matters in section 36C are met. For example, approval would not be granted where the Minister believed that the restructure would adversely affect the operating body's ability to meet its prudential requirements.

4.15 Subsection 36 defines the prudential requirements that an operating body is required to adhere to. This includes the relevant prudential standards, rules and guidance notes issued by APRA.

4.16 The Minister can impose conditions on a restructure approval under sections 36E(1)(a) and 36E(1)(b) to ensure that the restructure satisfies the matters outlined in section 36C.

4.17 Under section 36E(1)(a), the Minister can impose conditions on the operating body, the NOHC, or any body that will be related to the NOHC after the restructure, which must be satisfied prior to the restructure instrument coming into force. Conditions that could be imposed include, but are not limited to, obtaining approval for a scheme of arrangement by the Court, obtaining regulatory approvals under the *Financial Sector (Shareholdings) Act 1998* and the *Foreign Acquisitions and Takeovers Act 1975* and all necessary foreign regulatory approvals. A Court will only approve a scheme of arrangement at such a time as all of the other conditions imposed under the restructure approval have been satisfied.

4.18 Under section 36E(1)(b), the Minister can impose conditions on the operating body, the NOHC, or any body that will be related to the NOHC after the restructure, which must be satisfied prior to the entry into force of the internal transfer certificate. Conditions that could be imposed include, but are not limited to, obtaining approval for a scheme of arrangement by the Court, obtaining regulatory approvals under the *Financial Sector (Shareholdings) Act 1998* and the *Foreign Acquisitions and Takeovers Act 1975*, all necessary foreign regulatory approvals, and any matters the Minister considers appropriate to ensure any transfer of assets and liabilities would not comprise a prudentially regulated entity's ability to meet its prudential requirements. As part of its regulatory supervision of the operating body, and the group more generally, APRA has responsibility for determining whether an entity has satisfied the conditions imposed.

4.19 Subsections 36E(2),(3)&(4) provide for the submission of an application to the Minister requesting an amendment to, or revocation of, the conditions imposed on the restructure approval. The Minister will consider the request on the basis of the matters outlined in section 36C.

Notes on specific sections

4.20 Conditions imposed under section 36E must be satisfied prior to a Court order being issued under section 411(4) of the Corporations Act to approve a scheme of arrangement. A Court will not approve a scheme of arrangement where conditions set out in the restructure approval are outstanding. Entry into force of the internal transfer certificate will also be subject to the relevant conditions imposed being met.

Division 3 — Restructure Instruments

4.21 A restructure instrument may provide relief to the NOHC established as the ultimate holding company of the group in Australia, any body corporate related to that NOHC and any persons involved in complying with a

requirement, from section 254T, and sections in Division 1 of Part 2J.1 and Part 2J.2 of the Corporations Act.

4.22 The statutory measures described in 4.21 have been identified as impeding the adoption of a NOHC structure by a financial group by constraining the capacity of a NOHC to distribute dividends to shareholders following a restructure. This is not consistent with the adoption of a NOHC structure, which is an internal company restructure that is not aimed at changing the entitlements of its shareholders.

4.23 Section 254T of the Corporations Act requires that dividends be only paid out of profits. Without relief from section 254T, the pre-restructure profits paid from an operating body, and other related bodies, to a NOHC, following a restructure adopting a NOHC structure, would not be classed as profits under the Corporations Act. The implication of this is that the pre-restructure profits of the group would no longer be available as profits for distribution to shareholders as dividends. This provision materially affects shareholders by altering their rights to access profits of the group for which they have claim. This is a significant regulatory barrier to financial groups restructuring to adopt a NOHC structure.

4.24 Relief from section 254T of the Corporations Act would only apply to the payment of pre-restructure profits of an operating body, and other related bodies, to a NOHC. All profits earned by the operating body, and other related bodies, and paid to the NOHC subsequent to the restructure would be considered as profits and, therefore, available for distribution to shareholders.

4.25 Relief from section 254T of the Corporations Act will provide the NOHC with the ability to distribute the same amount of dividends as that available prior to the restructure. The relief will enable a NOHC to distribute those pre-restructure profits even though they may be classified as share capital or equity in the NOHC.

4.26 The amounts available for distribution must be sourced, directly or indirectly, to the pre-restructure profits of the operating body, and bodies related to the operating body, at the date of the restructure. These amounts should be separately disclosed on the financial statements of the NOHC in order to differentiate them from profits generated by the NOHC after the restructure.

4.27 As a consequence of granting relief from section 254T of the Corporations Act, relief from Division 1 of Part 2J.1 and Part 2J.2 of the Corporations Act will also be necessary to ensure that the distributions maintain the same entitlements as ordinary dividends.

4.28 The restructure instrument will provide the legal basis for the payment of dividends, up to the value of the pre-restructure profits of the operating body

and bodies related to the operating body at the date of the restructure, out of the NOHC's share capital.

4.29 For the purposes of section 256B of the Corporations Act and granting relief to the above mentioned provisions, the Minister will give consideration to whether allowing the distribution of pre-restructure profits from the NOHC's share capital materially prejudices the company's ability to pay its creditors and is fair and reasonable in relation to the company's shareholders as a whole.

4.30 Relief may also be granted from section 256D of the Corporations Act to ensure that any persons involved in the distribution of pre-restructure profits out of the NOHC's share capital is not considered to have committed an offence.

4.31 In the process of adopting of a NOHC structure, the operating body may hold shares in the ultimate holding company prior to the completion of the restructure and, as a result, breach section 259C of the Corporations Act. ASIC currently has power under section 259C(2) to exempt a company from the operation of section 259C. To facilitate the restructure in a timely fashion and streamline the approval process, the Minister will be provided with the power to exempt a company, that is part of a NOHC restructure, from section 259C. In such situations, a separate approval from ASIC will not be required.

4.32 In conjunction with the relief granted in relation to the Corporations Act, the income tax law will be amended to facilitate the distribution of pre-restructure profits from the NOHC's share capital and facilitate the adoption of the NOHC structure. These amendments are discussed in Schedule 2.

4.33 The relief provided through the restructure instrument is specific and considered transitional and consequential in nature to facilitate the restructure. It will not relieve the NOHC, operating body or bodies related to the NOHC from having to meet all their other obligations under the Corporations Act and other relevant legislation. The allowable relief is specific to section 254T, Division 1 of Part 2J.1 and Part 2J.2 of the Corporations Act and its duration is transitional. Although the payment of dividends from the pre-restructure profits of the operating body may not occur until an undetermined time in the future, the relief relates back to the restructure event. Only the payment of dividends out of the pre-restructure profits of the operating body will be given this exceptional treatment. The NOHC, operating body or bodies related to the NOHC are otherwise subject to the normal application of section 254T of the Corporations Act for the payment of dividends out of profits.

4.34 The restructure instrument provides the legal basis for granting relief to the NOHC, any body related to the NOHC, and any persons provided for, from the requirements of the specific provisions of the Corporations Act.

4.35 A restructure instrument's entry into force will be subject to the conditions imposed under section 36E(1)(a) having been met and the issuance of a Court order approving the scheme of arrangement under section 411(4) of the Corporations Act.

4.36 A restructure instrument may be amended by the Minister where particular aspects of the relief provided is either no longer required or considered appropriate. This provision is intended to address the implications of any future amendments to the Corporations Act that affect the relief provided under the instrument.

Notes on specific sections

4.37 Subsection 36G(3) provides definitional certainty that a restructure instrument is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. A restructure instrument is not a legislative instrument because it only applies in relation to a specific case. Restructure instruments will be provided a case-by-case basis and will be tailored to the specifics circumstances of the restructure.

Division 4 — Internal Transfer Certificates

4.38 Division 4 provides an alternative mechanism to financial groups wishing to restructure. It does not prevent a group from choosing to use other available restructure mechanisms in other legislation such as Part 5.1 of the Corporations Act.

4.39 As part of a restructure approval, the Minister may authorise APRA to issue an internal transfer certificate. An internal transfer certificate provides for the transfer of specified assets and/or liabilities or groups of assets and/or liabilities between any two related bodies of the group involved in the NOHC restructure. This could include a transfer between the operating body and the NOHC, the operating body and a subsidiary of a NOHC, or between two subsidiaries of a NOHC. These certificates can also provide for the transfer of, among other things, classes of financial securities and wholly-owned subsidiary entities.

4.40 In issuing an internal transfer certificate APRA will consider the application for restructure approval, any additional information provided by the operating body, the matters in section 36C(1)(b)&(c) and the restructure arrangement approved by the Minister. APRA has the flexibility to settle the detail of the transfer arrangements with the applicant consistent with the restructure approved by the Minister.

4.41 In determining a transfer certificate's entry into force and the specific timing of any transfer, APRA must take into account the wishes of the transferring and receiving body as practical and operational issues may constrain the timing of the transfer.

4.42 The internal transfer certificate must include the names of the entities involved in the transfer, the entities which will be the transferring and receiving bodies, an agreed list of all the assets and liabilities to be transferred and state a time or method when an internal transfer certificate will come into force.

4.43 In conjunction with an internal transfer certificate being issued, APRA must provide a written notice to the transferring and receiving body, the operating body (where it is not the transferring or receiving body) and the Minister. The notice must include a copy of the internal transfer certificate/s. In the event that APRA refuses to issue an internal transfer certificate, or issues a certificate different from that which was applied for, APRA must provide written notice to the transferring and receiving body, the operating body (where it is not the transferring or receiving body) and the Minister with an explanation of the decision or why the certificate has not been issued.

4.44 An operating body may apply to APRA to seek amendment to an internal transfer certificate provided the certificate has not entered into force. An application may be lodged in circumstances where the transferring and receiving body wish to modify the assets and liabilities to be transferred or the body transferring or receiving the assets and liabilities has changed. The application must be submitted in the form prescribed by the transfer rules.

4.45 APRA may amend an internal transfer certificate having regard to the matters outlined in subsections 36C(1)(b)&(c). If APRA amends a certificate, it must provide written notice to the transferring and receiving body, the operating body (unless it is the transferring or receiving body) and the Minister. If APRA amends a certificate, it must provide written notice to the transferring and receiving body, the operating body (unless it is the transferring and receiving body) and the Minister including a statement providing reasons for not amending the certificate.

4.46 An internal transfer certificate can enter into force in one of three ways: at the time the restructure instrument enters into force (restructure time); at the date specified in the certificate, which must be within twelve months of the restructure time; or at a time approved under section 36Q.

4.47 An internal transfer certificate can specify multiple transfer times to provide for the transfer of specific assets and liabilities at different times. On a practical and operational level, it would be very unlikely that the transfer of all assets and liabilities could be completed at one time.

4.48 An internal transfer certificate can specify the exact time of day that a transfer is to occur. For example midnight or market closing time in a particular location.

4.49 Any transfers provided for in an internal transfer certificate must be completed within twelve months of the entry into force of the restructure instrument.

4.50 The transferring and receiving bodies may submit an application to APRA seeking approval for a different transfer time to that specified in the transfer certificate. On the basis that APRA considers the revised timing appropriate, it can approve such applications.

4.51 The entry into force of an internal transfer certificate is subject to all conditions imposed by the Minister under subsection 36E(1)(c) having been satisfied. The Minister may impose conditions to ensure that the matters outlined in subsection 36C(1) are met. The conditions are discussed in more detail above.

4.52 At the time an internal transfer certificate takes effect, the assets and liabilities being transferred from the transferring body, become the assets and liabilities of the receiving body. Any duties or obligations relating to the assets and liabilities being transferred become the duties or obligations of the receiving body following any transfer. That is the transfer affects a statutory novation and not an assignment of rights.

Notes on specific sections

4.53 Section 36R provides for the receiving body becoming the successor in law to the transferring body for the specific assets or liabilities transferred under an internal transfer certificate. The receiving body is taken to be responsible for rights and obligations of the transferred assets and/or liabilities.

Division 5 — Engagements of employees and contractors

4.54 Division 5 provides for the continuity of term and conditions of employment for each person who was, immediately before the restructure, performing duties in the group. The objective is to leave the employer and employee in the same position, and with the same entitlements, following the restructure. The restructure cannot be used by either party to change employment conditions or to trigger redundancies.

4.55 To the extent that an internal transfer certificate results in the receiving body becoming the successor in law to the transferring body, the receiving body is responsible for the relevant employment contracts and contracts for service.

That is, if the activities of an employee are moved as a result of an internal transfer certificate, the employee can be moved with activities that relate to the assets and liabilities being transferred.

Key changes

4.56 Section 36S covers contracts for service unlike section 30 and 36 of the FSTBA.

Notes on specific sections

4.57 Subsection 36S(4) provides that employers and employees are not prevented from renegotiating the terms and conditions of employment in the event that both parties agree to do so.

Review of Decisions

4.58 Item 15 makes decisions made by APRA under section 36M, section 36P and section 36Q(3) reviewable by the Administrative Appeals Tribunal.

5

Schedule 2 — Restructure relief: taxation aspects

5.1 Schedule 2 to this Bill amends the consolidation membership rules, the imputation provisions and the capital gains tax (CGT) provisions in the *Income Tax Assessment Act 1997* (ITAA 1997) to remove tax impediments that prevent financial groups containing authorised deposit-taking institutions (ADIs) from restructuring for prudential reasons.

Context of amendments

5.2 The tax consolidation rules treat wholly-owned groups as a single entity for tax purposes. A consolidated group consists of a head company and all of its wholly-owned subsidiaries. An entity is a 'wholly-owned subsidiary' of the head company for the purposes of Part 3-90 of the ITAA 1997 if the head company beneficially owns, directly or indirectly, all the 'membership interests' in the subsidiary. In the case of a company, membership interests are any interests held by a member or stockholder of the company.

5.3 Currently, if a consolidated group contains an ADI, the head company tends to be the ADI. The membership interests in the ADI contribute to the ADI's capital holdings for prudential purposes. Part of the ADI's required capital holdings is Tier 1 capital (the highest form of capital), which includes certain preference shares issued by the ADI.

5.4 For prudential reasons, ADI groups may restructure and impose a non-operating holding company as the head company of the group, making the ADI a wholly-owned subsidiary (an ADI restructure). However, this prevents the ADI from issuing certain preference shares as part of the consolidated group, despite these shares lacking key ownership characteristics.

5.5 Therefore, to ensure that an ADI can be a wholly-owned subsidiary of a non-operating holding company for tax consolidation purposes following an ADI restructure and continue to issue certain preference shares to meet its

capital adequacy requirements, those shares will be disregarded for consolidation membership purposes.

5.6 The amendments will also ensure that shareholders who exchange their shares in the ADI or extended licensed entity for shares in the non-operating holding company can obtain a CGT roll-over.

Summary of new law

5.7 The amendments remove tax impediments that prevent financial groups containing ADIs from restructuring for prudential reasons by:

- disregarding certain preference shares issued by an ADI or an extended licensed entity member, for the purposes of determining whether the ADI or extended licensed entity member is a wholly-owned subsidiary of a consolidated group headed by a non-operating holding company;
- ensuring that certain dividends paid by the non-operating holding company are frankable if those dividends would have been frankable had they been paid by the ADI prior to the ADI restructure; and
- ensuring that shareholders in the original company (either an ADI or an extended licensed entity member) who exchange their shares for shares in the non-operating holding company can obtain a CGT roll-over if certain preference shares remain issued by the ADI and some foreign holders of shares do not receive shares in the non-operating holding company.

Comparison of key features of new law and current law

New law	*Current law*
Certain preference shares are disregarded for the purpose of determining whether an entity is a wholly-owned subsidiary of a consolidated group. Therefore, in certain circumstances, an ADI can be a subsidiary member of a consolidated group even though it issues preference shares to non-group members.	Preference shares are membership interests for consolidation purposes. Therefore, an ADI that issues preference shares to non-group members cannot be a subsidiary member of a consolidated group.
Distributions made by a non-operating holding company of an ADI from the company's share capital account or from certain other accounts will be frankable distributions if: • the distributions are sourced from the profits of the ADI; and • the distributions would have been frankable distributions had they been paid by the ADI prior to the restructure.	Distributions made by a non-operating holding company of an ADI from the company's share capital account or from certain other accounts will be unfrankable distributions.
Shareholders of an original company (either an ADI or an extended licensed entity) who exchange their shares for shares in an interposed non-operating holding company may obtain a CGT roll-over even if: • certain preference shares are not exchanged; and • some foreign holders of shares do not participate in the exchange.	A CGT roll-over is available when a company is interposed between an existing company and its shareholders only if all the shares in the original company are exchanged for shares in the interposed company.

Detailed explanation of new law

Modification to the consolidation membership rules to disregard certain shares

5.8 Section 703-37 ensures that certain preference shares are disregarded for the purpose of applying the consolidation membership rules following an ADI restructure. The object of the section is to ensure that an ADI restructure does not prevent an ADI, or a member of an extended licensed entity including the ADI, from being a subsidiary member of a consolidated group because it issues certain preference shares. ***[Schedule 2, item 3, subsection 703-37(1)]***

5.9 This is an exception to the general consolidation membership rule in section 703-15 that requires a subsidiary member of a consolidated group (in this case, the ADI or extended licensed entity member) to be wholly-owned, directly or indirectly, by the head company of the group (in this case, the non-operating holding company).

5.10 The exception enables the consolidation rules (except those applying specifically to multiple entry consolidated groups under Division 719) to apply as if the entity that issues the preference shares was a wholly-owned subsidiary of the holding body. That is, the preference shares issued by the ADI or extended licensed entity are effectively ignored for consolidation purposes. ***[Schedule 2, item 3, subsection 703-37(2)]***

5.11 The exception is limited to preference shares issued, either prior to or after the ADI restructure, by specific bodies at a time when a restructure instrument is in force and that have certain characteristics.

Who can issue the preference shares that are disregarded?

5.12 The preference shares can be disregarded for the purpose of applying the consolidation membership rules only if the body issuing the preference shares is:

- a body that would be a wholly-owned subsidiary of the holding body, were the shares not to exist; and
- an ADI, or a member of an extended licensed entity (within the meaning of the prudential standards) that includes the ADI.

[Schedule 2, item 3, subsection 703-37(3) and paragraph 707-37(4)(c)]

5.13 An entity is a member of an extended licensed entity if it is a subsidiary of the ADI which is used to conduct some of the ADI's activities. The

Australian Prudential Regulation Authority recognises that an ADI subsidiary operates, to all intents and purposes, as a division of an ADI. As such, an extended licensed entity member can be considered part of the ADI for tax consolidation membership purposes.

5.14 The 'prudential standards' are defined in subsection 995-1(1) to mean the prudential standards determined by the Australian Prudential Regulation Authority and in force under section 11AF of the *Banking Act 1959*.

Restructure instrument must be in force when shares issued

5.15 The exception in section 703-37 applies only if:

- a restructure instrument under Part 4A of the *Financial Sector (Business Transfer and Group Restructure) Act 1999* is in force in relation to the non-operating holding company; and
- because of the restructure to which the instrument relates, an ADI becomes a subsidiary (within the meaning of the *Financial Sector (Business Transfer and Group Restructure) Act 1999*) of the non-operating holding company.

[Schedule 2, item 3, paragraphs 703-37(4)(a) and 703-37(4)(b)]

Characteristics of disregarded shares

5.16 A share can be disregarded for consolidation membership purposes following an ADI restructure only if it is a preference share with certain specified characteristics. ***[Schedule 2, item 3, paragraphs 703-37(4)(d) and(5)(a)]***

5.17 First, any returns on the share must be fixed at the time of issue by reference to the amount subscribed. For these purposes, the returns can be fixed by reference to a rate, formula or amount set out in the terms of issue for the preference share. ***[Schedule 2, item 3, paragraph 703-37(5)(b)]***

5.18 Second, the share must not be a voting share. A 'voting share' is defined in subsection 995-1(1) of the ITAA 1997 to mean, so far as is relevant, a voting share as defined by section 9 of the *Corporations Act 2001*. ***[Schedule 2, item 3, paragraph 703-37(5)(c)]***

5.19 A voting share in a body corporate is defined by the *Corporations Act 2001* as an issued share in the body that carries any voting rights beyond the following:

- a right to vote while a dividend (or part of a dividend) in respect of the share is unpaid;
- a right to vote on a proposal to reduce the body's share capital;
- a right to vote on a resolution to approve the terms of a buy-back agreement;
- a right to vote on a proposal that affects the rights attached to the share;
- a right to vote on a proposal to wind the body up;
- a right to vote on a proposal for the disposal of the whole of the body's property, business and undertaking; and
- a right to vote during the body's winding up.

5.20 Third, the share must be either Tier 1 capital within the meaning of the prudential standards, or would be Tier 1 capital were it not for a limit imposed by those standards on the proportion of Tier 1 capital that can be made up of such shares. ***[Schedule 2, item 3, paragraph 703-37(5)(d)]***

5.21 The share may be issued on its own or as part of a stapled instrument. A share is issued as part of a stapled instrument if it is issued in combination with one or more schemes that are related to the scheme under which the share is issued. A 'related scheme' is defined in section 974-155 of the ITAA 1997. ***[Schedule 2, item 3, subsection 703-37(6)]***

5.22 Consequently, the share will satisfy the requirements of paragraph 703-37(5)(d), for example, if the share, either on its own or as part of a stapled instrument, is Tier 1 capital or would be Tier 1 capital were it not for a limit imposed by the prudential standards on the proportion of Tier 1 capital that can be made up of such shares or instruments.

What happens if the characteristics of the share change?

5.23 If the characteristics of a share change so that it no longer complies with the requirements of subsection 703-37(5), the share will continue to be disregarded for the purpose of applying the consolidation membership rules for a period of 180 days. ***[Schedule 2, item 3, subsection 703-37(7)]***

5.24 The most likely cause of a change in characteristics of a share that would result in the share failing the conditions in section 703-37 would be a change to the rights to returns or voting rights associated with the share. Subsection 703-37(7) provides consolidated groups with a transitional period in

which to adjust their holdings to avoid non-compliance with the consolidation membership rules.

Consequences of an ADI restructure

5.25 Generally a consolidated group will cease to exist where the head company of the group no longer satisfies the conditions for being a head company. However, as an exception to this rule, the consolidated group is taken to continue to exist if:

- an entity (the original company) ceases to be the head company because, through a share exchange, another company is interposed between the original company and its shareholders; and
- the interposed company makes an irrevocable choice that the consolidated group is to continue in existence.

5.26 In these circumstances, section 703-75 of the ITAA 1997 operates to ensure that the original company and the interposed company are treated as having exchanged identities throughout the period before the completion time. As all the tax attributes of the original company effectively become those of the interposed company, tax outcomes should be seamless and neutral.

5.27 Therefore, the interposition of the non-operating holding company as the head company does not create a new consolidated group and the single entity rule (section 701-1) continues under the new head company. The single entity rule ensures that subsidiary members of a consolidated group for head company core purposes and entity core purposes are treated as parts of the head company.

5.28 One effect of section 703-75, together with the single entity rule, is that, if a subsidiary is moved from the original company (that is, the ADI or an extended licensed entity member) to the non-operating holding company, the assets in the subsidiary are treated as moving within the head company and there are no taxation consequences. The membership interests in the subsidiary, being intra-group assets, are not recognised for taxation purposes. Consequently, the transfer of the membership interests cannot trigger a taxation event, such as CGT event J1, in the group.

5.29 A second effect of section 703-75 is that the interposed company (ie, the non-operating holding company) is taken to have the same shareholder history as the original company (that is, the ADI or an extended licensed entity member), including tracing through any interposed entities.

5.30 Therefore, for the purpose of applying the continuity of ownership test to determine whether the non-operating holding company is entitled to deductions for prior year losses and bad debts, the non-operating holding

company is taken to have the same ownership as the ADI or an extended licensed entity member prior to the completion time. Consequently, if the ADI was a widely-held company before the completion time, the non-operating holding company is taken to be a widely-held company before that time.

Modifications to the imputation provisions to ensure that certain distributions from the non-operating holding company are frankable

5.31 Following an ADI restructure, distributable profits of the ADI that are transferred to the non-operating holding company in connection with the ADI restructure may be classified under the accounting standards as, for example, share capital of the non-operating holding company. This may inappropriately result in distributions that would have been frankable if made by the ADI being treated as unfrankable because they are made from the non-operating holding company.

5.32 Therefore, a distribution made by the non-operating holding company will be taken to be a dividend for the purposes of the income tax law that is not an unfrankable distribution where:

- the distribution is sourced, directly or indirectly from the ADI's profits before the restructure instrument came into force; and
- the distribution would have been a frankable distribution if it had been made by the ADI prior to the ADI restructure.

[Schedule 2, item 2, section 202-47]

5.33 An amount sourced indirectly from the ADI's profits could include retained earnings of subsidiaries of the ADI prior to the ADI restructure.

Modifications to the CGT provisions to facilitate a CGT roll-over

5.34 Subdivision 124-G of the ITAA 1997 provides a CGT roll-over when shareholders of an original company exchange their shares in the company for shares in an interposed company. Requirements of the roll-over include:

- all the shareholders in the original company exchange their shares for shares in the interposed company;
- the percentage of shares that each exchanging member receives in the interposed company are equal to the percentage of the shares that each member owned in the original company; and

- the following ratios are equal:
  - : the ratio of the market value of each exchanging member's shares in the interposed company to the market value of the shares in the interposed company issued to all the exchanging members; and
  - : the ratio of the market value of that member's shares in the original company that were redeemed or cancelled to the market value of all the shares in the original company that were redeemed or cancelled.

5.35 Subdivision 124-G will be modified to ensure that shareholders of an original company who exchange their shares for shares in an interposed non-operating holding company are able to roll-over any capital gain or loss that arises from the exchange, into the shares they receive in the interposed non-operating holding company. ***[Schedule 2, item 1, section 124-382]***

5.36 The modification will apply if:

- the original company is either an ADI or part of an extended licensed entity;
- a non-operating holding company, within the meaning of the *Financial Sector (Business Transfer and Group Restructure) Act 1999*, is interposed between the original company and its shareholders;
- a restructure instrument under Part 4A of that Act is in force in relation to the non-operating holding company; and
- the ADI becomes a subsidiary of the non-operating holding company as a result of the restructure.

[Schedule 2, item 1, subsection 124-382(1)]

Certain preference shares are disregarded

5.37 If section 124-382 applies, then the preference shares that can be disregarded under subsection 703-37(4) are also disregarded in determining whether the requirements of Subdivision 124-G are satisfied. The characteristics of these preference shares are explained in paragraphs 5.16 to 5.22. ***[Schedule 2, item 1, subsection 124-382(2)]***

Certain foreign-owned shares are disregarded

5.38 In some circumstances, when a non-operating holding company is interposed between an original company and its shareholders, arrangements may need to be made for foreign holders of shares to dispose of their shares in the original company (or have their shares cancelled) through a share sale facility, rather than exchange their shares for shares in the non-operating holding company.

5.39 This is likely to occur because:

- the foreign holders of shares in the original company would not be permitted to own shares in the non-operating holding company; or
- the foreign holders of shares in the original company would only be permitted to own shares in the non-operating holding company after certain regulatory conditions are satisfied.

5.40 A foreign holder, as defined by section 9 of the *Corporations Act 2001*, is a holder of securities (including shares) whose address, as shown in the register which records the details of their holding, is a place outside Australia and the external Territories.

5.41 Under a share sale facility, the foreign holders would dispose of their shares in the original company to the non-operating holding company (or the shares would be cancelled) and an agent or nominee would acquire shares, on their behalf, in the non-operating holding company. The agent or nominee would then dispose of the shares in the non-operating holding company and give the capital proceeds (less expenses) from that disposal to the former foreign holders of shares in the original company.

5.42 To ensure that shareholders in the original company who exchange their shares for shares in the non-operating holding company can obtain the CGT roll-over when a foreign share sale facility is used, certain foreign-owned shares are disregarded when determining whether certain requirements of Subdivision 124-G are satisfied.

5.43 Shares in the ADI will be disregarded for the purposes of applying Subdivision 124-G if:

- the shares are owned by a foreign holder;
- the shares are either disposed of to the non-operating holding company or cancelled;

- an agent or nominee, appointed on behalf of the foreign holder, acquires shares in the non-operating holding company; and
- the agent or nominee subsequently:
  - : disposes of the shares; and
  - : gives the foreign holder an amount equal to the capital proceeds of the disposal less expenses.

[Schedule 2, item 1, paragraph 124-382(3)(a) and subsection 124-382(4)]

5.44 In some circumstances the agent or nominee may dispose of the shares in the non-operating holding company on a pooled basis. That is, the agent or nominee may dispose of the shares together with other shares that the agent or nominee acquired under the share sale facility.

5.45 In these circumstances the agent or nominee will be required to give the foreign holder of shares in the original company an amount equal to their proportion of the capital proceeds (less expenses). ***[Schedule 2, item 1, subparagraph 124-382(4)(f)(ii)]***

5.46 A foreign holder's proportion of the capital proceeds would be determined by reference to their shareholding in the original company relative to the total shareholdings of all the foreign holders in the original company who receive capital proceeds from the agent or nominee.

Example 5.1

Brilliant Banking Ltd (Brilliant Banking) is an ADI. It has three foreign holders of shares; Peter, Gary and Philip. Of the shares in Brilliant Banking, Peter holds 10 per cent, Gary holds 15 per cent and Philip holds 5 per cent. Together they hold 30 per cent of the shares in Brilliant Banking.

Brilliant Banking proposes to interpose a non-operating holding company, Gold Holding Ltd (Gold Holding), between itself and its shareholders under an arrangement where its ordinary shareholders exchange their shares in Brilliant Banking for shares in Gold Holding. However, Peter, Gary and Philip are unable to receive shares in Gold Holding and so set up a share sale facility with Paul as their agent.

Gold Holding is interposed between Brilliant Banking and its shareholders, and Brilliant Banking's shareholders (including Peter, Gary and Philip) dispose of their shares to Gold Holding. Paul then acquires

shares in Gold Holding on behalf of Peter, Gary and Philip and subsequently disposes of them on a pooled basis.

Peter's proportion of the capital proceeds would be determined by reference to his shareholding in Brilliant Banking relative to the total shareholdings of Gary, Philip and himself (that is, the foreign holders who will receive capital proceeds from Paul).

As the total shareholdings of Peter, Gary and Philip totalled 30 per cent of Brilliant Banking, and Peter held 10 per cent, he would be entitled to receive 33.33 per cent of the capital proceeds (less expenses) from Paul (that is, 10/30).

Similarly, Gary would receive 50 per cent and Philip would receive 16.67 per cent of the capital proceeds (less expenses).

5.47 Shares in the non-operating holding company will be disregarded for the purposes of applying Subdivision 124-G if the agent or nominee acquires shares in the non-operating holding company. ***[Schedule 2, item 1, paragraph 124-382(3)(b) and 124-382(4)(d)]***

Application and transitional provisions

5.48 The amendments to the consolidation membership rules and the imputation provisions apply to restructure instruments that come into force under the *Financial Sector (Business Transfer and Group Restructure) Act 1999* on or after 1 July 2007. ***[Schedule 2, subitem 4(2)]***

5.49 The amendments to the CGT rules apply to CGT events happening on or after 1 July 2007. ***[Schedule 2, subitem 4(1)]***

6

Schedule 3 — Consequential amendments

Australian Prudential Regulatory Authority Act 1998

6.1 One amendment is made to reflect the change in name of the FSTBA.

Financial Sector (Transfers of Business) Act 1999

6.2 To reflect the extended scope of the FSTBA, it will be re-named the *Financial Sector (Business Transfer and Group Restructures) Act 1999*. Other consequential amendments are made to reflect the extended scope of the FSTBA.

Income Tax Assessment Act 1997

6.3 Two consequential amendments are made to the *Income Tax Assessment Act 1997* (ITAA) to reflect the change in name of the *Financial Sector (Transfers of Business) Act 1999*. That Act will now become the *Financial Sector (Business Transfer and Group Restructure) Act 1999*. ***[Schedule 3, items 10 and 11, sections 320-300 and 320-305]***

6.4 Other consequential amendments to the ITAA 1997 ensure that the consolidation tax cost setting rules and general value shifting regime apply appropriately to preference shares that are disregarded for the purpose of applying the consolidation membership rules following an ADI restructure. These amendments mirror those applying to employee share schemes, which are also disregarded for consolidation membership purposes. ***[Schedule 3, items 12 to 24, sections 703-30, 705-85, 707-325, 709-80, 711-45 and 715-615]***

Life Insurance Act 1995

6.5 One amendment is made to reflect the change in name of the FSTBA.