

Banking and Finance Newsletter

Impact of the Group Consolidation Regime on Financiers

In 2002 and 2003 the Commonwealth government enacted various instalments of legislation which provided a mechanism under which wholly owned groups of companies and eligible trusts and partnerships can elect to consolidate as a group for tax purposes. The effect of consolidation is that a group will be treated as a single entity for tax purposes.

Under this regime, the head company of a wholly owned group of entities will be able to make an irrevocable choice to consolidate with its wholly owned Australian subsidiaries for income tax purposes.

Once consolidated, the group will pay consolidated income tax.

The head company will be liable for tax debts of the group during the consolidation period. Tax losses of each wholly owned subsidiary are automatically transferred to the head company.

Each group member automatically becomes jointly and severally liable to pay group tax where the head company fails to pay it on time. A subsidiary can remain liable for group tax assessments in respect of periods during which it was a group member even if the subsidiary has left the group (for example if the head company sells shares in the group).

Therefore consolidation can generate an additional financial risk to borrowers which are part of a consolidated group. In view of the automatic joint and several liability for group tax, consolidation creates external risks and insolvency pressures that at one time would have remained within a particular company.

Further, financiers who are taking into account accumulated tax losses when assessing the viability of a project need to be aware that once consolidation takes place (and this can be beyond the financier's control) the tax losses will be automatically transferred to the head company and no longer available to the borrower.

Joint and several liabilities of all companies within a group can be varied by a valid tax sharing arrangement. To be valid there needs to be a reasonable allocation of group tax amongst various companies within the group. The ATO guidelines as to what constitutes a reasonable allocation are not clear. If the arrangement is valid it can assist in providing certainty to financiers as to the extent to which an entity within a group will be liable for the group tax of other group members.

As a result of the amended consolidation legislation, when assessing loans to members of a group of companies, financiers need to know whether the group of companies has elected to consolidate for tax purposes and they need to review any valid tax sharing arrangement that may be in place.

However, even if a tax sharing arrangement is established this will not affect the automatic transfer of losses to the head company.

It should also be noted that there can be some difficulty in obtaining certainty as to the validity of a tax sharing arrangement. To be valid, section 721.25 of the *Income Tax Assessment Act 1997* provides that there must be a reasonable allocation of the total amount of group liability between members of a group. For larger projects financiers may need to obtain specialist advice in relation to tax sharing arrangements.

Other recommended steps include making it an event of default should there be an election to consolidate without the financier's written consent or should the borrower or any guarantor enter into a tax sharing agreement without the financier's approval.

In some circumstances a financier could also make it a condition of the loan that the borrower is removed as a subsidiary of a consolidated group by transfer of a share to an entity outside the group. However, this would not affect liability for group tax debts relating to periods prior to the removal of the entity from the group.

Recent Mortgage Duty Changes

There have been a number of significant changes recently to mortgage duty arrangements among the various states and territories.

NSW - discount for first home owners

From 4 April 2004 mortgage relief for eligible first home owners under the First Home Plus Scheme has been extended. Where the contract was entered into on or after 4 April 2004 there is a 100% exemption from mortgage duty for properties costing up to \$500,000.00 gradually phasing out at \$600,000. There is a 100% exemption from mortgage duty on vacant land costing up to \$300,000 and phasing out at \$450,000.

The general rate of duty remains unchanged at the rate of \$4 per \$1,000 or remaining part of \$1,000.

VICTORIA - abolition of mortgage duty

The Victorian Government has confirmed that it will abolish mortgage duty from 1 July 2004. Advances, or further advances that occur on or after 1 July 2004 on mortgages executed before that date are also not subject to duty.

AUSTRALIAN CAPITAL TERRITORY - plans to introduce mortgage duty abolished

The ACT Revenue Office has confirmed that the ACT Government has decided not to proceed with the introduction of a mortgage duty. The proposals were intended to have effect from 1 July 2003.

SOUTH AUSTRALIA - introduction of reduced rate on home mortgages

From 1 October 2003 two rates of stamp duty apply to mortgages. General mortgage duty of 0.45% (up from 0.35%) applies to all mortgages except home mortgages that are calculated at a reduced rate of 0.35%.

The lower home mortgage rate will apply to loans to natural persons which are applied solely to purchase a principal place of residence or vacant land on which it is proposed to build a principal place of residence, make additions or improvements to a principal place of residence or a re-finance for such a purpose.

QUEENSLAND - extension of mortgage relief to first home borrowers

From 1 May 2004 mortgage duty concessions for first home mortgages were raised from \$100,000.00 to \$250,000.00. Where a transaction is entered into on or after that date the first \$250,000.00 of borrowings to buy or build a first home secured by a mortgage is exempt from mortgage duty. Mortgage duty, at the rate of 0.40 per \$100.00 or part of \$100.00, will apply to any amount secured in excess of \$250,000.00.

WESTERN AUSTRALIA - mortgage duty rewrite

The Western Australian Government has introduced new mortgage duty provisions that narrow the mortgage duty base and bring it into line with the other states. From **1 January 2004** any instruments that do not create a charge over property will no longer be liable to duty. Duty has therefore been removed from debentures, guarantees, bonds, covenants and other instruments of security.

Duty at the rate of 0.4% is imposed on all mortgages except a Home Mortgage where a lower rate of applies.

The lower home mortgage rate applies to natural persons where the borrowings are used for any of the following purposes:

- Purchase a *dwelling house* that will be used as their principal place of residence;
- Construct a principal place of residence;
- Alterations or additions to a principal place of residence; or

Refinance an existing loan that has been previously used for the purchase of their residence, construction of their residence or the improvements of their residence.

Where the **whole** of the secured amount is used for the mortgagor's principal place of residence home mortgage duty is imposed at the rate of \$20.00 for any amount up to and including \$8,000, plus \$0.25 per \$100.00 and part thereof.

This rate does not apply where the amount secured is for the purchase of vacant land. Where the mortgage relates to a house and land package, the home mortgage rate would only be available for the house construction component.

Prevention of Double Duty

WA mortgage duty will now be calculated on the proportion of the amount advanced that is secured by WA property, bringing it into line with the other states. This will serve to simplify multi-jurisdictional transactions. As in the other states, this calculation excludes property located overseas and in jurisdictions that do not impose mortgage duty, eg ACT, Northern Territory and now Victoria.

Securing Water Licences & Entitlements

Water licences and entitlements are often valuable parts of a loan security particularly where part of the security is a mortgage over rural land.

It is important for a financier to be able to ensure that its rights to deal with these entitlements are properly secured and that the rights cannot be transferred or dealt with without the financier's consent.

In NSW water licences are governed by the *Water Management Act 2000*.

Access licences should be registered with a register kept by the Minister for Infrastructure Planning & Natural Resources and various transfers and other dealings associated with the licences are to be recorded in this register including assignments, subdivisions and surrenders.

There can be some variance in procedural aspects of the transfer of licences from region to region and it is important to ensure that all issues are dealt with according to the requirements of the relevant regional office.

Section 83 of the *Water Management Act 2000* provides that an access licence may be the subject of a security interest.

Section 83A(2) provides that an interest in an access licence that is registered in the General Register of Deeds (which is a register held by the NSW office of Land & Property Information) has priority for all purposes over an interest that is not so registered. This is regardless of whether the access licence is held by an individual or a corporation as the provisions for registration of the access licence are declared to be corporation legislation displacement provisions for the purposes of Section 5G of the *Corporations Act 2001*. In other words, registration of a mortgage over an access licence in the General Register of Deeds will take priority over a charge registered with the Australian Securities & Investments Commissions.

This means that in NSW it is essential that:

- anyone taking security over a water licence searches the General Register of Deeds before settlement to ensure that the access licence is unencumbered or if it is encumbered that steps are taken to discharge the security before settlement; and
- a mortgage over an access licence is registered in the General Register of Deeds upon settlement.

Notwithstanding registration, the access licence is still subject to provisions requiring the Minister's consent in relation to dealings.

There is a proposal to further reform the access licence system by creating a central register at the office of Land & Property Information to deal with water entitlements similar to the land register. This is scheduled to commence on 1 July 2004 when the Office of Land and Property Information will commence recording water entitlements on the central register. It is expected that the new system will simplify the trading of access licences and also give financiers a greater degree of certainty in relation to their securities. Once this occurs it will be necessary to search the central water access licence register and to ensure that mortgages are recorded on the register to properly protect financiers rights over access licences.

New “Fit and Proper” Standards

In March 2004, the Australian Prudential Regulation Authority (**APRA**) released its draft *Prudential Standards APS 520 – Fit and Proper for ADIs (Guideline)*. This Guideline contained a 21 point checklist, to be used by financial services companies to assess the quality of their boards, executives, senior managers, auditors and actuaries.

The *Banking Act 1959* was recently amended by the *Financial Sector Legislation Amendment Act 2003* and came into effect on 27 November 2003. This amendment gave APRA powers in respect of overseeing the fitness and propriety of directors and senior managers similar to those provided in the *Insurance Act 1973*.

Fit and Proper

Currently, there are no minimum fit and proper requirements for responsible persons of financial services. These financial institutions generally apply their own standards in the appointment of responsible persons. At present, only general insurers are subject to minimum requirements.

As the fit and proper standards applied by institutions vary, APRA perceives that without specifying any minimum fit and proper criteria for responsible persons of financial institutions, there is a risk that those occupying key roles within these institutions may not have the degree of probity and competence commensurate with their responsibilities. There is also currently no explicit process by which APRA can determine whether a person has met the required level of probity and competence for occupying the relevant position.

The absence of prudential standards that set out the minimum fit and proper criteria that APRA must consider, limits APRA's ability to remove any directors and senior management who are deemed not fit and proper from their duties. Similarly, APRA could not revoke the approval of an auditor or actuary or direct their removal on the basis of their being not fit and proper to carry out their role.

Guideline

The principal objective of the Guideline is to harmonise the fit and proper prudential requirements for all APRA-regulated institutions and to promote confidence in the financial system by reducing the likelihood of instability or financial stress that could result from the mismanagement or misconduct in APRA-regulated institutions. The Guideline will:

- strengthen requirements applying to responsible persons, such as directors, senior managers, auditors and actuaries, to ensure that these persons meet minimum standards of fitness and propriety;
- increase the protection provided to customers by ensuring only persons that meet minimum standards of fitness and propriety are charged with positions of responsibility;
- clarify existing prudential requirements and provide additional guidance for financial institutions as to APRA's expectations of standards that responsible persons should meet; and
- establish a harmonised framework for assessing responsible persons across APRA regulated industries.

According to the Guideline, the criteria to determine whether a person is fit and proper includes whether a person has:

- the appropriate knowledge, skills, experience, competence, judgement, character, honesty and integrity for the responsible person position in question;
- been subject to criticism, discipline, disqualification or removal by a professional or regulatory body or Court;
- been subject to adverse findings in relevant criminal or civil proceedings;
- been refused a licence for a commercial or professional activity;
- failed to manage personal debts satisfactorily;
- been a responsible officer in an entity at the time it failed;
- been obstructive, misleading or untruthful in dealing with regulatory bodies, or a Court;
- demonstrated a lack of willingness to comply with regulatory or professional requirements;
- breached a fiduciary obligation;
- been involved in business practices that appear negligent, deceitful, or otherwise improper;
- failed to deal with conflicts of interest appropriately; or
- been, or is, considered of bad repute.

Naturally, the criteria are to be considered in the context of the responsible person position for which the person is being considered, or already acts, and based on evidence that the institution can reasonably obtain with regard to the person concerned.

Application and Submissions

The fit and proper standards will apply to all banks, building societies, credit unions, general insurers and life insurers. These companies will be required to report regularly to APRA, confirming each institution has an adequate "fit and proper" policy in place.

A copy of the Guideline can be obtained from APRA's website at www.apra.gov.au. Submissions on the Guidelines is presently being received by APRA.

*Nancy Bramley-Moore
Finance Partner
Makinson & d'Apice
Level 12
135 King St
Sydney 2001*

*Phone: 02 9233 7788
Fax: 02 9233 1550
Email: nbramleymoore@makdap.com.au*