18 June 2009

The Manager
Company Tax Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: consolidation@treasury.gov.au

Dear Sir/Madam

Exposure Draft - Tax Laws Amendment (2009 Measures No 4) Bill 2009: Consolidation

On behalf of the Institute of Chartered Accountants in Australia (the Institute) and the Taxation Institute of Australia (the Taxation Institute), collectively referred to as the Joint Bodies, we attach our submission on the abovementioned Exposure Draft legislation (ED) released for comment on 28 April 2009.

The comments in our submission are set out under the following headings:

Section A	Implementation issues
Section B	Details of amendments
Section C	Other issues
Section D	Appendix A: Section 705-56(6) examples and observations
	Appendix B: CGT straddle issues sought to be addressed

Key recommendations

- Groups need to be given the opportunity to review the choices made in relation to the Consolidation regime (refer Section A1)
- Review the proposed date of effect of the various amendments (refer Section A2) and
- A meeting between Treasury, the Australian Taxation Office (ATO) and industry be convened to agree the operation of subsection 701-55(6) and identify the ATO interpretative products required (refer Section B1).

Given the importance of these issues the Joint Bodies would appreciate the opportunity to meet with Treasury and, if necessary, the Assistant Treasurer's Office, to progress our recommendations.

The concerns of the Joint Bodies regarding these issues are not new. They are addressed in detail in:

- 13 December 2007: the Joint Bodies' submission entitled "Consolidation: Draft legislation relating to measures announced on 1 December 2005 and Consolidation: Consultation papers on measures announced in October 2006, May 2007 and September 2007"
- 1 May 2008: the submission lodged by the Joint Bodies, the Corporate Tax Association and CPA Australia entitled "Submission: exercising transitional tax consolidation loss choices".

As indicated in the attached submission on the ED legislation and also in these earlier submissions, the tax consolidation regime is a uniquely wide-ranging and complex package of tax legislation which rewrites the income tax rules for companies which are in consolidated groups.

As a result of, amongst other things, the complexity of the consolidation rules and their interaction with pre-existing provisions of the tax law, tax legislation was not in place at the 1 July 2002 commencement date which dealt comprehensively with all of the issues arising as a consequence of the new regime.

The Government has sought to rectify significant gaps and shortcomings identified by the Australian Taxation Office (ATO) and stakeholders by foreshadowing amendments to the law. The proposed amendments seek to give effect to most of the announcements made from 1 December 2005, with consultation continuing in relation to the remaining announcements.

In making our recommendations in relation to the start dates for each of the proposed amendments and our recommendation that groups should be able to revisit their formation choices we have taken into account:

- the unique history of the tax consolidation regime
- the long lead time between announcement of proposed amendments and the ultimate introduction of legislation
- the overarching principle that proposed amendments that have an adverse impact should not be made retrospective other than in very limited circumstances and
- the need to balance the interests of the revenue and taxpayers.

In the meantime, if you have any questions regarding our submission please call at first instance either Susan Cantamessa from the Institute (02 9290 5625) or Michael Dirkis from the Taxation Institute (02 8223 0010).

Yours sincerely

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cc Mr Peter Downes, Assistant Treasurer's Office

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SECTION A IMPLEMENTATION ISSUES

A1 TRANSITIONAL CHOICES

A1.1 Summary of submission

In summary, we reiterate the Joint Professional Bodies' submissions made in 2007[1] and 2008[2] that the effect of these long-delayed consolidation legislative measures is such that consolidated groups should be permitted to re-examine their consolidation transitional choices made in earlier years.

The Joint Bodies would appreciate the opportunity to meet with Treasury to discuss how to progress technical and practical issues arising from the recommendation.

A1.2 Detail of submission

Tax consolidation involves a complex reworking of the tax consequences of consolidated groups' assets, liabilities, tax accounting and tax deductions and income.

When tax consolidation commenced, tax consolidated groups had five transitional choices which were available to them in relation to the tax cost setting amount (TCSA) of assets and the treatment of losses on formation of a consolidated group:

- whether the assets of subsidiary companies should be reset or should be transitioned into consolidation at their existing tax values[3]
- whether losses of joining entities were to be used by the joined group, with consequential adjustments in the tax cost setting value process, or the losses were to be cancelled[4]
- for purposes of determining whether losses incurred in the pre-consolidation environment were to be used by the consolidation group under the available fraction method, whether to use the value donor concessions to calculate available fractions[5]
- the choice to waive the capital injection rules for calculating available fractions[6]
- the choice to use losses meeting the continuity of ownership (COT) test prior to 21 September 1999 over three years rather than under the available fraction method.[7]

These choices had permanent financial implications, affecting the tax value of assets for capital allowance and tax recognition purposes, the amount of losses available to the consolidated group and also the pattern of recovery of those losses.

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[1] Refer the Joint Bodies' submission dated 13 December 2007 entitled "Consolidation: Draft legislation relating to measures announced on 1 December 2005 and Consolidation: Consultation papers on measures announced in October 2006, May 2007 and September 2007".

[2] Refer the submission lodged by the Joint Bodies, the Corporate Tax Association and CPA Australia dated 1 May 2008 entitled "Submission: exercising transitional tax consolidation loss choices".

[3] Sections701-5(2)(b) and 701-5(4)(a) of the *Income Tax (Transitional Provisions) Act 1997*.

[4] Section 707-145 of the *Income Tax (Transitional Provisions) Act 1997.*

[5] Sections 707-325 and 707-327 of the *Income Tax (Transitional Provisions) Act 1997*.

[6] Section 707-328A of the *Income Tax (Transitional Provisions) Act 1997.*

[7] Section 707-350 of the *Income Tax (Transitional Provisions) Act 1997.*

These choices had a deadline of 31 December 2004 and, once made, they became irrevocable.

However, when the tax consolidation laws required significant amending legislation, the then Assistant Treasurer allowed a one time extension of the deadline for the transitional choices until 31 December 2005[8] to “ensure that consolidated groups and MEC groups are not disadvantaged as a consequence of the amendments”.[9]

This current package of consolidation measures is the largest package of tax consolidation changes since 2004. The effect of these changes is significant.

For many groups the changes, which potentially affect transactions back to the commencement of tax consolidation, will mean that:

- the choice made to not consolidate may have been different had the law at the time reflected these amendments
- choices made in relation to the tax cost setting amounts on formation of their tax consolidated groups, in particular whether to “stick” with the existing tax values or to “spread” the allocable cost amount across the assets of the consolidated group, were made inappropriately and in a way which disadvantages the taxpayer and
- choices made in relation to their losses will be found to be incorrect, due to differences in asset values and the characteristics of various assets arising from the measures now being implemented.

We submit that it is necessary again to give groups an opportunity to review their transitional choices. Otherwise some groups will find that they will have been disadvantaged materially by the delay in releasing the legislation dating back to formation time.

For this reason we submit that the Government should allow a period of time for consolidated groups to consider again their transitional consolidation choices. The period should expire six months after the eventual consolidation amending Bill is passed, thus allowing a just outcome while not creating lengthy uncertainty. As before:

- this should be an optional, not mandatory, mechanism. It will not create a compliance burden for consolidated groups which do not wish to re-examine their choices
- many tax consolidated groups will not re-examine their choices because there are not sufficient benefits or they have insufficient interest in re-examining the choices. So it is considered likely that the disruption to compliance for consolidated groups or the Australian Taxation Office (ATO) is not likely to be significant.

A1.3 Date of effect

The one time capacity for consolidated groups to consider again their transitional consolidation choices, implemented in the same manner as for *Tax Laws Amendment (2005 Measures No. 5) Act 2005,* should expire six months after the eventual consolidation amending Bill is passed.

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[8] *Tax Laws Amendment (2005 Measures No. 5) Act 2005*, see discussion in paras 3.38 – 3.64 of Explanatory Memorandum.

[9] Para 3.6 of Explanatory Memorandum to *Tax Laws Amendment (2005 Measures No. 5) Act 2005.*

A2 ALIGNING THE COMMENCEMENT DATES OF THE MEASURES

A2.1 Summary of submission

Generally, we believe that there should be a uniform approach to the date of effect provisions for the measures contained in the Exposure Draft legislation (ED). This is consistent with the Joint Bodies' submissions of 2007 and 2008. In summary we recommend:

- an application date of 1 July 2002 – for amendments covering issues clearly apparent from consultation with business and the ATO, relating to clarification of the consolidation law
- application from no earlier than date of announcement/release of ED legislation – all other amendments, including those amendments which are clarifying in nature and have been or will be clarified by the courts (where such decisions have effect from 1 July 2002).

The Joint Bodies would also appreciate the opportunity to meet with Treasury to discuss how to progress technical and practical issues arising from our recommendations.

A2.2 Detail of submission

As Treasury and Government will be aware, the tax consolidation measure is a uniquely wide-ranging package of tax legislation, which in essence rewrites the entire income tax regime in relation to companies which are in consolidated groups or which are acquired or sold by consolidated groups.

Because the 1 July 2002 starting date for the tax consolidation regime did not result in income tax law dealing with all of the relevant issues, the proposed Bill introduces measures in relation to some issues which date back to the inception of the consolidation regime. However the issues had largely been identified, were being worked on in various forums by the ATO and then by Treasury and Government, and solutions were anticipated by various consolidated groups for several years, in some cases since 1 July 2002.

Therefore, tax consolidation requires special treatment as discussed below. The proposed amendments contained in the ED can be classified into two categories.

A2.2.1 Category 1 – Anticipated measures, clearly apparent from consultation with business and the ATO, relating to clarification of the consolidation law

Prima facie, these measures, in relation to which many businesses have been waiting for Government announcements and legislative changes, should be effective from the 1 July 2002 commencement of the consolidation rules, and not some later announcement date. To have the measures operative only from announcement date is inequitable where issues are relevant to the core design of tax consolidation and have been the subject of discussion for some years.

This retrospective effect should be subject to the qualification that, if the changes are adverse to taxpayers, then taxpayers should not be forced to reopen their prior year returns. That is, for businesses which have completed their consolidation formation calculations, we submit there should be an option for those businesses not to have to reopen their formation calculations in respect of income tax returns which have been lodged and assessed. In many if not most cases, we believe that consolidated groups will choose not to reopen prior year returns.

A2.2.2 Category 2 – other measures

Other measures should be effective no earlier than the date of their announcement by the Government or inclusion in the ED legislation. This category would include:

- Proposed amendments to implement measures that have been or will be clarified by way of judicial decisions, eg*Handbury Holdings Pty Ltd v Commissioner of Taxation* [2008] FCA 1787 and *Envestra Ltd v Federal Commissioner of Taxation [2008] FCA 24.* In these instances, if decided in the ATO's favour, then application from 1 July 2002 is not required. If decided in the taxpayer's favour then in our view this is an appropriate outcome for taxpayers who relied upon the existing law for the period prior to the announcement of any change.
- proposed amendments to implement measures which have not previously been announced and
- proposed amendments which, although previously announced, did not contain sufficient detail to allow taxpayers to reasonably anticipate the effect of the proposed amendment.

Our recommended date of effect for each of the proposed amendments is discussed in more detail in Section B.

SECTION B DETAIL OF AMENDMENTS

B1 USE OF THE TAX COST SETTING AMOUNT

B1.1 Summary of submission

We generally support the proposed changes to the use of the tax cost setting amount as set out in Schedule 1, Part 1 of the tax consolidation ED.

The extensive use of examples in the draft Explanatory Material (EM) is appreciated and will assist taxpayers assessing how the law is to be applied.

A number of useful observations arose following discussions between Treasury, the ATO and industry on 8 May 2009 that are worthy of further consideration in finalising the drafting.

B1.1.1 Subsection 701-55(6) legislative improvements

Subject to the outcome of follow up discussions (see B1.1.3 below), we highlight the following legislative improvements to subsection 701-55(6) that should be considered:

- clarifying what the subsection does and does not do in terms of characterising the TCSA now that it has been deemed to be incurred for other parts of the tax law
- reflecting more of the EM commentary in the legislative provisions
- additional deeming rules to better accommodate interaction issues for provisions such as bad debts, building amortisation deductions, foreign exchange gains and losses and investment allowance
- revisiting the transitional rule for foreign denominated trade receivables so as to better achieve a 'no disadvantage' outcome.

B1.1.2 EM improvements

We highlight that a number of the conclusions contained in the EM examples, after the analysis of the facts presented, could be better articulated.

B1.1.3 Follow-up discussions

A follow up teleconference between Treasury, the ATO and industry should be convened to discuss the current legislative drafting of the subsection, whether modifications to the subsection are warranted and the EM commentary.

B1.2 Detail of submission

B1.2.1 Subsection 701-55(6) legislative improvements

In our earlier submissions which commented on the drafting instructions, it was recommended that the legislation expressly confirm that the TCSA be taken into account in determining the loss or outgoing amount in respect of the asset. It was also recommended that the TCSA is taken to have satisfied the relevant incurrence test for the amount to be a loss or outgoing under the relevant provision of the income tax legislation. Clearly these submissions have been accommodated in the ED.

Characterisation

An important interpretative issue that was highlighted in our recent teleconference call was the limited effect of the deeming under subsection 701-55(6) in respect of the cost, outgoing, expenditure or other amount that is now deemed to have been incurred or paid to 'acquire the asset'.

We now understand the tax policy of this deeming is for the purpose, and only for the purpose, of quantifying an amount of assessable income or an allowable deduction. This does not extend to *characterising* the cost, outgoing etc. Thus, for the purposes of the relevant income/deduction provisions the head company is not deemed to have actually acquired the asset for the amount now deemed to have been incurred. Whilst this policy intent became clearer after Treasury explained the intent of the note to the subsection and the EM comments, we submit that the wording in the provision itself may not achieve the policy intent.

The subsection currently states that the expression (eg cost, outgoing, expenditure etc) means that the relevant provision is to apply as if the cost etc had been incurred or paid to acquire the asset. It is true that the above phrasing is qualified by the proviso "for the purpose of determining the amount included in assessable income or the amount of the deductions" which is re-emphasised at Note (a).

However, for the purpose of determining whether, for example, an amount is deductible under section 8-1 (either immediately, at some future time or not at all) it will be relevant to consider whether the outgoing incurred is of a revenue or capital nature. The answer to this question may well depend on whether the outgoing has been deemed to be incurred in acquiring the asset, or, just deemed to be an outgoing incurred at that particular time in connection with an asset that has previously been acquired and already has certain characteristics pursuant to the entry history rule.

In our discussions with Treasury we were led to understand that the policy intent is the latter. However, having regard to the wording of the proviso we believe the alternate interpretation is also open. Thus, based on current subsection 701-55(6) wording an acquisition characterisation for the outgoing incurred could be adopted in applying the section, contrary to the policy intent.

Given the ongoing importance of this subsection we believe that the current drafting should be the subject of further discussions between Treasury, the ATO and industry.

For example, our initial thoughts are that the words in the provision "as if the cost, outgoing, expenditure or other amount had been incurred or paid **to acquire** the asset" should be replaced with "as if the cost, outgoing, expenditure or other amount had been incurred or paid **in relation to or in respect of** the asset." We also note that the initial drafting instructions submitted in the consultation process did use the expression 'in relation to the asset'. The EM could be used to reinforce there is not an acquisition characterisation.

We also submit that it would be beneficial if some of the underlying principles that are discussed in EM 1.15 (ie the deeming is purely to override the history of the pre-joining time expenditure incurred) plus EM 1.14 and 1.17 (ie original acquisition date and the revenue/capital characterisation of the asset in the hands of the subsidiary member is retained) were incorporated into the legislative provision itself.

Interaction rules

An analysis of the Examples that currently appear in the EM (refer Appendix A) also highlights instances (eg bad debts, building amortisation deductions and foreign currency gains and losses) where the current scope of the deeming rules in subsection 701-55(6) is unclear. Moreover, our teleconference discussions on the operation of these deeming rules in the context of investment allowance (eg the joining entity has previously acquired new equipment and claimed an investment allowance deduction in respect of pre-joining expenditure) highlighted:

- uncertainty as to whether the tax outcomes in respect of the interaction of subsection 701-55(6) and Division 41 would in fact achieve the tax policy outcome of not duplicating investment allowance deductions and
- also highlighted an underlying principle issue, namely, the other deeming provisions in subsections 701-55(2)-(5B) are presumably to be switched on when applying subsection 701-55(6) to :
    - a provision not mentioned in subsections 701-55(2)-(5B) but nevertheless
    - that provision applies by reference to tax costs, outgoings, expenditure, etc that have been reset under subsections 701-55(2)-(5B).

We would again submit that specific legislative guidance clarifying the principles to be used in the interaction of subsection 701-55(6) with bad debts, building amortisation deductions, foreign currency gains and losses, investment allowance and the other subsections of section 701-55 is warranted.

Foreign currency trade receivables

It is also worth noting a number of specific observations concerning the interaction of Division 775 and the transitional and ongoing application of subsection 701-55(6) to foreign currency trade receivables.

If we assume Division 775 did apply to the fact pattern outlined in Example 1.11 in the EM then the analysis appears to be:

- Subsection 775-45(1)(b)(i) deems a forex realisation event 2 to occur in respect of the cessation of a right that represents ordinary income (pursuant to the application of the entry history rule).
- The forex cost base of the right is to be worked out at the tax recognition time. The tax recognition time appears to be at the time the income is derived (subsection 775-45(7) item 1(a)) which is 1 May 2003.
- [NB. It does not appear that the deeming under subsection 701-55(6) would extend to changing the derivation date of the income but it might be sufficient if we were dealing with the incurrence date of an expense.]
- The forex cost base of the right at 1 May 2003 pursuant to section 775-85(b) is presumed to be the market value of the trading stock (US$80). Further pursuant to section 960-50 item 11A we presume it is translated to AUD at the exchange rate applicable on 1 May 2003 (A$100).
- [NB. It *might* be the case that subsection 701-55(6) does now operate to deem the amount to be $106.67]
- The amount received on settlement of the debt on 30 November 2003 is A$100 which falls short of $106.67 pursuant to subsection 775-45(4).
- The question now arises whether some or all of this shortfall is attributable to a currency exchange rate effect as worked out under section 775-105 which asks you to work out the effect by applying the section 960-50 translation rules.
- However, it is not clear when the relevant time period begins (eg 1 May vs 1 July). It would appear that the tax policy is for the period to be from 1 July to 30 November based on Example 1.11 (albeit query whether pursuant to proposed underlying principle all forex history is inherited from 1 May).

In our view, it would be beneficial for subsection 701-55(6) to expressly clarify how it interacts with Division 775. This additional deeming rule should be tested against other foreign denominated assets and any other applicable Division 775 forex realisation events.

In connection with the transitional rule for foreign currency trade receivables, whilst this is intended to be a ‘no disadvantage’ rule for those taxpayers that have attempted to comply with withdrawn TD 2004/D80, a number of possible interpretations arising from this withdrawn TD could have been adopted.

Whilst we welcome the attempt to introduce a ‘no disadvantage’ rule we believe, such a transitional rule for subsection 701-55(6) should not be retrospective on a mandatory basis.

B1.2.2 EM improvements

The Examples in the EM are welcome and will ultimately assist in applying the law. In the table contained in Appendix A, we have set out a number of observations where we feel the commentary and conclusions reached in the Examples could be clarified.

B1.2.3 Follow-up discussions

The Joint Bodies’ submission of 13 December 2007 strongly recommended a joint design team approach on a tripartite basis between the Treasury, the ATO and industry to ensure clarity of the tax outcomes.

As canvassed in our earlier discussions, we are of the view that this tri-partite approach in considering the final revisions to the ED and EM is essential, particularly in interpreting subsection 701-55(6) and determining the final content and examples in the EM.. We submit that subsequent to the receipt of this submission, a tri-partite meeting should be organised between Treasury, ATO officials and industry to reach a consensus on the operation of subsection 701-55(6), the EM content and to agree any further ATO interpretative products.

B1.3 Date of effect

We support the suggested application date of the proposed amendment, being a retrospective application date of 1 July 2002. However, please note our comments above concerning the transitional rules.

B2 GROUP CONVERSIONS

B2.1 Summary of submission

As set out in our submission of 13 December 2007, these measures are a welcome development. We specifically agree with paragraph 1.32 of the draft EM which observes that the cessation of an old group and a new group coming into existence when a group conversion occurs can result in significant, inappropriate tax consequences.

We do, however, consider that the provisions contained within the ED to overcome these inappropriate tax consequences require significant clarification and expansion. We also consider that the effective date of enactment of the provisions must be 1 July 2002, subject to certain exceptions. Our key recommendations are as follows.

B2.1.1 Date of effect

The group conversion measures (absent the “integrity measures”) should apply with effect from 1 July 2002. This is required given the EM itself states that the application of the currently enacted law may result in “significant” and “inappropriate” consequences when a group conversion occurs.

However, taxpayers should be able to elect out of retrospective application of these measures, given they may have filed returns in the interim period based upon the law as currently enacted.

Furthermore, the integrity measures contained within the proposed law should apply prospectively only, given taxpayers could not have anticipated the extensive nature of these measures from the former Minister’s Press Release of 26 October 2006 in respect of group conversions. It is submitted therefore that the integrity measures apply only from the date of release of this ED. Refer to section B2.3 of this submission.

B2.1.2 Minimal tax consequences versus seamless transition

The former Minister’s Press Release provided that the conversion from a MEC Group to a consolidated group and vice versa would be “seamless” subject to the application of certain (but not announced) integrity measures. Whilst attempting to achieve this outcome without stopping a deconsolidation of one group and the formation of a new group, the ED requires clarification and expansion in relation to which provisions are actually “switched on or off”.

Division 705 and Division 711 – entry and exit calculations

For the avoidance of doubt, a specific comment should be inserted that the effect of subsection 719-130(5)(b) is to not apply Division 705 and Division 711 to ongoing members of the group, at least by way of a note to the provision. This should also be explicitly stated in the EM (ie, through expansion of the comments contained at paragraphs 1.41 and 1.42). Refer to section B2.2.1.

Carve out of “CGT L Event Provisions” – amendment to subsection 709-130(5)

For the avoidance of doubt, subsection 719-130(5) should be amended to extend to all applicable “CGT L event” provisions. Refer to section B2.2.1 of this submission.

B2.1.3 Subdivision 707-A – loss transfer testing

A specific provision (or at least a legislative note) should be inserted for the avoidance of doubt that the effect of subsections 719-130(1) and (5)(b) is that the provisions in Subdivision 707-A do not apply so as to otherwise require losses of the former head company to be tested before being able to be transferred to itself as the head company of the new group. Refer to section B2.2.2 of this submission.

B2.1.4 Exception for transfer-up of former subsidiary member to become an ET1

On the basis that this measure was not previously announced, we submit that it should not have application to transactions undertaken any earlier than at least the date that the ED was released and certainly not from 27 October 2006. Furthermore, we consider that there is lack of clarity in relation to the extent that the ongoing consolidation provisions are to continue to apply at the time the former subsidiary member leaves the consolidated group. Refer to section B2.2.3 of this submission.

B2.1.5 Application of integrity rules

The intended application of various integrity rules is not clear in the ED. Set out below are our recommendations in respect of clarifying the intended application of such rules.

Integrity rules set out in paragraphs 1.45 and 1.47 of the EM

If it is intended that the integrity rules that will continue to apply when a MEC group is created from a consolidated group (listed at paragraph 1.45 of the EM) and when a consolidated group is created from a MEC group (at paragraph 1.47 of the EM) are to be applied on the change of a status of a group because they apply other than because an ongoing member joins or leaves the group, it would be preferable if the legislation made that explicitly clear. It is not currently clear that the legislation achieves these outcomes. Refer to section B2.2.4 of this submission.

Loss integrity rules – Subdivisions 165-CC and 165-CD

We recommend that a full review of the interaction of proposed Subdivision 719-BA with the loss integrity rules in Subdivision 165-CC and Subdivision 165-CD be undertaken. In particular, there needs to be adequate clarification as to how the modifications of those integrity rules would apply when a group changes its status. Refer to section B2.2.4 of this submission.

B2.1.6 Impact of a group conversion on tax sharing agreements

We seek clarification as to whether a group conversion would have an impact on tax sharing agreements and the application of the provisions in Division 721. Refer to section B2.2.5 of this submission.

B2.1.7 Additional policy considerations

“Savings Provisions” – non-application of section 719-280

In the case of a conversion of a MEC group to a consolidated group, consideration should be given to allowing the “savings provisions” within subsections 165-12(7) and 165-123(7) to have application so as to not apply the outright failure of the “continuity of ownership test” as provided by section 719-280. Refer to section B2.2.6 of this submission.

Seamless conversion and group losses

We recommend that Treasury extend the circumstances in which groups can be formed via a seamless transition with no leaving or joining consequences. Furthermore, we submit that group losses should not become subject to available fraction limitation on special conversion event or on expansion of a MEC group by the addition of a new eligible tier-1 company. Refer to section B2.2.6 of this submission.

B2.1.8 Explanatory Material requires examples

The group conversion provisions are complex. To assist in the interpretation of these provisions, we recommend that the EM be expanded to include examples setting out the effect of the measures in the case of a consolidated group becoming a MEC group, a MEC group becoming a consolidated group and also to highlight the exception which would apply when a MEC group was created following a transfer up of a former subsidiary member of a consolidated group.

B2.1.9 Recommended modification to the provision

We submit that these ambiguities (including those noted at item 3 below) may have been dealt with in a simpler way by simply ensuring that the legislation applied by preventing the former group from ceasing to exist in conversion cases.

B2.2 Detail of submission

B2.2.1 Minimal tax consequences versus seamless transition

Division 705 and Division 711 – entry and exit calculations

The ED operates on the basis that there is still a cessation of a consolidated or MEC group (which results in deconsolidation) and a reformation of a new MEC or consolidated group, as relevant. The proposals simply switch off the consolidation provisions that are relevant when an entity becomes or ceases to be a member of a consolidated group or MEC group to the extent that the member is an ongoing member of both groups (subsections 719-130(1) and (3)) and ensures there is retention of the history of the head company of the old group (section 719-125).

In this respect, subject to one exception, we consider that the proposed legislation operates suitably to ensure that an exit allocable cost amount (ACA) calculation (Division 711) does not need to be performed in relation to the former members of the consolidated or MEC group which continue to be members of the newly formed group following the change in its status, and that an entry ACA calculation (Division 705) does not need to be performed for those former members of the group that join the newly formed group (by the operation of subsection 719-130(5)(b)). The one exception (which we see as an “integrity measure”) is the application of subsection 719-130(4)(c) which applies when an entity ceases to be a member of a consolidated group and becomes an eligible tier-1 company of the newly formed MEC group (discussed below at section B2.2.3).

For the sake of assisting taxpayers in understanding the effect of the new rules, we recommend that there be a specific comment that the effect of subsection 719-130(5)(b) is to not apply Division 705 and Division 711 for the applicable ongoing members of the group, at least by way of a note to the provision and in the EM (ie through expanding the comments at paragraphs 1.41 and 1.42).

We agree with the need to include a rule (section 719-135) to ensure that there can be appropriate application of Subdivision 719-K in cases where a consolidated group is formed from a MEC group.

Carve out of “CGT L Event Provisions” – amendment to subsection 709-130(5)

We have a concern that there may be scope for the consequential CGT events which can arise when an entity joins or leaves a consolidated group to continue to apply.

Where a conversion event occurs, Part 3-90 is taken not to apply when an ongoing entity ceases or becomes a member of a consolidated group or MEC group (subsection 719-130(5)(b)). However, we question whether the drafting of the provisions goes far enough to also switch off the relevant CGT events that could apply when a subsidiary member joins or leaves a consolidated group.

For the avoidance of doubt, we recommend that subsection 719-130(5) be amended to extend to all applicable “CGT L event” provisions, for example, CGT event L1, L2, L3, L4 and L5. In particular, most taxpayers were expecting to see a specific carve-out from CGT event

L5 which can potentially apply when a subsidiary member leaves a group and would at least like to see that specifically stated.

B2.2.2 Subdivision 707-A – loss transfer testing

The announcement by the then Minister for Revenue made it clear that when a change in the type of consolidated group occurs losses of the ongoing group will not be tested upon conversion. Although we acknowledge that proposed subsections 719-130(1) and (5)(b) can be interpreted as ensuring that the provisions in Subdivision 707-A do not apply so as to otherwise require the losses (including group losses) of the former head company to be tested before being able to be transferred to itself as the head company of the newly formed group, we would recommend for the avoidance of doubt that this be made explicitly clear in the legislation.

In the context of a special conversion event, a number of complexities emerge in relation to the effect of the proposed measures in dealing with losses (group and previously transferred losses) of the former group. These complexities arise in understanding the intention of whether and if so, how, the existing rules within Subdivision 719-F apply and in the event that all or some losses are to be transferred to the head company (in accordance with Subdivision 707-A) of the newly formed MEC group. Refer to our comments under section B2.2.4 below in relation to the application of Subdivision 719-F in relation to MEC groups for further details.

B2.2.3 Distinguishing between consolidated group converting to a MEC group, and MEC group expansion by way of new eligible tier-1 company

In cases where a MEC group is created by a special conversion event, other than where the special conversion event happens because an existing member of the consolidated group is transferred up to become an eligible tier-1 company of the newly formed MEC group, the issues as raised above remain relevant considerations insofar as the application of the provisions to the head company of the former consolidated group and newly formed MEC group. We appreciate that the intent of the provisions is to ensure that there is no “joining” or “leaving” implications on the change in status for those entities, including the head company, that are members of both groups immediately before and immediately upon formation of the MEC group.

However, there are certain issues which need to be addressed and which this ED highlights as requiring further consideration and resolution, particularly in relation to the expansion of an existing MEC group following the inclusion of a new eligible tier-1 company in the group (which we accept is not a conversion event subject to the new rules).

Transfer up of an existing member of a consolidated group

We understand that the proposed Subdivision 719-BA will only apply to a special conversion event in relation to the ongoing members of the groups. However, a special rule is proposed to apply to ensure that consolidation provisions which apply when an entity ceases to be a member of a consolidated group continue to apply (subsection 719-130(4)) when a MEC group is formed out of a consolidated group in cases where the former subsidiary member of the consolidated group becomes an eligible tier-1 company of the newly formed MEC group (“transfer-up” scenario). We have specific concerns about the effect of this exception.

Firstly, if it is intended the exception is intended to apply only to the transferred-up entity that becomes the new eligible tier-1 company of the newly formed MEC group, then subsection 719-130(4) needs to specifically state that subsection 719-130(3) is switched off for only the entity that is being transferred up, not the remaining ongoing members (including the head company) of the consolidated group that form part of the MEC group, nor any subsidiary members that were owned by the entity that becomes the eligible tier-1 company of the newly formed MEC group (ie linked entities).

More generally, it would seem that the effect of subsection 719-130(4) is that provisions governing an exit ACA calculation (and associated notification requirements) from the former consolidated group will continue to be invoked.

In particular, it would seem to be the case that the consequences that could emerge on the transfer-up scenario which triggers the change in status of a consolidated group to a MEC group is that:

- Division 711 (exit calculations) will be required to be performed for at least the transferred-up entity (but note our earlier concerns)
- CGT event A1 will arise for the former consolidated group on the disposal of the membership interests to the non-group member
- CGT event L5 can apply in relation to the transferred-up entity
- To the extent that a capital gain arises to the former group from the transfer up, Subdivision 126-B CGT rollover relief may be available (provided that the relevant membership interests are taxable Australian property)
- The cost of the membership interests to the acquiring non-resident entity will reflect the cost base worked out in accordance with the normal CGT provisions (subject to the application of the MEC pooling rules (Subdivision 719-K) at the time of a subsequent event)
- Division 705 will not apply to the transferred-up entity (and any of its subsidiaries) which joins the newly formed MEC group (due to the application of subsections 719-130(1) and (5))

As you are no doubt aware, the transfer-up scenario can also happen when a subsidiary member of an existing MEC group is transferred up to become an eligible tier-1 company of the same MEC group and for which the provisional head company of the MEC group chooses to expand the group (under subsection 719-5(4)). In this scenario, it is clear that there can be no cessation of the MEC group or change in its status as a MEC group.

In reviewing the tax consequences emerging on that transaction, the ATO had issued a discussion paper in November 2006 where it was conceding the possibility that in the case of a MEC group expansion undertaken by way of a transfer up of an existing subsidiary member, the new eligible tier-1 company does not leave or join the group. However, this paper also flagged that there would still be CGT issues for the group on the transfer of the membership interests to the non-group member, and without the benefit of having a tax cost setting amount determined for such interests.

Although we do not necessarily perceive any inconsistency between subsection 719-130(4) and the ATO's discussion paper, there is however a passing comment in paragraph 1.43 of the EM, which suggests that Division 711 could apply to both types of the transfers-up. It is submitted that clarification should be made in the EM to limit those comments only in a group conversion context and that it does not affect the operation of the existing law to a transfer up within an existing MEC group. (We would suggest however, that the outcomes of this ED act as a suitable prompt to have the matters raised in the ATO's discussion paper dealt with.)

We also seek confirmation that in the transfer-up scenario, subsection 719-300(4) or (5) would continue to apply so as to limit the application of sections 719-300 to 719-325 which affect group losses and other originally transferred losses. Specifically, the comment at paragraph 1.45 of the EM should not have any application in cases where subsection 719-300(5) applies because the transferred-up entity that becomes the eligible tier-1 company was a subsidiary member of the consolidated group prior to the special conversion event. There needs to be clarification that proposed Subdivision 719-BA does not affect the application of any exceptions contained in section 719-300. Our comments previously around the re-testing of losses under Subdivision 707-A more generally are also applicable in this case.

Application of Subdivision 707-C

We consider that the comments in paragraph 1.45 of the EM indicating that item 4 of the table in subsection 707-320(2) will continue to apply when a MEC group is created from a consolidated group in the transfer-up scenario need to be put into the context of whether or not there is in fact an appropriate injection of capital or non-arm's length transaction which has the effect of increasing the market value of the group.

In addition, we draw to your attention that the statement is inconsistent with the views previously expressed by the ATO in its notice of withdrawal of draft Taxation Determination TD 2005/D46.

If it is the intention that item 4 of the table in subsection 707-320(2) is to apply on the transfer-up scenario, then this should be expressly stated in the legislation as we are not certain that this would always be the outcome.

Ongoing application of Subdivision 719-F for bundles of losses

As noted earlier, a number of complexities emerge in applying the rules in Subdivision 719-F which modify the rules for a MEC group when applying the continuity of ownership test following the conversion and also in relation to requiring bundles of losses to be subject to an available fraction or a modified available fraction.

Firstly, in the context of the COT test modifications, appropriate consideration needs to be given to the identification of the company that would be considered to be the test company (section 719-265) – this will depend upon whether or not losses of the former consolidated group are transferred to the head company of the MEC group at the time of the conversion. In addition, this will also affect the appropriate time for the purposes of testing the continuity of ownership in the context of section 719-275.

Secondly, it is disappointing that the ED proposes no changes to limit the application of the provisions in Subdivision 719-F (sections 719-300 to 719-325 inclusive) which convert prior year group losses into transferred losses when a MEC group forms by way of a special conversion event. In fact, the EM clearly states that this is intended to occur when a MEC group is created when a new eligible tier-1 company joins and invokes a special conversion event (paragraph 1.45) (refer to section B5 for further discussion).

As previously mentioned, there needs to be acknowledgement that subsection 719-300(4) or (5) could apply to prevent the application of those rules when a special conversion event occurs on the transfer-up of a subsidiary member of a consolidated group.

B2.2.4 Integrity rules

Integrity rules set out in paragraphs 1.45 and 1.47 of EM

There is uncertainty in relation to whether the comments in the EM as to the provisions ("integrity rules") that will continue to apply when a MEC group is created from a consolidated group (at paragraph 1.45) and when a consolidated group is created from a MEC group (at paragraph 1.47) are actually reflected by the provisions as drafted. The provisions which are listed in those paragraphs as having ongoing application are stated to not be affected by section 719-130 because they are not triggered by an on-going member joining or leaving the relevant group that changes its status. We are not so certain that this can be argued as always being the case.

If it is intended that these "integrity rules" are to be applied on the change of status of a group, insofar as they affect the ongoing head company of the group, it would be preferable if the legislation made that explicitly clear so that there can be no argument that the provisions apply not because an on-going member joins or leaves the group.

Loss integrity rules – Subdivisions 165-CC and 165-CD

Noting the comment in the EM (paragraph 1.45) in respect of the application of the loss integrity rules in Subdivision 165-CC and Subdivision 165-CD, that the normal provisions would continue to apply so as to set the reference time for the head company of a MEC group that converted from a consolidated group, we would like specific clarification as to what that reference time would be based on (i.e, the time that the new group was formed) (refer section 719-900 and section 719-720).

In addition, we would suggest that a full review of the potential interaction of Subdivision 719-BA with the loss integrity rules in Subdivision 165-CC (eg identification of 165-CC tagged assets) and Subdivision 165-CD be undertaken to ensure that appropriate outcomes arise, including in the case of where a MEC group becomes a consolidated group (noting the comments in paragraph 1.47 of the EM).

B2.2.5 Impact of a group conversion on tax sharing agreements

We seek clarification as to whether a group conversion would have an impact on tax sharing agreements and the application of the provisions in Division 721.

In particular, the ED simply provides that when Subdivision 719-BA applies, the head company of the new group will retain the history of the head company of the old group. It is submitted that this alone may not be sufficient to prevent triggering ‘clear exit’ payments obligations for all group members at the conversion time. In the transfer-up scenario which is subject to the exception in subsection 719-130(4), the transferred-up entity will still be taken to have left the former group, which will invoke the application of the clear exit rules.

In addition, consideration needs to be given to whether from a practical perspective, it would be expected that a new tax sharing agreement would need to be entered into, or whether the ongoing members of the group would be covered by the former tax sharing agreement.

For the purposes of Division 721, it is not entirely clear whether the group tax liability of the new group can continue to be covered by the tax sharing agreement of the old group after the conversion time. Even if an old tax sharing agreement still functions for Division 721 purposes after the conversion, the actual wording of the agreement may not permit its continued application. This is because Subdivision 719-BA operates on the basis that the old group still ceases to exist at the conversion time, and the relevant contributing entities may also cease to be legally bound by the agreement at the conversion time. It is therefore quite possible in practice that the new group will need to amend the old group’s tax sharing agreement to ensure its continued application. However, unless these amendments are effected at the conversion time, there will possibly be a gap period in which the new group is not covered by a valid tax sharing agreement.

B2.2.6 Additional policy matters

“Savings Provisions” – non-application of section 719-280

To the extent that the rules will continue to apply so as to treat the MEC group as ceasing to exist and that the consequences as outlined in the EM at paragraph 1.47 are to continue to have application on the basis that section 719-130 does not affect the operation of those provisions, we would like to raise a matter of policy in the context of the COT test modifications in sections 719-280 and 719-465.

Although we acknowledge the current application of the law to deem a failure of the COT test (subsections 719-280(2) and (4)) when the MEC group ceases to exist, we request that consideration be given to allowing the “savings provisions” within subsections 165-12(7) and 165-123(7) to have application so as to not apply the effect of section 719-280 which simply deems the company to fail to meet the conditions in section 165-12. There may be instances in which the MEC group ceases to exist but with ongoing continuity of ownership following a restructure where a consolidated group is formed out of the MEC group.

Extend the circumstances in which groups can be formed via a seamless transition

Although we acknowledge that this is beyond the scope of the issues under consideration in the current ED we reiterate our comments made in our submission of 13 December 2007 that consideration should be given to allowing the following circumstances to be treated as a seamless transition with no leaving or joining consequences:

- a single entity acquiring a consolidated group and forming a new consolidated group on the acquisition date
- a selective buy-back or share cancellation on the part of the joining group, which leaves the joined group as the only entity holding membership interests in the joining group
- the migration to Australia of an interposed non-resident holding company that is a 100% subsidiary of the joined group, and
- certain indirect acquisitions which result in an existing consolidated group joining another consolidated group.

It would be expected that if the above were accepted, the broad approach adopted by new Subdivision 719-BA would form a useful basis to achieve seamless outcomes. We would welcome the opportunity to further discuss this proposal.

Group losses should not become subject to available fraction

We acknowledge that the proposed amendments to be made by Part 2 of the ED only have application when a consolidated or MEC group changes its status and does not apply to deal with instances in which a MEC group might expand by way of the addition of a new eligible tier-1 company (in accordance with subsection 719-5(4)). However, we consider that this is an opportune time to revisit the policy behind the operation of these rules within Subdivision 719-F, not only in relation to its application on a special conversion event, but also on the expansion of a MEC group by the addition of a new eligible tier-1 company.

Broadly, sections 719-300 to 719-325 apply where a new eligible tier-1 company joins a MEC group, or the MEC group comes into existence because it has converted from being a consolidated group, to provide that an available fraction must be calculated for "prior group losses" incurred in each of the years preceding the formation of the MEC group. This results in an available fraction being assigned to the prior group losses, which would otherwise have been able to be used without restriction. In addition, the available fraction (for the prior group losses now deemed to be transferred losses) is subject to subsequent adjustments for, among others, capital injections or a future acquisition of a subsidiary or group with losses (refer to the table in subsection 707-320(2)), or when a new eligible tier-1 company is introduced to expand the MEC group (on reapplication of the relevant rules in sections 719-300 to 719-325 inclusive).

The Explanatory Memorandum (EM) to the *New Business Tax System (Consolidation and Other Measures) Act (No 1) 2002* explains at paragraph 3.75 that when a new eligible tier-1 company joins the MEC group or a MEC group is created through a special conversion event, this increases the group's income generating capacity and reduces the proportion of the group's income that the original loss entity (or the MEC group before its expansion) could now be regarded as generating. For this reason when a new eligible tier-1 company joins a MEC group or when a special conversion event occurs, the available fraction for transferred losses is reduced and prior group losses are deemed to be transferred losses and are given an available fraction.

This cited *policy* reason is inconsistent and inequitable on the basis that when an ordinary consolidated group expands by acquiring another consolidated group or subsidiary with losses, the joined group's losses incurred post-formation of the tax consolidated group do not lose their status as group losses and do not become deemed transferred losses (and subject to a loss available fraction restriction), whilst a MEC group expanding via the addition or acquisition of an eligible tier-1 company (which could be a shelf company), does give rise to unfavourable implications.

It is difficult to accept the argument that the MEC group rules are needed because the market value (as a proxy for "income generating capacity") of the expanded MEC group increases when it acquires an eligible tier-1 company, whereas the market value of an ordinary consolidated group acquiring a target company does not increase because of the presumption perhaps *that* debt funding is used to finance the acquisition. There are many instances where the acquisition of a target by an ordinary consolidated group may not have been financed by debt (but by equity), which means that the market value/income generating capacity of the ordinary consolidated group would increase on acquisition of the target. Yet, there is no provision which seeks to restrict the use of group losses in that instance. The distinction between ordinary consolidated groups and MEC groups is unwarranted, particularly because in the MEC group case, both group losses as well as transferred losses are impacted, whilst group losses remain untainted in the ordinary consolidated group acquisition scenario.

In light of the *intent* of ensuring that consolidated group restructures can occur seamlessly, it would make sense that the provisions in sections 719-300 to 719-325 be reviewed and the provisions which convert group losses into transferred losses be repealed, as part of the amending legislation to enact the group conversion measures.

B2.3 Date of effect

B2.3.1 Summary of submission

It is currently proposed that the measures apply to conversion events that happen on and after 27 October 2006, being the date of announcement of this measure. Whilst this is consistent with the Press Release of the then Minister for Revenue and Assistant Treasurer, the Press Release also referred to a “seamless” transition for conversions.

Given the acknowledgement in the EM that the consequences of a group conversion can be both “significant” and “inappropriate”, and to allow a seamless transition for all taxpayers who are affected, it is submitted that the changes should be retrospective to 1 July 2002. Furthermore, given the fact that most of the measures included in the ED are stated to apply from 1 July 2002 we can see no material reason why this measure has not also been made retrospective to 1 July 2002. Listed below are our reasons and observations on why this is considered necessary:

The policy intent of the tax consolidation regime

The clear policy intent of the tax consolidation regime, as stated in the Explanatory Memorandum to the first consolidation provisions introduced into Australian taxation law, is to treat a group as a single entity for income tax purposes, with the subsidiary entities losing their individual taxation identities and instead being treated as parts of the head company of the consolidated group for the purpose of determining the income tax liability during the period which are they are members of the group. Furthermore, a key feature of the new law set out in the Explanatory Memorandum was that all intra-group transactions are ignored.

It is clear that during the period from 1 July 2002 to the proposed date of effect of these changes, being 27 October 2006, that the policy intent has not been achieved in respect of groups subject to a conversion.

It is recommended that the date of effect of the changes in respect of group conversions is 1 July 2002 such that the proper policy intent of the consolidation regime is achieved.

We are aware of at least one international group for which a wholly internal restructure has adversely affected their tax position, which is against the original policy intent of the consolidation regime.

The arbitrary nature of the current date of effect of the changes

As noted in our submission of 13 December 2007, the tax consolidation regime is a uniquely wide-ranging package of tax legislation, which in essence rewrites the entire income tax regime in relation to companies which are in consolidated groups or which are acquired or sold by consolidated groups. There was an absence of comprehensive legislation enacted as at 1 July 2002 and where amending acts are not effective from 1 July 2002 there will be inequitable outcomes to taxpayers who engage in transactions where the legislation is not comprehensive and results in unintended and inappropriate outcomes.

The proposed start date of 27 October 2006 for this measure is an arbitrary date following the date on which the former Minister made the announcement and to our knowledge there is no policy or integrity issue which would result in this date being necessary to protect the revenue. On this basis, it is recommended that the measure should be enacted with effect from 1 July 2002.

Reputational issues for the Australian taxation system

Group conversion events impact multi-national taxpayers. The application of “inappropriate” tax law to such taxpayers for an extended period of time, particularly when acknowledged by the Government in subsequent law changes, will result in the Australian taxation regime appearing draconian to foreign parent companies of Australian taxpayers who may be affected by the failure to rectify the law on group conversions from the inception of the consolidation regime. This will particularly be the case for those taxpayers who are deemed to derive a capital gain as a result of a CGT event associated with the conversion.

The characterisation of the Australian taxation system as draconian can act as a significant deterrent to multi-national taxpayers considering doing business in Australia. The Australian tax system already has an international reputation for being complex. Measures such as this do not assist where acknowledged inappropriate outcomes are not rectified from inception.

No reason not to change the date to 1 July 2002

We can see no valid policy or technical reason why this measure should not apply from 1 July 2002. To do otherwise would represent only a partial rectification of the law.

It may be that the Government feels that some taxpayers may have already accepted and applied the existing law and could be prejudiced if the law were to be changed. This can however be easily catered for through an exception to the 1 July 2002 start.

B2.3.2 Exceptions to 1 July 2002 start date

We recommend that there be two exceptions to having the measures commence with effect from 1 July 2002 as follows:

Optional full election out of 1 July 2002 start date

It is also our recommendation that groups are able to elect out of the proposed earlier 1 July 2002 start date. This is on the basis that some groups may have applied the taxation law as currently enacted when a conversion occurred. Tax returns may have been lodged on the basis of the outcomes determined based on the application of the law. It would be inappropriate for these taxpayers to be required to amend lodged income tax returns, unless they elect to do so.

Application of integrity measures

We have concerns around the fact that taxpayers had no knowledge of the extent of the “integrity” measures which were stated to apply in the former Minister’s announcement until the ED was released.

The ED contains various integrity measures that will operate in conjunction with this measure. Despite our above comments that the measure should apply with effect from 1 July 2002, we submit that the start date for associated integrity measures should be no earlier than the date that the ED was released, ie 28 April 2009. The basis for this submission is as follows:

Lack of detail contained in the Press Release

The Press Release stated only that "aside from certain integrity measures, a group conversion will, in essence, be a seamless transition for the ongoing group". No detail of those "certain integrity measures" was provided.

The integrity measures included in the ED are extensive and could not have been anticipated by taxpayers based upon the content of the Press Release. This includes the exception for the transfer-up of a former subsidiary of a consolidated group which becomes an eligible tier-1 company of a newly formed MEC group (ie proposed subsection 719-130(4)) and the following measures which the EM suggests will continue to apply:

- subsection 707-320(2), in respect of the available fraction of a bundle of losses
- sections 709-300 and 719-325, in respect of treating group losses as transferred losses
- measures that deem the continuity of ownership test to be failed, and
- measures which deem a changeover time or alteration time and to set the refererence time when applying the loss integrity rules in Subdivisions 165-CC and 165-CD.

It is submitted that such measures should only have application on a prospective basis. This is consistent with normal government practice in respect of the introduction of integrity measures.

Principles of tax equity

There are important principles of tax equity to be considered in retrospectively enacting integrity measures. There is a need for taxation to be subject to the rule of law, and it is therefore problematical for retrospective changes to adversely impact taxpayers who have lawfully undertaken arrangements and filed tax returns based on the state of the legislation in force at a particular time. Where taxpayers' positions are reasonably arguable and consistent with the legislation at the time, we submit that the relevant taxpayers should not be exposed to retrospective legislative change.

B2.3.3 Date of effect of Item 9, subparagraph 709-65(3)(d)(i)

We understand that Treasury is aware and will amend the date of effect for Item 9 which amends subparagraph 709-65(3)(d)(i) so as to allow a new provisional head company to be appointed to certain MEC groups so that it applies with effect from 1 July 2002. This is consistent with paragraph 1.242 of the EM, but is not reflected in the ED.

B3 PRE-CGT PROPORTIONS

B3.1 Summary of submission

The change to the pre-CGT proportion calculation, determined by way of market values, is in line with our previous submissions. Accordingly, we support the changes to the calculation method to be contained in Division 705 (section 705-215).

However, we oppose applying the proposed Division 149 integrity provision to group formations happening before the release of the ED legislation without appropriate compensating adjustments. The effect of the Division 149 integrity provision is so significant that it would have effected whether a consolidated group chose to consolidate or not. Given a choice to consolidate is irrevocable, the imposition of this proposed integrity provision to group formations before the release of the ED would cause significant inequities, as highlighted in this submission. We recommend that Treasury either apply the integrity provisions from the date of releasing the ED, or alternatively provide a mechanism to remove the inequities caused by the current proposal.

We also highlight inappropriate results that may occur under the proposed CGT event K6 modifications. In particular these relate to the inappropriate results that occur when the single entity rule is turned off under the proposed modifications. We also highlight that this modification is inconsistent with the proposed extension of the single entity rule for the purpose of CGT event K6.

B3.2 Detail of submission

B3.2.1 Importance of pre-CGT protection

A significant concern of the SME market on transitioning into tax consolidation was the effect of consolidation on the status of pre-CGT shares and assets. Many submissions were made by professional bodies and firms to ensure the protection of pre-CGT interests. Certain provisions were included.

Those taxpayers that went into tax consolidation early (ie before the release of the ED) would have weighed up the law as it currently stood and would have made an irrevocable decision to enter tax consolidation (or not). The considerations at the time were:

- the pre-CGT factor almost in all cases resulted in a dilution of pre-CGT status
- consolidation offered the only opportunity for group concessions
- Division 149 provided a market value cost base for shares outside of tax consolidation where pre-CGT shares turned post-CGT
- while Division 149 did not apply in a consolidated context, taxpayers' interests and integrity were achieved by a balance between a diluted pre-CGT factor and the potential application of CGT even K6 on exit.

Knowledge of these issues was taken into account and irrevocable elections were made on this basis. While the amendments to the pre-CGT proportion favourably restore the proportion to what is should have been under the first draft of the consolidation legislation, the amendments to Division 149 are severely unfavourable to groups that chose to consolidate – to the extent that we have been informed that consolidated groups would not have chosen to form a tax consolidated group had they known of the Division 149 implications under tax consolidation.

This issue is explained further below by way of an example, however we re-iterate that the public release of this integrity provisions in an ED some seven years after raises significant concerns of inequity where consolidation choices are irrevocable. As proposed section 711-70 is also inconsistent with the policy of Division 149 (as also demonstrated below) Treasury must, as a matter of priority for SMEs, remove this inequity for those groups that have made an irrevocable choice to consolidate.

Our recommendations on how this could be done are also detailed below. We are of the view that Treasury should include one of these options in the final legislation.

B3.2.2 Policy intent of the integrity provisions

When Division 149 applies to any pre-CGT asset, it provides a market value substitution rule to ensure that taxpayers receive an equitable result on transitioning into the CGT provisions. That is, the CGT provisions will only tax gains that occur after Division 149 applies to the asset. For a non-public company, the market value rule is contained in section 149-35. CGT event K6 is an additional integrity provision that seeks to tax gains on pre-CGT shares to the extent attributable to gains on underlying post-CGT assets of the company. . These provisions were originally introduced via section 160ZZS and 160ZZT.

The proposed Division 149 integrity provision is not consistent with this policy intent behind these provisions.

Section 711-70 only provides one side of the operation of Division 149. It clears the pre-CGT proportion by reducing it to nil (ie turning the shares into post-CGT shares). However, section 711-70 is deficient as it does not have an equivalent to section 149-35. For the integrity rule to be consistent with Division 149, the provision requires an equivalent to section 149-35 to ensure that the provision operates in an equitable way.

B3.2.3 Comparison of consolidated outcome to a non-consolidated outcome

A very simple example can be used to demonstrate the inequitable outcomes that may occur under proposed section 711-70. Assume that a head company's interests in the joining entity (Aco) are all pre-CGT on 1 July 2002, and that the group formed a tax consolidated group. Assume that at a later date, a Division 149 event occurred to the head company, such that the proposed section 711-70 provision would operate. At that date, the balance sheet of Aco is as follows:

Assets	Terminating value	Market value
Post-CGT	$2 million	$6 million
Pre-CGT	-	$4 million
Total	**$2 million**	**$10 million**

If Aco were sold immediately after the trigger of the Division 149 event, the head company would realise a capital gain of $6 million, $4 million (given the market value uplift of the underlying pre-CGT asset to $4 million). However, if the group had chose not to consolidate, no capital gain or loss would have occurred on the sale of Aco. This is because of the market value uplift of the shares to $10 million and the non-application of CGT event K6 (due to the 75% threshold not being satisfied) would have resulted in no capital gain (ie as the pre-CGT property is not deemed to be post for the purpose of CGT event K6 – refer to TR 2004/18, para 15).

As demonstrated by the example, the proposed integrity provision is inconsistent with the purpose of Division 149, as the shares are deemed to be post-CGT but are not provided a market value uplift.

Furthermore, as demonstrated by the above example, had the group known of the proposed integrity rule, it would not have chosen to consolidate due to the inappropriate potential tax cost on $4 million. We note that this is a critical issue. Due to irrevocable elections to consolidate, we highlight that these proposed integrity provisions would be inappropriate if applied on a retrospective basis.

B3.2.4 Recommendations to restore policy intent

There are two basic ways in which section 711-70 could be introduced in a manner that would restore equity to taxpayers.

Date of application

Perhaps the easiest method, is to have section 711-70 apply to formations that occur after 28 April 2009. We do not believe that this will cause an inappropriate cost to the revenue, as the amendments to CGT event K6 will likely result in the collection of any amounts attributable to post-CGT underlying assets.

Interaction with Division 705

Alternatively, Treasury could provide taxpayers with an option to apply Division 705 as if there had been an acquisition of the shares in the entity affected. This measure would require an application of Division 711 and 705 simultaneously, but would not result in an exit and entry of the subsidiary member. The application of this proposed rule would automatically result in the application of section 705-57, acting as a protection mechanism. This alternative proposal is consistent with the intention of Division 149, as stated in the original EM to the provision.

We are of the view that at least one of these proposed alternatives needs to be incorporated into the provisions. We reiterate that we do not support the changes proposed by section 711-70 unless Treasury includes one of these options.

B3.2.5 Proposed CGT event K6 modification

Turning off the single entity rule for CGT event K6 purposes

The objectives of proposed subsections 711-70(2) and (3) in relation to the application of CGT event K6 are expressed in paragraph 1.71 of the EM. As such, the objective is that in applying CGT event K6 on the disposal of shares in a leaving entity, regard can be had to the tax status of shares in any underlying subsidiaries of the leaving entity that may otherwise be disregarded on application of the single entity rule.

However, totally ‘turning off’ the application of the single entity rule for CGT event K6 purposes is too dramatic and needs to be more targeted in order to avoid the following inappropriate and inequitable outcomes.

Prior intra-group transfers of pre-CGT assets

Prior to the leaving time, underlying pre-CGT assets (eg land) could have been transferred between members of the consolidated group. By virtue of the single entity rule, these transfers will not impact on the pre-CGT status of the transferred underlying assets.

Totally turning off the single entity rule for the purpose of the application of CGT event K6 could have the inequitable and inappropriate outcome that these earlier transfers of the underlying assets are now ‘seen’ in such a way that for CGT event K6 purposes these assets are taken to have a post-CGT status.

More broadly, similar issues/problems would also arise in respect of prior intra-group transfers of post-CGT assets. For example, in undertaking CGT event K6 calculations on the basis that the single entity rule had not applied, these assets would obtain an adjusted cost base for CGT event K6 calculation purposes based on the application of Divisions 110 and 112 at the time of the earlier intra-group transfer (eg their market value at the time of their intra-group transfer).

CGT status of intra-group shareholdings

When an entity leaves a group at a time when it also has underlying subsidiaries, the tax status of the intra-group shareholdings in these underlying subsidiaries should again be re-established using the proposed pre-CGT proportion rules. We would have also thought that the application of these rules in determining the CGT status of the underlying CGT shareholdings should also be recognised for the purposes of the application of CGT event K6 on disposal of the shares in a higher-level leaving entity. However, under the proposed draft provisions this will not be the case given the turning-off of the single entity rule in such circumstances. By virtue of paragraph 1.71 of the EM, surprisingly, this appears to be the intended outcome.

Such an outcome would be inequitable, in that if these lower-level intra-group shareholdings would have a pre-CGT status if directly disposed of, then they should also have a pre-CGT status in applying CGT event K6 at a higher level in the corporate chain. To do otherwise would be to further complicate and confuse divestments relevant to SME consolidated groups, with no apparent policy justification. It would also be at odds with the way CGT event K6 would have applied if the group had never elected to consolidate.

Technical amendment

Subsection 711-70(3)(b) makes a modification to CGT event K6 by changing “just before the other event happened” to “at the leaving time”. This amendment is inconsistent with other amendments to Division 711, which change the reference to “just before the leaving time”. To avoid issues similar to those in *Handbury Holdings Pty Ltd v Commissioner of Taxation [2008] FCA 1787*, we would recommend this minor technical amendment.

B3.2.6 Location of provisions within the Act

It is proposed that the mechanical provisions for determining a pre-CGT proportion remain in section 705-125 and hence within Subdivision 705-A.

While this may have previously been an appropriate location for these provisions in the context of determining pre-CGT factors because a ‘push-down’ type calculation was also required, this will no longer be the case.

In addition, the inclusion of these provisions in Subdivision 705-A may suggest to a non-technical user that they have no application to *chosen transitional entities* – which is certainly not the case.

Given that the pre-CGT proportion concept now only has relevance when an entity leaves the group (irrespective of whether, on entry, it was a stick or a spread entity), it is submitted that it would be more appropriate (and convenient) if all provisions relevant to pre-CGT proportions were corralled in or near section 711-65.

It would also be appropriate to include a note in section 705-65 that the ACA step 1 amount can include the cost base of a membership interest that is pre-CGT, while also noting that the pre-CGT status of this share may have some impact if and when that entity subsequently leaves the consolidated group.

B3.3 Date of effect

But for the recommendation relating to integrity measures contained in section B3.2.4 of this submission, we agree that the amendments should otherwise have an application date of 1 July 2002.

B4 NO DOUBLE COUNTING OF AMOUNTS IN ACA

B4.1 Summary of submission

We support the broad objectives of proposed section 705-62 that the one economic impact should not be taken into account more than once in the ACA calculations. However, we believe that the aspects contained below should be clarified/addressed in these provisions prior to their enactment.

B4.2 Detail of submission

B4.2.1 Consistently recognising that there can be multiple ACA impacts

The operative provisions of proposed subsection 705-62(2) recognise that '2 or more provisions' can alter the ACA in relation to a particular economic attribute of a joining entity. However, somewhat confusingly the object provision in proposed subsection 705-62(1) states that this provision is intended to prevent 'a particular amount from being taken into account twice in calculating the ACA'.

It is submitted that the object's clause, consistent with proposed subsection 705-62(2), should recognise that in some cases the one economic attribute can have '2 or more' ACA impacts. While this is potentially an uncommon event, it can occur and therefore subsection 705-62(1) should be amended accordingly. For example, this is recognised in paragraph 1.79 of the draft EM, where potentially 3 ACA impacts can arise in respect of losses incurred by the joining entity.

B4.2.2 Clarifying the concept of 'altering the ACA'

The section states that it applies to an amount that is counted more than twice. It is suggested that the reference to "twice" in subsection 705-62(1) be changed to "more than once". The proposed EM clarifies that these measures are designed to address the potential duplication (perhaps better referred to as 'multiplication' given the above comments) of an economic attribute on the ACA, whereas the actual provisions refer to an amount being 'taken into account twice in calculating the ACA' or '2 or more provisions of the Act operating with the result of altering' the ACA.

Potentially, the wording of the proposed provisions has a broader impact than stated in the proposed EM. For example, an economic liability of a joining entity can in effect be taken into account twice in the ACA calculation, hence potentially triggering the provisions as currently worded; whereas these impacts net each other off rather than causing duplication. The liability will reduce the market value of the shares in the joining entity and hence the ACA step 1 amount, but these liabilities will also increase the ACA step 2 amount.

Therefore, it is submitted that in line with the draft EM, the actual legislative provisions should confirm that their target is multiplication of ACA impacts rather than just being taken into account more than once in the ACA calculations.

B4.2.3 Only the most 'appropriate' ACA impact continues to apply

Proposed subsection 705-62(3) states that 'only the alteration that is most appropriate (in the light of the objects of this subsection) is to be made'. The draft EM, in paragraph 1.85, states that 'the question as to which alteration is most appropriate is a matter of judgement for the head company of a consolidated group'. A similar statement is also included in Example 1.14.

It is submitted that to avoid any uncertainty in this regard, proposed section 705-62 should confirm that it is for the head company to determine which ACA impact is the most appropriate to be included in the final ACA amount.

B4.2.4 Definition of ‘economic attributes’

It has generally been accepted that the ATO’s attempt to address ACA double counting in the context of profits accruing in an underlying subsidiary of the joining entity (as dealt with in TD 2004/53) was somewhat of an interpretational ‘stretch’ in order to arrive at an appropriate tax outcome.

Arguably, in the circumstances addressed in this TD, the proposed provisions of section 705-62 would not offer support to address this double taxation issue, given the proposed definition of ‘economic attributes’ contained in subsection (4). As such, we recommend that further consideration be given to this particular definition.

B4.2.5 Examples

We believe that it would be of great assistance to those reading the provision if some examples were included in the EM of the kinds of double counting which might be expected to arise in calculating the allocable cost amount for a joining entity. In particular, useful examples would include the section 705-75 / 705-80 interaction in respect of deductible liabilities and double counting involving two subsidiary members of the same consolidated group.

B4.3 Date of effect

We agree that the proposed amendment to be contained in section 705-62 should have an application date of 1 July 2002.

B5 PRE-JOINING TIME ROLLOVERS

B5.1 Summary of submission

We have concerns in relation to a number of the proposed amendments that have a retrospective application date to 1 July 2002. We disagree with Treasury that these amendments restore the policy intent of the provisions, as the wording of existing section 705-93 clearly achieves the policy intent outlined in the Explanatory Memorandum to the Bill which introduced that section. The proposed amendments extend the operation of section 705-93 and clearly extend the policy intent of Step 3A. Accordingly, the amendments should not be retrospective to 1 July 2002.

Furthermore, as the amendments effect irrevocable choices to consolidate and irrevocable choices to use ‘stick’ versus ‘spread’, the retrospective application date for the extended Step 3A provision is clearly inappropriate.

B5.2 Detail of submission

As correctly highlighted in paragraph 1.88 of the EM, Treasury has relatively recently come to the conclusion that Step 3A is deficient as it does not apply to circumstances where Treasury considers it to be warranted. Accordingly, the amendments do not restore the original policy intent of the provision, but rather extend the operation of the provision to address additional rollover circumstances.

As identified in the original Explanatory Memorandum to the provision, Step 3A was intended to cover a very limited set of rollover circumstances. The Explanatory Memorandum stated that the provision would be limited to only certain types of rollovers (and not all types of rollovers). It stated that:

> “This step applies in <u>limited circumstances</u> where:
>
> - before the joining time there was a roll-over of a CGT asset under Subdivision 126-B, or section 160ZZO of the ITAA 1936;
> - the originating company of the roll-over was a foreign resident and the recipient company was an Australian resident that did not become the head company of the joined group;
> - there was not a CGT event, other than another roll-over, in relation to the asset between the roll-over time and the joining time;
> - the CGT asset is not a pre-CGT asset at the joining time; and
> - the entity that holds the asset subsequently becomes a member of the joined group where that entity was the recipient of the asset or received the asset as a result of a further roll-over.

The wording of existing section 705-93 is not deficient in achieving the policy intent as prescribed in the Explanatory Memorandum to the Bill which introduced the provision.. The type of transaction outlined in the Explanatory Memorandum is clearly covered in existing section 705-93. The amendments go further by targeting a wider range of rollover scenarios where Treasury now considers it appropriate to do so.

However, changing the provision retrospectively is clearly inappropriate as the proposed amendments affect irrevocable elections that have been made by taxpayers. That is, Step 3A may result in CGT event L2 on entry into tax consolidation. The extent of the capital gain under the proposed amendments may be so significant that taxpayers may not have made an irrevocable choice to consolidate if there was knowledge of the amendment at the time.

Furthermore, Step 3A may apply under the proposed amendment where an entity is defined as a ‘stick entity’. Had taxpayers known that a Step 3A implication could have occurred by choosing ‘stick’ versus ‘spread’, taxpayers may not have chosen to stick with tax cost amounts for various entities.

Accordingly, due to the inappropriate outcomes that may occur for taxpayers that have made irrevocable choices and given that the amendments do not restore the original policy intent of Step 3A (but rather expand that policy intent), we are of the clear view that the amendments must be prospective and not retrospective.

B5.3 Date of effect

For the reasons outlined above, we are opposed to these amendments having a retrospective application date of 1 July 2002.

B6 PHASING OUT OF OVER-DEPRECIATION

B6.1 Summary of submission

We support the legislative amendments to phase out the over-depreciation adjustment. Our only additional comment is that given that section 705-50 will have no practical effect with effect from 1 July 2009, since the last time that the inter-corporate dividend rebate for unfranked dividends could have applied was 30 June 2004, whether the package of legislative amendments could at the same time include a provision to repeal it with effect for entities that become members of a consolidated or MEC group after 30 June 2009.

B7 LIABILITIES ON LEAVING

B7.1 Summary of submission

The ED Bill broadly proposes a number of amendments and outcomes in relation to liabilities on leaving. We highlight a number of concerns in relation to the proposed redrafting of subsection 711-45(8) and the use of the “just before the leaving time”. These concerns are summarised below. We also commend the decision not to amend subsection 711-45(5) consistent with our previous submission.

B7.1.1 Subsection 711-45(8) re-write

We broadly agree with the decision to rewrite subsection 711-45(8) as the previous section was problematic.

However, the proposed replacement version of subsection 711-45(8) will continue to result in huge compliance activities for every exit from a consolidated group in seeking to identify if the liability was the same liability, the entry amount as adjusted, the adjusted entry ACA, etc. We question whether this represents an appropriate long term enduring policy for Australia given the compliance overhead it will create for every subsidiary divestment.

We submit that, in the same way as the Government decided to phase-out the over-depreciation rules (Part 6, Items 51 and 52) and repeal CGT event L7 (Section B14), the Government should consider a significant streamlining of these rules.

We submit firstly that there is both a policy and technical issue as to whether the replacement version of subsection711-45(8) should only apply to the extent that a liability is the same liability in both nature and amount.

We submit further that, given the significant compliance burden in accurately analysing relevant liabilities where there is a significant time internal between the joining time and leaving time for the relevant subsidiary member, that subsection 711-45(8) should not apply where the leaving time is more than 2 years after the joining time.

If the proposed subsection711-45(8) can be satisfactorily rectified the changes should apply on an optional basis from 1 July 2002.

B7.1.2 Just before the leaving time

The proposed amendments regarding the recognition of assets and liabilities “just before the leaving time”, needs clarification in the legislation and the explanatory memorandum. This proposal should only apply from the date of the original announcement on 8 May 2007.

B7.2 Detail of submission

B7.2.1 Amendments to subsection 711-45(8)

In our view, even as redrafted, the proposed section results in a high level of compliance and, in cases where an exit arises several years after an entry, a requirement for exit research equivalent to the work required under CGT event L7 (to be repealed) and the over-depreciation adjustment (to be phased out).

We can understand the need for subsection711-45(8) in the context of ‘buy then sell’ scenarios where a consolidated group may acquire a subsidiary (as part of a group of entities) requiring entry ACA calculations then, shortly afterwards, dispose of the entity causing exit ACA calculations which might result in different entry and exit ACA outcomes for the same liabilities

However, leaving aside that case, we question if there is any loss to the revenue in cases of exits which occur years after the relevant entry. We also question the revenue integrity yield from the large compliance task which will continue to arise under the proposed redraft.

The new provision is likely to give rise to a significant compliance burden in accurately analysing relevant liabilities, where there is a significant gap between the joining time and leaving time for the relevant subsidiary member (especially for liabilities such as annual leave/long service leave for large groups with significant employee numbers).

The draft EM at paragraph 1.122 is flawed in its claim that the proposed replacement subsection711-45(8) will reduce compliance costs by limiting the circumstances in which it applies. In our view the types of liabilities practically impacted are no different to those covered by the existing subsection 711-45(8).

The most effective compliance relief would be for subsection711-45(8) to apply for a limited time frame only. We submit that where the leaving time is more than 2 years after the joining time, subsection 711-45(8) should not apply.

Submission – a better mechanism

We submit that proposed subsections 711-45(8), (9) and (10) should work as follows:

(a) if a gross liability was taken into account in entry ACA Step 2 (producing a particular adjusted outcome under entry ACA Step 2);and

(b) the same gross liability is taken into account in exit ACA Step 4 (producing a particular adjusted outcome under exit ACA Step 4);and

(c) if the adjusted outcome under exit ACA Step 4 was used to replace the adjusted outcome under entry ACA Step 2 the overall entry ACA result would be different then

(d) if the difference arises from a reduced adjusted entry ACA (which suggests that the exit ACA has been understated) then exit ACA Step 4 should be increased by the difference. Conversely, if the difference arises from an increased adjusted entry ACA (which suggests that the exit ACA has been overstated) then exit ACA Step 4 should be reduced by the difference.

We submit that subsection711-45(8) should be limited to dealing with the situation where the leaving liability is the same liability as the liability taken into account in the entry ACA calculation, where the result after adjustments in both ACA calculations differs. In this regard the "same liability" should mean the same type of obligation and the same (accounting) value of the obligation.

Furthermore, subsections711-45(8),(9) and (10) should only apply **to the extent** that the leaving liability is the same as the joining liability in nature and in (accounting) value. Consequently:

- the draft EM example 1.15 is in our view correct when it applies subsectuib711-45(8) to the situation where a provision for annual leave at the leaving time of $20,000 is, to the extent of $10,000, the same as the joining liability of $10,000 (assuming there has only been an increase in the liability over that time);

- the draft EM examples 1.16 and 1.17 are incorrect in their application to foreign exchange liabilities where the amount of the accounting liability has altered due to foreign exchange fluctuations and/or repayments. In each of the examples the accounting liability amount is different at the leaving time to the joining time. As the leaving liability is less than the joining liability, there should be no partial application of subsection711-45(8). Instead, the liabilities in this case should only be adjusted under subsection711-45(5) as is correctly indicated in the examples.

We note further that the proposed replacement subsection711-45(8) seems technically problematical in that it does not expressly require that the relevant liability at the leaving time be the same liability as at the joining time. Whilst this intention is clarified in the draft EM at 1.124, this is insufficient, and the legislation should include some express terms to clarify this key threshold requirement.

B7.2.2 Special rule for equalising deferred tax liabilities in exit ACA calculations

Deferred tax liabilities (DTLs) can create anomalous and inappropriate outcomes when taken into account for the purposes of exit ACA Step 4, as is recognised in the ATO's detailed discussion paper issued for the National Tax Liaison Group (NTLG) Consolidation Subcommittee meeting on 26 February 2009, which highlights the inappropriate lowering of exit cost base and resulting double taxation on exit of members of consolidated groups.

We submit that the rewrite of subsection 711-45(8) presents an excellent opportunity to remedy the problems for DTLs in exit ACA calculations. Failing to take this opportunity will mean an extended discussion process with the ATO, which clearly supports improvement of the exit scenario, and would mean another round of amending consolidation legislation. This can be short-circuited by action now.

We submit that consideration should be given to developing a specific rule for DTLs, which could be located in subsection 711-45(8), with the effect that if the exit ACA Step 4 amount for a DTL exceeds the entry ACA Step 2 amount recognised for the DTL then the excess should be disregarded for the purposes of the exit ACA calculation. For the purposes of this rule, a nil DTL at Step 2 would still be considered a relevant amount.

This special rule for DTLs should apply retrospectively from 1 July 2002.

B7.2.3 Just before the leaving time - clarification of meaning

The proposed amendments regarding the recognition of assets and liabilities from at the leaving time to just before the leaving time, needs clarification in the legislation and the explanatory memorandum.

The legislation and the explanatory memorandum should expressly clarify the meaning of “just before the leaving time”. To remove all doubt, the legislation and explanatory memorandum should confirm that transactions or events that occur more than 1 hour before the leaving time, will not be taken to occur just before the leaving time.

The explanatory memorandum should provide some examples to illustrate:

- when a liability would be taken into account just before the leaving time (for example a convertible note (that is an accounting liability) conversion to equity which causes a subsidiary to leave the consolidated group)

- when a liability would not be taken into account just before the leaving time (for example an intra-group loan that is discharged a day before the leaving time)

A greater degree of precision is necessary to ensure that any pre-disposal restructuring that may be undertaken in order to prepare a subsidiary for sale, such as, the repayment of intra-group debts etc, is not inadvertently taken into account as part of the exit ACA calculation.

B7.3 Date of effect

Application date for the amended subsection 711-45(8)

The abovementioned proposed changes are significant and in our view they should have a mandatory application date from the date of Royal Assent.

However, groups should be given the option of applying the proposed changes on a retrospective basis from 1 July 2002.

Application date for "just before the leaving time"

The proposed amendment should apply prospectively from the date of the original announcement on 8 May 2007.

The amendment should not apply retrospectively, on the basis that the decision in *Handbury Holdings Pty Ltd v Commissioner of Taxation* [2008] FCA 1787 was the subject of an appeal which has yet to be finalised. We understand that the current status of this case is that the Full Federal Court heard the appeal and the judgement (by Justices Finn, Sundberg and Perram) was reserved on 11 May 2009.

If the Federal Court decision is upheld then the existing provision will give the equivalent result as the proposed amendment (so retrospective legislation would not be required). If the taxpayer's appeal is successful, then the proposed amendment should not frustrate the court's interpretation of the existing legislation that may be consistent with that adopted by taxpayers based on a plain reading of the existing legislation.

B8 ACCOUNTING PRINCIPLES

B8.1 Summary of submission

We are concerned with the proposed amendments to section 705-70, especially in relation to its interaction with the proposed subsection 705-70(1A). We believe that the proposed amendment goes further than the announcement and policy intent and that Treasury should not continue with the amendment. Instead, in our view the ATO should rely on the decision in *Envestra Ltd v Federal Commissioner of Taxation [2008] FCA 249* to achieve the correct policy outcome.

B8.2 Detail of submission

Modifications to section 705-70 are stated in the draft EM to be consistent with the decision in the case of *Envestra – that is "[t]o remove doubt, the amendments will modify the tax cost setting rules to confirm this position"*. We are unsure why a legislative change is required to confirm the decision in Envestra, which was decided upon favourably for the ATO.

Furthermore, we believe that the proposed modifications do not confirm this position, but instead may result in a policy change. Specifically, there is an issue on the interaction of subsection 705-70(1A) on deferred tax liabilities that has been raised by the ATO in a recent paper titled "Deferred Taxes in the Allocable Cost Amount (ACA) and the Tax Cost Setting Process" released at the 26 February 2009 meeting of the NTLG Consolidation Subcommittee. In that paper, the ATO raises issues associated with the interaction with AASB 3 when applied by the head company. The policy regarding this interaction has not been clarified and the ATO raises a number of policy issues in that paper, including the possible removal of DTLs from entry calculations. The proposed amendments to subsection 705-70(1A) seem to address the issues raised in that paper, and accordingly seem to go further than just clarifying *Envestra* and the policy of section 705-70.

It is therefore our recommendation that Treasury does not proceed with the section 705-70 amendments and that the ATO rely on the *Envestra* decision to achieve policy intent. We recommend that Treasury and the ATO consult with members of the NTLG Consolidation Subcommittee in developing any further changes to that section on a prospective basis.

B8.3 Date of effect

Based on our comments above, we do not support the amendments being made with effect from 1 July 2002. If, however, such amendments were to be made with effect from 1 July 2002, we do not support the proposed amendments to section 705-70(1A).

B9 INHERITED DEDUCTIONS

B9.1 Summary of submission

We agree with the proposed amendments (and their proposed date of effect) to exclude from the ambit of the step 7 entry ACA and step 2 exit ACA, s43-15 deductions for undeducted construction expenditure in relation to assets acquired before 7.30pm on 13 May 1997.

However, we have a concern around the proposed date of effect of the remaining modifications and recommend that those amendments apply from 8 May 2007 (being the date of announcement) and for the particular amendment which had not previously been announced, recommend that it apply no earlier than from the date that the Exposure Draft legislation was released. Additionally, we seek further clarification around the breadth of the inclusion of the single entity rule in the case of the step 7 entry ACA.

B9.2 Detail of submission

B9.2.1 Inherited deductions and single entity rule

We note that the legislative amendments seek to “clarify” that inherited deductions taken into account at step 7 of the entry ACA are those deductions that the head company becomes entitled to as a consequence of the operation of the single entity rule (as well as the entry history rule).

Given the technical complexity of the interaction between inherited deductions and the various provisions in the capital allowance regime (which apply in a different manner depending on whether the taxpayer is the current owner of the capital works or had incurred the relevant capital expenditure), we recommend that the Explanatory Memorandum include examples to clearly list the types of expenditure which is intended to fall within the modified step 7 (entry ACA).

It is our understanding that the effect of the amendment (item 87) to make reference to the single entity rule would be to pick up deductions available under Subdivision 40-F which apply to grapevines and horticultural plants of a joining entity which would be inherited by the joined group due to the operation of the single entity rule (not the entry history rule).

Although this clarification accordingly may be detrimental to consolidated groups in the horticultural/viticulture industries which had not so accounted for such deductions at step 7 of the ACA, we have concerns as to whether it would be appropriate to have this measure apply with retrospective effect to 1 July 2002. Whether or not taxpayers have in practice taken the view that step 7 did not apply in respect of this capital allowance is not clear, but given the potential for detrimental outcomes, we recommend that item 87 of the Exposure Draft be given a commencement date of 8 May 2007 (being the date on which this measure was announced) rather than 1 July 2002.

B9.2.2 Item 89 (leaving ACA “technical amendment”)

Item 89 of the Exposure Draft proposes to make a “technical amendment” to “clarify” that the step 2 amount is worked out by multiplying all the deductions of the head company that are inherited by the leaving entity by the company tax rate.

On the basis that this measure was not previously announced, we strongly submit that it should not have retrospective application to 1 July 2002. Instead, this measure should not have any application any earlier than the date that the ED legislation was released.

The effect of this proposed amendment is to reduce the amount of the step 2 of the exit ACA which has a detrimental impact to taxpayers as it will reduce the resulting tax cost of membership interests in the leaving entity. The Explanatory Memorandum to the Bill which resulted in the currently enacted section 711-35(1) made it clear (paragraph 5.120) that there is a distinction to be made between “owned deductions” and “acquired deductions” in working out the total of the step 2 leaving amount. It is for this reason, that we submit that any retrospective application would be unduly harsh and inappropriate.

B9.3 Date of effect

As outlined above, but for the amendment relating to pre 13 May 1997 assets, we do not support a retrospective start date to 1 July 2002 in relation to the other amendments and would recommend a start date no earlier than 8 May 2007 for those measures that were announced on that date.

In relation to Item 89 (which was not previously announced), as noted above, we oppose any application to leaving times that occurred at any time prior to the date that the ED legislation was released.

B10 GENERAL INSURANCE COMPANIES

B10.1 Summary of submission

We generally agree with the policy of the amendments, however believe that there are some technical issues associated with the amendments. We also believe that the retrospective application date should be on an elective basis only.

B10.2 Detail of submission

The consultation document adequately describes the issue with general insurance liabilities and the interaction with the accounting versus tax liabilities. The solution seems appropriate.

However, as pointed out in our earlier submission, the changes should go further and include the following:

- the changes should also deal with a general insurance company joining a group where a member of the group is an insured. At the moment, the current rules result in the liability effectively "disappearing" and a bring forward of income or denial of deductions referable to income (premiums) previously returned

- in relation to claims paid, allowance of a deduction for claims paid under a policy with another group member would in many – although not all – be a "wash" (expense/deduction to insurer, income to insured, expense for underlying outgoing to insured). However, in relation to the premiums, the amount of premium referable to the cover may have been previously brought to account in part prior to the joining time. The joining results in the unearned premium reserve in respect of the other group member reducing to nil and therefore a bring forward of income. While this can be argued to be appropriate in comparison to a situation where the insurer was always part of the same group, there is a practical need to try and separate the amount referable to other group members from external parties. This is particularly onerous part way through a policy term. Some recognition of "self insurance" (per ANZ and Mitsubishi Motors principles) and recognition of real insurance being carried on in these kinds of circumstances might help ameliorate this issue. Practically, there seems to be some resistance to this approach.

B10.3 Date of effect

It is proposed that this amendment apply from 1 July 2002. We recommend that the amendments only apply on an elective basis, ie if a taxpayer chooses to apply the amendments retrospectively from 1 July 2002. Treasury may place a time limit on the making of that choice. We believe that a choice needs to be provided, rather than an automatic application to 1 July 2002, because an automatic retrospective change carries with it certain administrative and compliance issues.

B11 CASH MANAGEMENT TRUSTS AND RIGHTS TO FUTURE INCOME

B11.1 Summary of submission

B11.1.1 Cash management trusts

Proposed subsection 705-25(5)(ba) and the proposed definition of 'cash management trust' is broadly in accordance our submission of 13 December 2007. We therefore support the proposed amendments with only one qualification. Due to reasons outlined below, we believe that paragraph (b) should be removed from the definition of cash management trust to be contained in section 995-1.

B11.1.2 Rights to future income

We are generally supportive of the proposed changes to the rights to future income as set out in Schedule 1, Part 11 of the ED. Clarification points are noted below.

B11.2 Detail of submission

B11.2.1 Cash management trusts

Further research since that submission was lodged has revealed that cash management trusts do not predominantly invest in retained cost base assets.

To generate enough return to be commercial, the cash management trust needs to invest predominantly in short-dated traded securities such as bank bills. Because these are 'marketable securities' for the purposes of the definition of 'retained cost base asset', they are not retained cost base assets.

The following is an extract from the product disclosure statement for The Macquarie Cash Management Trust which is the oldest and largest cash management trust in Australia:[10]

> <u>What are the investments?</u>
> The Trust only invests in investments allowed under its Constitution. The CMT only invests in government securities or bank issued securities and deposits with a Standard & Poor's rating of A1 or A1+. At any one time the CMT does not invest more than 25% of its investments into A1 bank securities and deposits. The CMT invests to adhere to the Standard and Poor's (S&P) criteria to achieve the S&P AAAm rating – the highest credit rating available to a cash management trust.

Just as a bank could not provide an appropriate return on a bank account by only investing in retained cost base assets, a cash management trust could not do so either. The proposed paragraph (b) of the definition of 'cash management trust' therefore needs to be removed. The proposed paragraph (a) along with the other proposed restrictions will be sufficient for the provision to achieve its intended effect.

B11.2.2 Rights to future income

The amendments under subsection 705-25(5)(d) apply to a right to receive a payment in respect of work, provided the work has not been performed to a stage where a recoverable debt has arisen. The issue is whether this also includes those future rights for which no work has been performed to date.

Thus in Example 1.18, the relevant construction contract may include many rights to receive payments in respect of work over the life of the contract. Subsection 705-25(5)(d) appears to

[10] product disclosure statement dated 19 September 2008 page 2

be only treating a certain sub-set of those rights as retained cost base assets, in which case the point should be made clearer in the explanatory memorandum to the legislation..

Example 1.18 also has similarities with Example 1.3 where the construction company was using the profits emerging basis, not the billings basis. In these circumstances is it intended that the TCSA would still be nil even though the taxpayer may not yet have deducted those work in progress costs under the profits emerging basis?

B11.3 Date of effect

We support the suggested application date of the proposed amendment, being a retrospective application date to 1 July 2002.

B12 LOSSES WITH NIL AVAILABLE FRACTION

B12.1 Summary of submission

But for the comments in the detailed section below, we are generally content with the form of the legislative amendments to give effect to this measure, and in particular welcome the extension of the sort of losses to which this measure can apply to now include net capital losses in addition to tax losses.

However, in addition to the inability for a choice to cancel applicable loss bundles to be revoked, we raise two specific issues which warrant particular consideration prior to finalising the legislation – the practical limitation of losses with a nil available fraction (due to rounding) and the need for losses to have otherwise been able to be utilised.

B12.2 Detail of submission

Although foreign losses are not included, it is our understanding that there is likely to be limited practical application (and particularly when taking into account the repeal of the foreign loss quarantining measures for income years commencing on or after 1 July 2008).

We still have a concern about the inability for taxpayers to have these measures apply in cases where bundles of losses which had an available of fraction of nil were cancelled (particularly in relation to loss cancellations that were made prior to the announcement on 1 December 2005). As expressed in our submission of 13 December 2007, there is no ability to revoke the cancellation of a transfer of a loss. Due to the retrospective native of this amendment, we request that Treasury consider providing an ability to reconsider these choices that were previously made.

Limitations on having an available fraction of nil

The proposed measures will only apply where the available fraction as calculated under subsection 707-320(4)(a) would be 0. However, there will be many situations where due to the extended rounding requirement now provided by subsection 707-320(4)(b) that the available fraction for a bundle of losses is negligible (but still more than nil). For example, a joining entity may be worth only $1 but will still be given an available fraction that is something other than nil due to the requirement to round to the number of decimal places that includes the first or only such digit (or rounded up if the next decimal place is 5 or more). As currently proposed, that group will be unable to rely on section 707-415 due to the operation of subsection 707-415(1)(c).

We therefore recommend that subsection 707-415(1)(c) be redrafted to address this inequity, with wording as follows:

> "*(c) that loss is included in a *bundle of losses that but for the operation of subsection 707-320(4)(b) would be 0.000"*

Limit on the application of loss

As currently drafted, a loss can only be applied to the extent that it could be utilised by the head company for the income year on the assumption that the available fraction of the bundle of losses was 1 (subsection 707-415(3)).

While it is clear that this would limit the ability to apply the reductions in cases where the group had failed the COT and same business test (which we accept), it will also mean that it will only apply to taxpayers which have sufficient taxable income or capital gains (in the case of using net capital losses) for the income year in which the taxpayer seeks to apply section 707-415. This will naturally prevent groups in a loss position for the year in question or which have carry forward group losses (which must be used prior to “transferred losses” in accordance with subsection 707-310(3)(b)) from applying the concession.

We recommend that subsection 707-415(3) be redrafted such that there is an additional assumption that there is also “sufficient taxable income” or “sufficient capital gains” for the losses to be utilised. In the absence of such an amendment, groups which have a current year loss or which had themselves made group losses in prior years which have not yet been utilised would be disadvantaged as compared to groups which only had transferred losses.

B12.3 Date of effect

Although the amendment is proposed to have an application from 1 July 2002, some taxpayers may not be able to give practical effect to the amendment as their losses with nil available fractions were cancelled out of administrative convenience. Accordingly, the retrospective application date must be coupled with an ability to revisit non-revocable elections that have been previously made by taxpayers.

B13 APPLICATION OF CGT EVENT L7 BEFORE 8 MAY 2007

B13.1 Summary of submission

It is our view that CGT event L7 should be repealed with effect from 1 July 2002. However, to the extent that there will be no change in policy to have CGT event L7 repealed with effect from 1 July 2002, then we agree that this amendment is required to ensure that there is no double taxation or double benefits in cases where the difference between the original liability and the amount that is actually discharged is already taken into account elsewhere in the income tax law.

B13.2 Detail of submission

B13.2.1 Policy basis for retaining CGT event L7

We strongly recommend that further consideration be given to the policy basis of retaining CGT event L7 from 1 July 2002 through to its proposed date of repeal of 8 May 2007.

The removal of CGT event L7 from 1 July 2002 would achieve certainty for taxpayers and the revenue as there has been since its inception significant issues concerning its interpretation and the breadth of its application, in particular for non-legal liabilities. For example, there is potential for the provision to have applied upon the change of accounting standards or policy (noting in particular, the introduction of the Australian international financial reporting standards from 1 January 2005) where the change in accounting may have resulted in the change in the amount of certain liabilities. Although the Australian Taxation Office has stated its position in relation to some of these issues through its Consolidation Reference Manual, this is by no means legally binding for taxpayers.

As these issues will continue to remain uncertain and potentially expose taxpayers (and the revenue) to risks of interpretation and practical application for the first five years of the consolidation regime, we consider it would be more than appropriate to simply repeal CGT event L7 in its entirety from 1 July 2002.

B13.2.2 Review of the drafting of the provision

We agree that the wording of proposed subsection 104-530(6) is sufficiently wide enough to ensure that there will be an appropriate adjustment to the resulting CGT event L7 gain or loss where another provision of the income tax law has or will apply to the head company of the group to adjust in any income year:

- an amount in assessable income
- a deduction
- the tax cost for a revenue asset
- the cost base or reduced cost base of a CGT asset, or
- revenue or capital losses.

This amendment has potential application to an insurance company with outstanding claims (as per example 1.20 in the Explanatory Materials), but is likely to have more common application to limited recourse debts that are subject to Division 243, extinguished debts that gives rise to an assessable amount for the head company under section 6-5, and also in the context of foreign exchange gains and losses. We would recommend that this be explicitly stated in the Explanatory Materials for the sake of certainty as to the breadth of the subsection's application.

In reference to the implicit enquiry in the drafted provision as to whether the proposed amendment needs to take into account amounts that are taken into account in the income tax law for other taxpayers (ie the italicised reference to “your” taxable income or “your” tax loss), we would recommend that this be considered as being necessary.

For example, it is possible that the CGT event L7 arises due to the forgiveness of a commercial debt that was a liability taken into account in the entry ACA. To the extent that a net forgiven amount arises in respect of that debt, Subdivision 245-G of Schedule 2C of the Income Tax Assessment Act 1936 would apply to deem part of the net forgiven debt to be that of a related company (this will be particularly relevant to wholly-owned foreign groups that do not operate as a single MEC group) which affects its losses, and tax costs. Although in this instance, it is the taxable income or tax loss of a related company that is affected, we consider that the impact of CGT event L7 to the group which had the applicable entry ACA liability discharged be capable of being adjusted to the extent that the net forgiven amount affects the group and any other related company.

We would like to see some comment in the Explanatory Materials that confirms that the amendment is sufficient to ensure that there is no need for the group to consider CGT event L7 in relation to liabilities that may have previously left the group before their discharge and that were taken into account in working out the tax cost setting amount for the membership interests of the leaving entity as part of the exit ACA calculation of the leaving entity that took the liabilities with it.

In addition, if it is recognised that section 711-45(8) (which applies when the entry amount of a liability is different to its exit amount at the time that an entity leaves the consolidated or MEC group) ensures a consistent outcome with CGT event L7, the proposed modifications to section 711-45(8) (as set out in Part 7 of the Exposure Draft) to apply from 1 July 2002 now makes the provision inconsistent with the operation of CGT event L7 from 1 July 2002 until its date of repeal. In this respect we would recommend that any proposed modifications to subsection 711-45(8) (that apply prior to the date of any repeal of CGT event L7) be also considered to apply in the context of CGT event L7.

B13.3 Date of effect

As outlined above, it is our view that CGT event L7 should be repealed with effect from 1 July 2002. However, where this is not the case, we support the proposed application date of the proposed amendment.

B14 REMOVAL OF CGT EVENT L7

B14.1 Summary of submission

We support the legislative amendments to repeal CGT event L7.

B14.2 Date of effect

However, as noted in Section 13 of this submission,, it would be preferable if the provision could be repealed with effect from 1 July 2002 due to the practical difficulties and uncertainty (acknowledged in the EM at paragraph 1.203) around the extent to which it applied in the period up until the date it was announced that it would be repealed.

B15 DOUBTFUL DEBTS AND CGT EVENT L3

B15.1 Summary of submission

We broadly support the proposals to CGT event L3 in relation to debts that are impaired. However, we see no reason why the proposed amendments contained in section 705-27 should not be extended to cover situations where a capital gain arises under CGT event L3 by reference to a retained cost base asset that is a debt but is not an impaired debt at the joining time. Accordingly, we question the policy reason to only apply the mechanism to doubtful debts.

If the policy is not extended to other debts, we make two further comments in relation to the proposed amendment relating to the title of the provision and the broader policy concerns about doubtful debts.

B15.2 Detail of submission

B15.2.1 Extending the policy to debts other than doubtful debts

The proposed amendments contained in section 705-27 should be extended to cover situations where a capital gain arises under CGT event L3 by reference to a retained cost base asset, where the retained cost base asset is a debt but is not an impaired debt at the joining time.

A CGT event L3 capital gain can arise simply due to an insufficient ACA to cover the tax cost setting amount of retained cost base assets. In such cases, consolidated groups should also have the option of reducing the tax cost setting amount of a retained cost base asset (that is a right to receive a specified amount of such Australian currency covered by subsection 705-25(5)(b)) by the whole or part of the amount of the capital gain arising under CGT event L3.

B15.2.2 Considerations in relation to current drafting

Title of the provision

As noted in our earlier submissions, we would prefer no reference to the term ‘doubtful debts’ or ‘impaired debts’. While section 705-27 does not specifically require one to identify an impaired debt, the reference to an impaired debt in the title to the provision may result in a ‘quasi’ intention provision requiring one to prove that the debt meets the ‘impairment’ requirements of AASB 139 or an equivalent accounting standards. As proposed subsection 705-27(1)(b) uses a market value test, we request that the title to the provision be amended to “reduction in tax cost setting amount for retained cost base assets where market value is less than its tax cost setting amount.”

Intragroup assets

The requirement in proposed subsection 705-27(1)(d) does not seem appropriate if a $1 deduction is claimed in relation to the intragroup asset. That is, section 705-27 does not appear to apply to any extent. The requirement in subsection 705-27(1)(d) should only limit the application of the provision to “the extent that” a deduction has been claimed in relation to the intragroup asset that represents the difference between market value and its tax cost setting amount.

B15.2.3 Broader policy amendment still required

Furthermore, in our earlier submissions, we noted that the CGT event L3 amendment only partially removes the inequities and cost base allocation issues caused in a provision for doubtful debt case. We still recommend that Treasury consider introducing a rule similar to subsection 168-230(2) that was contained in The New Business Tax System (Consolidation) Bill 2000 Exposure Draft released in December 2000, which stated:

> However, if the retained cost base asset is a debt owed to the joining entity and, in the opinion of the *head entity of the group joined, the full amount of the debt will not be repaid, the payment for the debt is instead equal to the *market value of the debt.

We believe that this amendment would more appropriately result in a systemic resolution to the impaired debt issue.

B15.3 Date of effect

As the issue of doubtful debts and retained cost base assets was highlighted from the inception of the consolidation provisions, we are of the view that the provision should have retrospective effect from 1 July 2002.

B16 BLACKHOLE EXPENDITURE OF MEC GROUPS

B16.1 Summary of submission

This is a welcome development and the proposed amendments are consistent with the Assistant Treasurer's 8 May 2007 Press Release.

B16.2 Date of effect

It is appropriate that this measure apply to CGT events occurring on or after 1 July 2005.

B17 APPLICATION OF TRANSITIONAL CONCESSIONS TO SAPS

B17.1 Summary of submission

This is a welcome development and the proposed amendments are consistent with the Assistant Treasurer's 8 May 2007 Press Release. The proposed start date is 1 July 2002.

We welcome the proposed amendment to section 170 to allow affected taxpayers to amend assessments within 4 years after the date of Royal Assent, to give effect to the proposed consolidation amendments, as it is particularly important for this proposed amendment. However, as the existing legislation had a significant effect on Step 3 and thus ACA calculations, a number of affected taxpayers chose 'stick' rather than 'spread'. Accordingly, the amendment is not helpful in many cases where taxpayers cannot revoke their election to use the stick method.

B17.2 Detail of submission

Transitional groups potentially eligible for the proposed Step 3 amendments should be permitted to revoke any previous chosen transitional entity election made in respect of the transitional group (where the subsidiary member would be directly or indirectly impacted by the proposed amendments).

The proposed amendment could be made to subsection701-5(4)(a) which currently permits a revocation of a chosen transitional entity election before the end of 31 December 2005.

Whilst the ability to make/revoke chosen transitional entity elections is relevant for many of the proposed consolidation amendments, we have specifically raised it as part of this item as it will be of critical importance for groups seeking to apply this proposed amendment.

B17.3 Date of effect

Whilst these proposals would generally correct an unintended taxpayer detriment, we recommend that the amendments only apply on an elective basis, ie if a taxpayer chooses to apply the amendments retrospectively from 1 July 2002. Treasury may place a time limit on the making of that choice. We believe that a choice needs to be provided, rather than an automatic application to 1 July 2002, because an automatic retrospective change carries with it certain administrative and compliance issues with reviewing prior returns and (at the least) calculating CGT event L6 errors.

B18 INTER-ENTITY LOSS MULTIPLICATION RULES FOR WIDELY HELD COMPANIES

B18.1 Summary of submission

The proposal to restrict the operation of the inter-entity loss multiplication rules to widely held entities is welcomed.

We are however disappointed that the ED does not cover the previously proposed extension of the concession to a widely held top company of a MEC group (contained in the 2007 consultation papers at page 38). We recommend that the proposal reinstate the special concession for MEC groups.

We submit that a consolidated group that is a subsidiary of a widely held entity (where there is no loss duplication in respect of debt or equity issued by the consolidated group) should also be excluded from the application of Subdivision 165-CD.

B18.2 Detail of submission

<u>*Widely held MEC groups*</u>

The ED does not cover the previously proposed extension of the concession to exclude the head company of a MEC group from the loss multiplication rules where the top company is a widely held company (subject to the controlling stakeholder exception). The extension was contained in the Treasury paper titled "Consolidation: Consultation papers on measures announced in October 2006, May 2007 and September 2007" (released in October 2007). The relevant text is contained in section 13, items 10 and 11, located at page 38, which we have reproduced below:

> "10. To ensure this principle applies appropriately to MEC groups, a special rule is required to apply the new provision to the head company of a MEC group where the top company (as defined in section 719-20) is a widely held company.
>
> 11. That is, a further amendment is proposed to section 165-115X so that, if an entity is the head company of a MEC group and the top company of the group is a widely held company (as defined in subsection 995-1(1)), then the head company will have a relevant equity interest in a loss company at a particular time only if:
>
> - it satisfies the conditions in subsection 165-115X(1); and
>
> - an entity that has a direct or indirect equity interest in, or is owed a debt by, the top company has a controlling stake in the loss company at that time, and:
>
> - that entity could, if a CGT event happened in respect of the interest or debt, make a capital loss (other than a capital loss that would be disregarded) that reflects part of the loss company's overall loss; or
>
> - that entity has deducted or can deduct, or could deduct at a later time, an amount in respect of the cost of acquisition of the interest or debt, or a net loss on the disposal of the interest or debt, where the deduction reflected, or would reflect any part of the loss company's overall loss."

The previously proposed extension should have been adopted in the ED, in order to allow the proposed amendments to apply appropriately to widely held MEC groups. The previously proposed extension should be reinstated, for a range of important policy reasons which we have set out below.

The provisional head company of a MEC group cannot itself be a widely held entity, as it will ultimately be owned by a foreign company (even if that “top company” is itself widely held). If the only entities that can benefit from the proposal are entities that are themselves widely held, then, contrary to the original announcement on 8 May 2007 which indicates that the measures would apply to MEC groups, the ED proposal could not ever be available for a MEC group.

If the ED proposal is in effect available only for widely held locally owned entities, and not for foreign-owned entities, there is a concerning issue as to the maintenance of a level playing field, especially for those foreign owned groups which compete with locally owned entities. By denying genuine economic losses, Subdivision 165-CD creates uncertainty and increases the cost of doing business in Australia which will, in turn, discourage foreign investment. This is unfair and discriminates against foreign investors.

There is also a lack of consistency between the ED proposal and the existing treatment of widely held foreign-owned groups under Division 166. Division 166 allows subsidiaries of widely held foreign companies to utilise concessional tracing rules in determining, for various purposes, including the application of the COT test, whether there have been changes in their ultimate beneficial ownership. This is despite the fact that foreign-owned entities are not themselves widely held – almost invariably only the ultimate owner is widely held. The availability of these concessions can have a significant impact in ascertaining whether an “alteration time” has taken place under Subdivision 165-CD. It would therefore be discriminatory and inconsistent with existing policy to withhold from widely held foreign-owned groups the benefit of any amendments to Subdivision 165-CD and Subdivision 715-B (the latter containing the linking provisions which determine how Subdivision 165-CD applies to entities leaving consolidated groups).

There is a significantly reduced revenue protection role of the inter-entity loss multiplication rules following the introduction of tax consolidation and other measures, due to the following:

- Leaving subsidiaries can only leave with unrealised losses not crystallised losses (which may never crystallise), due to the tax consolidation loss rules which require unutilised released losses to be held by the head company
- There is no opportunity for loss multiplication if a leaving subsidiary (loss company) becomes a subsidiary member of another consolidated group or MEC group where the tax cost of assets of the loss company are reset to their market value
- There is a limited opportunity for loss multiplication if a leaving subsidiary (loss company) does not become a subsidiary member of another consolidated group or MEC group where any future utilisation of its unrealised is subject to the application of subdivision 165-CC (where the same business test must be satisfied).

It is likely that the limited opportunity for loss multiplication was a key factor when the Government formulated the proposal of 8 May 2007 to limit the operation of the loss multiplication rules for widely held companies. We submit that the opportunity for loss multiplication would continue to be insignificant if the loss multiplication rules were extended to apply to widely held MEC groups.

We recommend that the amending legislation reinstate the special concession for MEC groups that are themselves not widely-held, but are wholly-owned directly or indirectly by a non-resident company that is widely-held. This would ensure that the proposed modifications to the loss multiplication rules will be consistent with the statement in the announcement that the measure will primarily impact upon consolidated groups and MEC groups.

Consolidated groups that are subsidiaries of widely held entities

Where the head company of a consolidated group is not itself widely held, but is a subsidiary of:

- a resident widely held entity (such as a listed trust) or
- A non-resident widely held entity

Then the head company of the consolidated group should also be excluded from the loss-multiplication rules (where there is no loss duplication in respect of debt or equity issued by the consolidated group).

This would ensure that the proposed modifications to the loss multiplication rules should enable foreign-owned consolidated groups to be placed on an equal footing with MEC groups. Furthermore, consolidated groups wholly owned by resident widely held entities should not be disadvantaged where there is no loss duplication in respect of debt or equity issued by the consolidated group.

Loss integrity choices

Under the loss multiplication rules, tax consolidated groups have a number of choices including:

- whether to reduce the tax cost setting amount of the head company's membership interest in a loss company to nil (subsection 715-255(2)) or to calculate the amount under a statutory method (subsection 715-255(3).
- in calculating the adjusted unrealised loss amount of a leaving company (subsection 715-245(3)), whether to value the assets of the company globally (subsection 165-115U(1D)) or individually.

For many consolidated groups (widely held or not), the proposed retrospective legislative changes could materially alter the tax cost setting amount of their underlying assets. As a result, the above choices made by these groups could be made inappropriately and disadvantage them.

In addition, for widely held groups that would not be subject to Subdiv 165-CD adjustments under the proposed measures, they could nevertheless still be bound by their prior choices under subsection 715-255(2) to reduce their interests in a loss company to nil. This would be an extremely inequitable outcome and clearly contradicts to the policy intent.

We therefore submit that it is necessary again to give consolidated groups and MEC groups, widely held or not, an opportunity to review their loss integrity choices. We submit that the Government should allow a period of time for consolidated groups to consider again their loss integrity choices (including the choice to use the global method). The period should expire six months after the eventual consolidation amending Bill is passed, thus allowing a just outcome while not creating lengthy uncertainty.

B18.3 Date of effect

We support the proposed date of effect for these amendments, being in relation to alteration times happening from 1 July 2002.

SECTION C OTHER ISSUES

C1 CGT STRADDLES

C1.1 Summary of submission

We confirm support for the introduction of the ‘CGT straddle’ amendments as proposed in the Government’s press release of 13 May 2008 (and the previous Government’s press release of 8 May 2007), and that these amendments should continue to have retrospective effect back to 8 May 2007.

While we had earlier considered other potential options for dealing with these important issues,[11] they now concur that the most appropriate way of comprehensively and efficiently dealing with these issues is in a manner proposed by the Government.

Therefore, we request that the Government introduce the associated amending provisions as soon as possible, and preferably in association with the other measures detailed in the ED provisions released on 28 April 2009. However, given that draft legislative provisions have yet to be released in respect of this measure, we would be able to consult with Treasury in any way thought appropriate to fast-track their development.

Given the clear statements by the Government (and the previous Government) that these important changes would be operative from 8 May 2007, a number of taxpayers will have entered into transactions and/or lodged income tax returns on this basis. Therefore, it would be extremely inequitable if a decision was made not to proceed with this measure, and in any event to do so would simply perpetuate the anomalous outcomes that arise based on the ATO’s view as to the operation of the existing provisions.

Table A below lists the various issues and inequities that can arise in the context of CGT straddle transactions where a contractual arrangement is entered into to dispose of a CGT asset but the transaction is not completed before the contracting entity enters or leaves a tax consolidated group. Then in relation to each of these issues, this table notes whether the relevant issue will be addressed by the proposed legislative amendments. For completeness, the table also comments on whether the issue could otherwise be addressed by legislative refinements based, broadly, on the approach adopted in *Taxation Determinations* TD 2008/29 to 2008/31, which deal with the existing legislative provisions.

The points summarised in Table A below are dealt with in more detail in the attached Appendix B. What is more than apparent from this table is that:

- most CGT straddle related issues will be readily addressed by the proposed legislative amendments
- and
- in most cases these issues could not similarly have been addressed by legislative refinements based on the approach adopted in the current tax determinations.

At section C1.2 of this submission, a number of specific technical/implementation issues are noted. The Joint Bodies would be able to further consult on these and other technical/implementation issues if required.

[11] Refer Appendix CP-11 to our submission dated 13 December 2007.

As also noted at section C1.2.6 below, some broader issues of double taxation of the same economic gain and also the impact of deferred tax liabilities (DTLs) not only arise in CGT straddle transactions but can apply to entity disposal issues more generally. Therefore, not surprisingly these broader issues will remain and could be the subject of further tax policy consultation at a later date.

C1.2 Detail of submission

C1.2.1 Issues sought to be addressed by the CGT straddle amendments

The following table summarises CGT straddle transaction issues that arise under the existing provisions and how they would be addressed under the proposed CGT straddle legislative amendments. The table also notes whether or not these issues could be simply addressed by legislative refinements to support the approach adopted in TDs 2008/29 to 2008/31. The issues contained in the following table are outlined in more detail in Appendix B to this submission.

Table A – summary of Appendix B

CGT straddle transactions policy issues	Dealt with by proposed legislative amendments	Could these policy issues be addressed only by legislative refinements based on the approach in the existing tax determinations?
CGT quantification and timing information known by the relevant taxpayer	Automatically addressed	No
Taxable entity does not receive sale proceeds	Automatically addressed	No
Different entities both taxed on same proceeds	Automatically addressed	No
Double taxation of contracting taxpayer	Automatically addressed	Yes
Allocation of the allocable cost amount (ACA): entry-sell scenarios	Specific legislative amendments are not required but EM confirmation recommended	Legislative amendment required

C1.2.2 Effected CGT events

Previous discussion material issued by Treasury in relation to these proposed CGT straddle amendments listed the relevant CGT events that could be effected as being CGT event A1, CGT event C2, CGT event D3, CGT event E8, and CGT event F1.

There are a number of CGT events that seem to have the same issue that are not included in the list of provisions to be amended by Treasury. For example, CGT event C1 can give rise to a straddle issue if:

- the head company receives compensation for the destruction of the asset, and then
- the exiting entity holds the asset that is ultimately lost or destroyed.

CGT events F4 and F5 could also give rise to a straddle issue if:

- the head company is party to the lease variation, and then
- the exiting subsidiary receives the payment for the variation.

The systemic issue should be examined for all CGT events and not just the ones listed which involve ‘contracts’.

Alternatively, rather than listing specific CGT events, consideration could be given to the adoption of a more ‘principle based’ approach. In this regard, the amendments would only apply to a particular CGT event where the stated CGT event time would otherwise precede the asset’s legal disposal/cancellation/variation in circumstances where there is an intervening joining or leaving time. The use of a general clause of this nature would avoid the need to update it every time another CGT event is added, but may require the introduction of exclusions for specific CGT events which are not considered appropriate from a policy perspective (eg CGT event B1).

C1.2.3 Time of the CGT event

In the discussion material previously released by Treasury, specific timing rules were specified for each of the impacted CGT events. However, it is queried whether these are correct for the events listed.

For example, for CGT event F1, the paper proposes that a ‘renewal of a lease’ would mean that the CGT event at the time ‘will be taken to arise at the start of the lease’. This timing rule would not be acceptable.

To minimise the likelihood of straddle ‘timing’ issues arising because of drafting errors, a single coherent principle could also be established. That is, the time of the event could be taken to occur when the criteria for the CGT event are satisfied. For example, CGT event A1 is satisfied when there is a change of ownership (subsection 104-10(1)). Accordingly, the time of the event should be this time.

C1.2.4 Specific placement of the amendments in the Income Tax Assessment Act

It would seem that the amendments could be placed either as an amendment to each CGT event or as an amendment to either Division 715 or Division 716. However, if the latter is chosen, then it would also seem appropriate for Treasury to include signposts to alert taxpayers to the modifications.

Given that this may require signposts for each CGT event affected, and an amendment to each CGT event to include the signpost, it may be easier to simply modify the timing rule in each of the CGT events rather than place these in a separate subdivision.

C1.2.5 Possible need for notification of a vendor or acquirer of a contracting entity

It is important to consider whether modifying the CGT timing rules in such circumstances will require the introduction of specific notification requirements in regard to any other potentially impacted entity. For the reasons outlined below, it does not appear that there will be a need for consolidated groups to provide specific notification to other parties in circumstances where these CGT straddle provisions apply. In contrast, without the introduction of these CGT straddle amendments, at a minimum a specific notification requirement would be essential for reasons outlined in the table at C1.2 above and in the detailed Appendix B.

The party contracting to purchase the underlying asset

The taxpayer acquiring the CGT asset under the contract will not be impacted by these CGT straddle amendments, and therefore the CGT timing of their acquisition of the asset should not change and no specific notification issues arise.

Entry-sell scenarios

Given that the disposal contract in respect of the underlying asset will not have been completed at the joining time, the joining entity will not have had a disposal prior to that time that would have activated a CGT event back at the contract date.

Therefore, if the joining entity is an unconsolidated entity or the head company of a consolidated group, the joined group will control the joining entity at the date the underlying asset is ultimately disposed of, and hence when the CGT event would otherwise have been retrospectively triggered. Therefore, no specific notification requirements arise in such circumstances.

If the joining entity was previously a subsidiary member of another consolidated group at the contract time, the proposed CGT straddle amendments will apply such that a CGT event will not arise for the vendor group in respect of the underlying asset. As such, no specific notification requirements will be necessary.

Exit-sell scenarios

If a leaving entity that has entered into a disposal contract in regard to the underlying asset immediately joins a new consolidated group, no specific notification requirements are needed. This is due to the fact that under the proposed CGT straddle amendments the acquiring group should anticipate that it will experience a CGT event on completion of the sales contract in regard to the underlying asset.

If the leaving entity is not joining another tax consolidated group, then because of its prior membership of the vendor tax consolidated group, it should be directly aware of the fact that the CGT straddle provisions will apply such that the CGT gain will not arise until completion of the relevant sales contract. As such, no specific notification requirements should be necessary.

C1.2.6 Issues that are accepted as outside the scope of the CGT straddle amendments

It is acknowledged that proposed CGT straddle amendments only seek to deal with these issues noted above which are directly relevant to the timing of a CGT event and the actual disposal of the relevant asset. Other broader consolidation issues can arise when an entity leaves a consolidated group, holding an asset in respect of which there is an unrealised gain, with the Division 711 treatment of associated DTLs being of particular concern.

Given that this DTL/exit issue impacts on a broader range of transactions than just CGT straddle events, we agree that it is more appropriate to separate consider the range of consolidation issues associated with DTLs (and deferred tax assets) and the potential introduction of targeted legislative amendments at a later time. As such, we support the initiative of the ATO to facilitate a broader discussion of these tax effect accounting issues and appropriate policy responses, as per the discussion paper issued at the NTLG Consolidation Subcommittee meeting on 26 February 2009.

C1.3 Date of effect

We support the suggested application date of the proposed amendment, being from the date of announcement of 8 May 2007.

C2 AMENDED ASSESSMENTS

C2.1 Summary of submission

We welcome the ability to reopen prior year assessments pursuant to tem 4, allowing amendments to be made within 4 years after the commencement of Schedule 1.

However, we see a number of significant administrative issues which we think need to be resolved with the ATO, in order to ensure that the practical administration of the changes proceeds smoothly.

We do not propose at this stage any formal adjustment of the proposed words, but highlight that there might be further submissions on this score.

C2.2 Detail of submission

Because of the extended time to implement the relevant government proposals, and that various of the proposals have commencement dates which go back to the inception of tax consolidation, the following challenges arise.

Currently the management of amendments to prior year income returns involves long form amendments to prior year returns, in this case potentially affecting seven years' prior year income tax returns for consolidated groups.

Subdivision 705-E (adjustments for errors) assists when reopening prior year returns. Section 705-315 provides that in some circumstances taxpayers can elect not to reopen individual prior year income tax returns and treat the entire resulting adjustments as a capital gain under CGT event L6. The 'one shot CGT treatment' is only available in a limited range of circumstances, where:

- errors cause the TCSA to be different from the correct amount and
- it is not reasonable to require a recalculation of the individual tax return amounts

Most importantly, the one shot CGT adjustment under CGT event L6 is limited in its effect. It allows only for the amount or quantum of the net overstated or understated TCSA to be taken into account, without any consideration of the allocations of the TCSA as between revenue assets and assets subject to the capital gains tax provisions. CGT event L6 operates only for capital gains tax purposes.

So it is quite possible that various adjustments arising from the proposed Schedule 1, particularly those resulting from the application of the changes to subsection 701-55(6) may affect consolidated groups' prior year revenue deductions or income, but there is no shortcut 'one shot' treatment of such prior year revenue effects, no revenue equivalent of CGT event L6.

We are concerned also that taxpayers may determine that the prior year effects of the changes in the proposed Schedule 1 will not warrant any prior year adjustments, but that the ATO might instead require a substantial compliance workload to deal with the prior year adjustments. Taxpayers might decide to take no further action for legitimate reasons including;

- the fact that their consolidation entry was many years ago, the relevant employees have left and reopening the consolidation formation calculations would be costly and distracting at this time of financial crisis
- taxpayers may have chosen to use existing tax values in which case the effects of many of the changes are quite immaterial.

We are concerned therefore that, while some businesses will find after an initial brief overview that there are no material prior year adjustments to merit reopening prior year returns, there is a risk that demands by the ATO for reopening of returns might cause significant cost and difficulties for some consolidated groups. This might not be a real concern pending discussions with the ATO, but it is a significant background issue in relation to administration, and one which, if left unresolved, has the potential to cause significant business aggravation.

Additionally, while the ATO has previously issued Practice Statement Law Administration PS LA 2005/9 "Consolidated groups putting their affairs in order following enactment of legislation or release of public rulings and determinations" allowing 'one shot annual amendments' to deal with consolidation changes occurring through a year, there is no formal statutory mechanism for taxpayers to agree a 'one shot multi-year adjustment' in relation to tax consolidation or other changes.

We plan to initiate a discussion with the ATO, to be undertaken quickly, to identify a practical approach to dealing with the potential prior year effect of the proposed amendments. It is possible that, emerging from the ATO consultation, we will make some further proposals to Treasury by the end of June in relation to any necessary amendments to enable suitable solutions.

SECTION D APPENDICES

APPENDIX A – SECTION 701-55(6) EXAMPLES AND OBSERVATIONS

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.

APPENDIX A – SECTION 701-55(6) EXAMPLES AND OBSERVATIONS

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.
<u>Example 1.1 – Trade receivables</u> Company J sells trading stock valued at $20,000 to a customer on credit (30 day term) on 25 June 2009. As Company J is taxed on an accruals basis, it includes the amount derived ($20 000) in its assessable income for the 2009-09 income year. Therefore, on 30 June 2009, Company J holds an Australian dollar trade receivable of $20,000. On 1 July 2009, Head Co acquires all the membership interests in Company J. As a result, Company J joins Head Co's consolidated group. Under the tax cost setting rules, the Australian dollar trade receivable is a right to receive an amount of Australian currency, and therefore is a retained cost base asset (paragraph 705-25(5)(b)). The TCSA is the amount of Australian currency concerned – that is, $20,000. Head Co eventually collects $18,000 in respect of the Australian dollar trade receivable and writes off the balance of $2000. Head Co can deduct the amount of the Australian dollar trade receivable written off as a general deduction under section 8-1 or as a bad debt deduction under section 25-35.	Where a deduction provision depends on an amount previously having been included in assessable income, the draft amendments do not appear to deem the amounts in 701-55(6)(a) to (d) to have been assessable income. For example, the principles underlying the proposed ss.701-55(6) do not suggest that the TCSA in respect of the debt is now taken to have been included in assessable income, as required for the purposes of ss. 25-35(1)(a). However, this is inferred in the conclusions reached in the Example. We do acknowledge that a section 8-1 bad debt loss is not precluded by the above analysis, however, it would be better for the interaction with s. 25-35 to in fact operate as intended. We infer from discussions with Treasury the intent is for ss. 25-35(1)(a) to be broadly interpreted (based on the current deeming under ss. 701-55(6)) so the TCSA of $20,000 is deemed to have been included in assessable income in the current or prior income year. However, by way of contrast, we note that in the context of building amortisation deductions for a taxpayer who has constructed the building itself, Treasury intends for the ss. 701-55(6) amount that is allocated to the building asset not to be deemed to have the character of construction expenditure. It is our view the wide interpretation of ss. 701-55(6) that is used to apply the bad debt provision is difficult to reconcile with the narrower interpretation that is needed to achieve the building amortisation outcome. We submit that the legislative provision requires additional deeming rules. In our view the provision would need to do more to deem the TCSA to have satisfied s. 25-35(1)(a) but it should also be clarified that the TCSA is not to be taken to be actual new construction expenditure for the purposes of division 43.

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.
Example 1.2 – Consumable stores Company J operates a transport business and pays $100,000 to acquire a quantity of fuel on 25 June 2009. The fuel is for use in its transport business. Generally a taxpayer can deduct an amount for consumable stores, such as stockpiled fuel, under section 8-1 when the expenditure to acquire the consumable stores is incurred (the incurred basis) or as the consumable stores are used (the usage basis). Company J applies the incurred basis to deduct the amount paid to acquire the fuel ($100,000) in the 2008-09 income year. On 1 July 2009, Head Co acquires all the membership interests in Company J. As a result, Company J joins Head Co's consolidated group. Company J still holds 70% of the fuel that it acquired on 25 June 2009 at the joining time. Under the tax cost setting rules, consumable stores are a reset cost base asset and the tax cost setting amount of the fuel is $70,000. Head Co will be taken to have incurred an amount equal to theTCSA to acquire the fuel at the joining time. Therefore, assuming that Head Co uses the fuel in the transport business, it can deduct the TCSA of the fuel ($70,000) in the 2009-10 income year	We suggest that the facts should assume that Head Co also applies the incurred basis for consumables. We recommend that the concluding paragraph states that the deduction in respect of the TCSA arises for the head company at the joining time. We also believe that the Example should include a short comment at the end on the tax outcomes assuming both parties adopted the usage basis. That is, the deduction is available when the consumables are used. Finally, for more complicated scenarios where there are different bases being used by the two companies, the ATO could provide an interpretative product at a later stage.

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.
<u>Example 1.3 – Long-term construction contract</u> Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group. Company J has a partially completed construction contract at the joining time – that is, broadly, it has partially performed some work under the contract that has not yet been completed to a stage where a recoverable debt has arisen. For accounting purposes, Company J has estimated the amount of partly earned unbilled income as $25,000. Under the tax cost setting rules, the construction contract is a reset cost base asset. The TCSA allocated to the asset is $20,000. If the construction contract is a revenue asset (as defined in section 977-50) of Company J, then subsection 701-55(6) will apply to specify the use of the TCSA for the contract by Head Co. That is, Head Co can use the TCSA for the contract ($20,000) to work out: • the amount of profit to be included in assessable income under section 6-5 in respect of the contract when it is completed; or • the loss to be deducted under section 8-1 in respect of the contract when it is completed.	The example needs to better explain the relevance of the $25,000 unbilled income to the $20,000 TCSA and to reach more definitive conclusions as to the timing of the profit/loss recognition under ss. 6-5 and 8-1 once the TCSA is to be used in those calculations. We understand from our recent discussions with Treasury that the ATO may hold the view that profit/loss is only available on completion of the contract. However, in our view, under a profit emerging basis as per IT2450, the TCSA would be used, from the joining time, to recalculate the future estimated profit/loss under the contract and for that amount to be brought to account over remaining life of the contract (together with any subsequent variations). This is a matter that needs to be resolved as part of the tripartite consultative process prior to finalising the legislation. We also believe that the Example should include a short comment at the end on the tax outcomes assuming the billings basis under IT2450 is used. We believe a deduction for the TCSA is available at the joining time for this amount under this basis.

APPENDIX A – SECTION 701-55(6) EXAMPLES AND OBSERVATIONS

The relevant examples in the Explanatory Memorandum.	**Observations having regard to the current drafting and discussions with Treasury.**
<u>Example 1.4 – Rights to deferred management fees</u> Company J operates a retirement village business and has rights to deferred management fees – that is, rights to fees that accrue over a resident's tenure in a retirement village unit but are not payable until the time of ceasing to be a resident. Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group. Under the tax cost setting rules, the rights to deferred management fees are a reset cost base asset and have a TCSA of $80,000. If the rights to deferred management fees are a revenue asset (as defined in section 977-50) of Company J, then subsection 701-55(6) will apply so that Head Co can treat the TCSA ($80,000) as the cost of the asset to work out: • the amount of profit to be included in assessable income under section 6-5 when the management fees are eventually derived; or • the loss to be deducted under section 8-1 when the management fees are eventually derived.	We recognise that rights to management fees may arise in many different factual scenarios. This may ultimately result in the TCSA not being connected with a revenue asset (i.e. CGT provisions apply); the TCSA may be fully deductible at joining time; or the TCSA amount may form part of a profit/loss computation as suggested in this particular example on deferred management rights. A short generic comment at the end of the Example consistent with the above would be useful in highlighting the 'facts and circumstances' approach that needs to be adopted.

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.
<u>Example 1.5 – Rights to unbilled income for the supply of gas</u> Company J carries on the business of supplying gas to its customers (being both domestic and commercial gas consumers) in very similar circumstances to those in FC of T v Australian Gas Light Co 83 ATC 4800; (1983) 15 ATR 105. In its profit and loss statement for the income year ended 30 June 2003, Company J recorded unbilled gas income of $25 000. Its balance sheet contained an unbilled gas asset of the same amount. The unbilled gas income is recognised as income for accounting purposes. However, it has not yet been recognised as assessable income for income tax purposes in accordance with Taxation Ruling No. IT 2095. On 1 July 2003, Head Co acquires all of Company J's membership interests. As a result, Company J joins Head Co's consolidated group. Under the tax cost setting rules, the rights to unbilled gas income are a reset cost base asset. The TCSA for the rights is $20 000. If the rights to unbilled gas income of Company J are a revenue asset (as defined in section 977-50), then subsection 701-55(6) will apply so that Head Co can use the TCSA for the rights ($20,000) to work out the amount of loss or outgoing that is deductible under section 8-1.	In our discussions it was noted that the income recognition principles in IT2095 may now be different in practice. Nevertheless, the assumption on which the Example is based is clear and thus can remain as is.

APPENDIX A – SECTION 701-55(6) EXAMPLES AND OBSERVATIONS

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.
<u>Example 1.6 – Assets held on revenue account</u> Company J is an investment company which held a significant share portfolio. Its investment strategy for the share portfolio is to maximise dividend yields. Where the dividend yield on investments fell, those shares would be sold and the proceeds invested in other shares with a higher dividend yield. In times of rising share values but falling dividend yields, Company J regularly switches between investments. Although only a small proportion of the Company J's portfolio was earmarked for imminent sale at any given time, its entire investment portfolio constituted revenue assets (as defined in section 977-50). All the investments were held on the basis that, hypothetically, they could be sold as part of Company J's normal business activity, and if sold at a profit would constitute ordinary income (per *London Australia Investments Co Ltd v. FC of T* (1977) 138 CLR 106; 77 ATC 4398; 7 ATR 757). Company J acquired two parcels of shares to add to its share portfolio being parcel A for a cost of $100,000 and parcel B for a cost of $80,000. Company J subsequently joins Head Co's consolidated group. Under the tax cost setting rules the TCSA for the parcel A and B shares is $105,000 and $82,000 respectively. Head Co also holds the two parcels of shares on revenue account. It subsequently sells the parcel A shares for $120,000. The gain on the disposal of the shares is the difference between the disposal proceeds ($120,000) and the TCSA ($105,000) – that is, $15,000. Therefore, Head Co will include $15,000 in its assessable income as ordinary income (section 6-5) in respect of the disposal of the parcel A shares. Head Co also sells the parcel B shares for $75,000. The loss on the disposal of the shares is the difference between the disposal proceeds ($75,000) and the TCSA ($82,000) – that is, $7,000. Therefore, Head Co's can deduct $7,000 as a general deduction (section 8-1) in respect of the disposal of the parcel B shares.	This Example is an appropriate place to note that while assets such as those discussed are revenue assets they, like all other revenue assets, are nonetheless CGT assets for which the provisions of ss. 701-55(5) can apply.

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.
<u>Example 1.7 – Traditional Securities</u> Company J acquires two assets that are traditional securities (as defined in subsection 26BB(1) of the *Income Tax Assessment Act 1936* (the ITAA 1936) on 1 July 2005 – asset A was acquired for a cost of $10,000 and asset B for a cost of $20,000. Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group. Under the tax cost setting rules, the traditional securities held by Company J are a reset cost base asset and: • the TCSA for asset A is $11,000; and • the TCSSA for asset B is $19,000. Head Co subsequently disposes of asset A for $13,000. Therefore, it makes a gain of $2,000 on the disposal of the asset (ie, the amount received on the disposal of the asset ($13,000) less the TCSA ($11,000)). The amount of this gain is included in Head Co's assessable income under subsection 26BB(3). Head Co also disposes of asset B for $15,000. Therefore, it makes a loss of $4,000 on the disposal of the asset (ie, the amount received on the disposal of the asset ($15,000) less the TCSA ($19,000)). Head Co can deduct the amount of this loss under subsection 70B(2).	This Example could also explain at the end that ss 701-55(5A) & (5B) would be relevant if Division 230 is to apply in relation to the assets.

The relevant examples in the Explanatory Memorandum.	**Observations having regard to the current drafting and discussions with Treasury.**
Example 1.8 – Land carrying trees Company J paid $850,000 to acquire land carrying trees. At that time $50,000 is set out in the contract as being attributable to the trees. Before the joining time, Company J fells 100% of the trees, claiming a deduction of $50,000. Company J then replants trees on the land. Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group. At the joining time, Head Co gets a valuation of the land which documents that the market value of the land (including the trees) at the joining time is $900,000. The value attributable to the newly planted trees is $20,000. Under the tax cost setting rules, the TCSA for the land (including the trees) is $1 million. Therefore, the tax cost setting amount attributable to the trees is $22,222 (ie, $20,000 / $900,000 x $1 million). Head Co subsequently fells the trees, and sells the timber for $50,000. Head Co will include the amount received on the sale of the timber ($50,000) in its assessable income and can deduct the TCSA attributable to the trees ($22,222) under subsection 70-120(4).	No specific comment

The relevant examples in the Explanatory Memorandum.	**Observations having regard to the current drafting and discussions with Treasury.**
Example 1.9 – Capital Works Company J holds a building at the time it joins a consolidated group. At the joining time, Company A has undeducted construction expenditure of $75,000 in relation to the building. Under the tax cost setting rules, the building is a reset cost base asset. The TCSA allocated to the building is $300,000. Generally, a taxpayer can deduct an amount for undeducted construction expenditure in relation to capital works under Division 43. The amount that can be deducted is the undeducted construction expenditure in relation to the capital works. The deduction under Division 43 is based on the construction costs of the capital works. Therefore, Head Co can deduct the balance of the undeducted construction expenditure ($75,000) under Division 43 by applying the entry history rule (subsection 701-5). Head Co cannot claim deductions for undeducted construction expenditure in relation to the building based on the TCSA allocated to the building.	As noted earlier, in discussions with Treasury it was apparent that the policy is not to give the TCSA at joining time the characterisation of building construction expenditure for the purposes of Division 43. However, please also see our comments at EM example 1.1.

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.
<u>Example 1.10 – Foreign currency trade receivable – no forex gain or loss</u> This example in based on the example in Draft Taxation Determination TD 2004/D80 (which has been withdrawn). The example assumes no foreign currency exchange gain or loss tax consequences. On 1 May 2003, Company J derives ordinary income of $100 by selling trading stock to Entity Z on credit for US$80. At that time, A$1 is equivalent to US$0.80. Company J joins Head Co's consolidated group on 1 July 2003. Under the tax cost setting rules, a TCSA of A$85 is allocated to the trade receivable. There are no currency fluctuations between 1 May 2003 and 1 July 2003. Entity Z pays US$80 (which translates to A$100) to Company J in settlement of its trade debt on 30 November 2003. Under the consolidation provisions, Head Co is taken to receive that A$100 payment. The amount received by Head Co (A$100) exceeds the cost base (being the tax cost setting amount) of the foreign currency trade receivable of A$85. None of the excess is attributable to a currency exchange rate effect. Therefore, Head Co makes a capital gain under CGT event C2 of $15.	Please refer to our earlier comments in this submission on Division 775 and foreign denominated trade receivables.

The relevant examples in the Explanatory Memorandum.	Observations having regard to the current drafting and discussions with Treasury.
<u>Example 1.11 – Foreign currency trade receivable – forex loss</u> On 1 May 2003 Company J derives ordinary income of $100 by selling trading stock to Entity Z on credit for US$80. At that time, A$1 is equivalent to US$0.80. Company J joins Head Co's consolidated group on 1 July 2003 when A$1 is equivalent to US$0.75 and the trade receivable translates to A$106.67. Under the tax cost setting rules, a TCSA of A$106.67 is allocated to the trade receivable. As the trade receivable is a revenue asset in the hands of Company J, subsection 701-55(6) applies to the TCSA. Entity Z pays US$80 to Company J in settlement of its trade debt on 30 November 2003. At that time, under the exchange rate, A$1 is equivalent to US$0.80c and A$100 cash is received by Head Co. The amount received by Head Co (A$100) is less than the TCSA of the foreign currency trade receivable (A$106.67) and a capital loss of $6.67 arises under CGT event C2. However, this difference is wholly attributable to the movement in the exchange rate from 1 July 2003 to 30 November 2003. Division 775 does not apply to the right to receive foreign currency as, under the entry history rule, Head Co is taken to have acquired the right prior to 1 July 2003 and has not elected for the Division to apply to the right. Therefore, Head Co can deduct the amount of the difference ($6.67) under section 8-1 (reducing the capital loss to nil).	See above.

APPENDIX B – CGT STRADDLE ISSUES SOUGHT TO BE ADDRESSED

The following table summarises CGT straddle transaction issues that arise under the existing provisions and how they would be addressed under the proposed CGT straddle legislative amendments. The table also notes whether or not these issues could be simply addressed by legislative refinements to support the approach adopted in TDs 2008/29 to 2008/31.

CGT straddle transactions policy issues	Legislative amendments required	Could these policy issues be addressed only by legislative refinements based on the approach in the existing tax determinations?
CGT QUANTIFICATION AND TIMING INFORMATION KNOWN BY THE RELEVANT TAXPAYER		
The taxpayer that enters into the contract may not be aware of: ▪ when the contract is settled; ▪ the CGT proceeds ultimately received; or ▪ the cost base of the asset at settlement.	**Automatically addressed** if the CGT gain/loss is taken to arise at the contract completion time for an entity that enters into a contract and then joins or leaves a consolidated group before the contract completion time.	**No –** these problems could not be comprehensively addressed under the TDs approach, particularly in relation to 'control' over timing/proceeds/cost base aspects.

APPENDIX B – CGT STRADDLE ISSUES SOUGHT TO BE ADDRESSED

CGT straddle transactions policy issues	**Legislative amendments required**	**Could these policy issues be addressed only by legislative refinements based on the approach in the existing tax determinations?**
<u>*Comments*</u> ▪ *From a policy perspective it is totally inappropriate that a taxpayer can be subject to tax without being aware of or having control of the elements that are critical in determining their tax liability.* ▪ *This problem arises in all exit-sell scenarios, and also in entry-sell scenarios where the joining entity was a member of another consolidated group at the contract date.*		
TAXABLE ENTITY DOES NOT RECEIVE SALE PROCEEDS		
The contracting taxpayer that will be subject to the CGT gain will not directly receive the settlement proceeds, and therefore may not have sufficient funds to meet their CGT liability.	**Automatically addressed** if the CGT gain/loss is taken to arise at the contract completion time for an entity that enters into a contract and then joins or leaves a consolidated group before the contract completion time.	**No –** these issues could not be addressed by legislative refinements to the approach adopted in the TDs.

APPENDIX B – CGT STRADDLE ISSUES SOUGHT TO BE ADDRESSED

CGT straddle transactions policy issues	Legislative amendments required	Could these policy issues be addressed only by legislative refinements based on the approach in the existing tax determinations?
<u>*Comments*</u> ▪ *This is a very important practical and equitable issue.* ▪ *While the contracting consolidated group may have received consideration on the sale of the shares in the relevant leaving entity, this may not provide it with sufficient funds for various reasons, including:* o *the settlement proceeds may exceed initial estimates;* o *because of the liabilities of the leaving entity, the proceeds received on sale of the late leaving entity may be substantially below the settlement proceeds.* ▪ *This problem arises in all exit-sell scenarios, and also in entry-sell scenarios where the joining entity was a member of another consolidated group at the contract date.*		
DIFFERENT ENTITIES BOTH TAXED ON SAME PROCEEDS		
The proceeds in respect of the CGT event could potentially be taxed to 2 different taxpayers, as the provisions which prevent the same amount being taxed twice apply only to a single taxpayer.	**Automatically addressed** if the CGT gain/loss is taken to arise at the contract completion time for an entity that enters into a contract and then joins or leaves a consolidated group before the contract completion time.	**No –** the contracting taxpayer would be unable to predict with certainty the tax outcomes for the settlement entity, and any mechanism that sought to overcome this problem by proposing ongoing information sharing obligations between the parties would be burdensome and problematic.

APPENDIX B – CGT STRADDLE ISSUES SOUGHT TO BE ADDRESSED

CGT straddle transactions policy issues	Legislative amendments required	Could these policy issues be addressed only by legislative refinements based on the approach in the existing tax determinations?
<u>*Comments*</u> ▪ *For example, the 'contracting taxpayer' could bear the full CGT exposure, notwithstanding that the proceeds when received will be assessable to the 'settlement entity'. Subsection 118-20(1) would not operate to address double taxation in these circumstances as 2 different taxpayer are being impacted.* ▪ *This problem arises in all exit-sell scenarios, and also in entry-sell scenarios where the joining entity was a member of another consolidated group at the contract date.*		
DOUBLE TAXATION OF CONTRACTING TAXPAYER		
The same economic gain double taxed to the contracting taxpayer: ▪ once in respect of the CGT event relating to the contract to sell the underlying asset, and ▪ again on the sale of shares in the leaving entity holding the underlying asset due to the fact that under section 711-25 the cost base of these shares is determined by reference to the cost base of the underlying asset.	**Automatically addressed** if the CGT gain/loss is taken to arise at the contract completion time for an entity that enters into a contract and then joins or leaves a consolidated group before the contract completion time.	**Yes -** this issue has been identified by the ATO and in TD 2008/29 the ATO indicate they will 'not disturb' a taxpayer self-adjusting the resulting CGT gain to avoid this double taxation, but no technical basis for this approach is stated. It is apparent that this issue could be more appropriately addressed by legislative refinement. For example, utilising the TD approach by legislative amendment, the Division 711 exit cost base could be increased by any gains already taxed to the group in respect of CGT straddle transactions.

APPENDIX B – CGT STRADDLE ISSUES SOUGHT TO BE ADDRESSED

CGT straddle transactions policy issues	Legislative amendments required	Could these policy issues be addressed only by legislative refinements based on the approach in the existing tax determinations?
<u>*Comments*</u> ▪ *Double taxation in respect of the same underlying economic gain is a broader issue in the Australian income tax environment, and it will not be totally addressed by the proposed CGT straddle amendments. However, these amendments will operate to avoid the <u>same taxpayer</u> being directly taxed twice in respect of the same economic gain.* ▪ *This prevention of double taxation for the same gain actually realised by 'a consolidated group' (ie the same taxpayer) is as per section 700-10 the first stated policy objective of the consolidation regime.* ▪ *This problem arises in all exit-sell scenarios, and also in entry-sell scenarios where the joining entity was a member of another consolidated group at the contract date.*		

APPENDIX B – CGT STRADDLE ISSUES SOUGHT TO BE ADDRESSED

CGT straddle transactions policy issues	Legislative amendments required	Could these policy issues be addressed only by legislative refinements based on the approach in the existing tax determinations?
ALLOCATION OF THE ALLOCABLE COST AMOUNT (ACA): ENTRY-SELL SCENARIOS		
In entry-sell scenarios issues can arise as to whether the ACA should be allocated to the underlying asset that is the subject of the disposals contract or to the contractual rights in the straddle contract itself. .	**No specific legislative amendments are required** as this issue commonly arises in the context of other assets that are subject to associated contractual rights. While this ACA allocation issue is currently addressed by the application of normal market valuation parties (and this is consistent with the position adopted by the ATO in *Taxation Determination* TD 2008/31 and the associated compendium, TD 2008/31EC), confirmatory comments in the relevant Explanatory Memorandum could be of assistance.	**Legislative amendment required** – while under the approach adopted in the TDs the joined group will not bear a CGT exposure in respect of the underlying asset on the contract settlement date, the TDs state that the tax cost setting amount should still generally be allocated to the underlying asset that is subject to the sales contract. If CGT is triggered back at the contract date prior to the joining time, this then creates some ambiguity as to 'what happens' to the ACA allocated to the underlying asset at the joining time and what, if any, cost base is obtained by the joined group in respect of the rights to receive proceeds under the sale contract. Therefore, if the CGT straddle amendments were not to be introduced, it would be necessary to address the above ACA allocation anomalies by way of specific legislative amendment (and hence introduce a significant policy distortion from the normal market value ACA allocation principles).

APPENDIX B – CGT STRADDLE ISSUES SOUGHT TO BE ADDRESSED

CGT straddle transactions policy issues	Legislative amendments required	Could these policy issues be addressed only by legislative refinements based on the approach in the existing tax determinations?
<u>*Comments*</u> ▪ *The ATO in Taxation Determination TD 2008/31 and the associated compendium, TD 2008/31EC, indicate that they are of the view that in an entry-sell scenario ACA should generally be allocated to the underlying asset that is the subject of the sales contract, and only in very limited circumstances should ACA be allocated to the contractual rights themselves (eg possibly where, since the contract date, the underlying property has substantially diminished in value or where the entity has dealt with assets arising under the contract separately from the underlying assets).* ▪ *However, to avoid any confusion in this regard it may be preferable if the associated Explanatory Memorandum could confirm that the appropriate asset in relation to the allocation of the ACA is generally the underlying asset rather than the rights under the disposals contract, because in most circumstances the right to sale proceeds, etc, will be dependent on the transfer of ownership of the underlying asset.* ▪ *Similar ACA allocation issues commonly arise in relation to yet-to-be-completed contracts for the sale of depreciating assets and trading stock, etc (eg long term supply contracts in relation to minerals). Under normal market valuation principles, generally ACA is allocated to the underlying asset rather than the pending sales contract.*		