2 May 2012

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cc: Tony Regan (Treasury) – anthony.regan@treasury.gov.au
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Dear Nan

Exposure draft: Tax Laws Amendment (2012 Measures No. 2) Bill 2012 – Schedule 2

The bodies that are signatories to this letter welcome the opportunity to comment on exposure draft legislation, Tax Laws Amendment (2012 Measures No. 2) Bill 2012 – Schedule 2, containing amendments to the Taxation of Financial Arrangements (TOFA) and Consolidation interaction provisions.

Nevertheless, we believe the consultation timeframe for the exposure draft legislation and accompanying explanatory memorandum was not sufficient given the complexity of the areas of tax law covered by Schedule 2 and in view of the same due date for comments on Schedule 1 dealing with consolidation and rights to future income. Furthermore, as there was little consultation on the measures in Schedule 2 in the lead up to the then Assistant Treasurer's announcement of the measures on 25 November 2011, there should have been a longer consultation period for the exposure draft legislation, especially in view of the retrospective nature of some of the measures.

As outlined in the joint professional bodies' submission to Treasury on the announcement of these measures (attached for your reference), introducing retrospective legislation that adversely affects taxpayers is generally undesirable as it disrupts the stability of our tax system. Furthermore, introducing retrospective legislation without appropriate prior consultation increases uncertainty for those taxpayers who are impacted by the measures.

Even if Treasury decided to retrospectively apply the amendments proposed in Schedule 2 to TOFA liabilities that are subject to the TOFA elective methodologies (where the taxpayer has made a transitional election), the retrospective application of the proposals to TOFA liabilities subject to the accruals and realisation methodologies under TOFA reflects a clear change in policy (from the original TOFA explanatory memorandum) and it seems inappropriate to have these measures apply retrospectively.

The proposed retrospective legislation will adversely affect a range of taxpayers who relied on the existing tax legislation when they were making significant business investment decisions, or deciding whether or not to make a transitional election. Those taxpayers can be divided into two categories:

- head companies of consolidated groups who made a transitional election to ungrandfather their existing financial arrangements at the time that Division 230 started to apply to them, which included financial arrangements that were held at that time as a result of either a formation event for the tax consolidated group or the acquisition of a joining entity; and
- head companies of consolidated groups which have acquired entities with certain financial arrangement liabilities since the time that Division 230 started to apply to them (whether or not they made a transitional election).

First category – taxpayers that made transitional elections

The Australian Taxation Office (ATO) TOFA election and lodgement statistics (based on lodged tax return data) which were referred to in the minutes of the last NTLG TOFA Working Group meeting on 20 March 2012, confirmed that a total of 1,233 taxpayers have lodged TOFA returns and out of those taxpayers, 424 have made transitional elections. At the meeting, the ATO did not have the number of tax consolidated group taxpayers reflected in their data, but were working on identifying statistics for consolidated groups. We note that the Large Business & International taxpayers and Small & Medium Enterprise taxpayers who made transitional elections totalled 365.

It is our view that a commencement date for the final legislation should be 25 November 2011, so that taxpayers who relied on the tax legislation introduced by the Government, and made significant decisions and elections based on that law, are protected. We consider that taxpayers that had made the transitional election, i.e. the TOFA "ungrandfathering election", based on the law prior to 25 November 2011, should not be subject to any adverse outcomes (i.e. in relation to the calculation of their transitional balancing adjustment amounts and any gains/losses recognised under the Subdivision 230-G balancing adjustment mechanism) as a result of the proposed measures. They should continue to be able to calculate their transitional balancing adjustment amounts and Subdivision 230-G balancing adjustment amounts on the basis of the law as it stood prior to 25 November 2011.

If, however, the Government proceeds with a commencement date of 26 March 2009 then, as submitted in our previous submission, at the very least, the first category of taxpayers should be given the opportunity to reconsider TOFA transitional elections which were made prior to the announcement of these measures and on the basis of the law as it then stood (and which is now being retrospectively amended). The following example illustrates how the retrospective nature of these amendments will impact taxpayers inequitably.

<u>Example – pre-TOFA acquisition</u>

Company A acquired Company B in 2007. As a result of the acquisition, Company A (as head company) assumed various financial liabilities. When Company A acquired Company B it priced the acquisition on the basis that it would be entitled to deductions on close-out of the financial liabilities assumed. On 1 July 2010, the TOFA provisions applied on a mandatory basis to Company A. At this time, Company A had to decide whether to make the ungrandfathering election and apply the TOFA provisions to all of its existing financial arrangements (including those acquired from Company B in 2007 - assuming that they are still on foot). When Company A made this decision in 2010, it did so on the basis that its tax cost in the financial liabilities assumed from Company B would not be reset to their accounting value at the joining time. As such, Company A thought that it would still be able to claim tax deductions when the financial liabilities were closed out. Company A made the ungrandfathering election.

The effect of the new provisions is that Company A will lose the benefit of the tax deductions that it was expecting in relation to the financial liabilities assumed when it acquired Company B. This arises from the fact that the proposed provisions will operate to retrospectively adjust Company A's tax cost in the liabilities assumed to the accounting value of the liabilities at the time that Company A acquired Company B. This will have the effect of permanently wiping these deductions out of the tax system (the amount of the deductions wiped out will be equal to the accounting value of the liability at the joining time).

In this example, Company A made two significant decisions based on the law as it stood at the relevant time - (i) to acquire Company B and to calculate the price it would pay for Company B and (ii) to elect to ungrandfather its existing TOFA financial arrangements. When it made both decisions, Company A believed that it would be entitled to tax deductions equal to the amount of the financial liabilities assumed (assuming they were otherwise deductible).

The proposed changes reverse this position and retrospectively deny these deductions. Furthermore, as can be seen from the example above, a taxpayer that has chosen to ungrandfather its TOFA financial arrangements is now in a significantly worse position than a taxpayer that chose not to ungrandfather (a taxpayer in exactly the same position who chose not to ungrandfather its financial arrangements in 2010 would still be entitled to the deductions).

It is not apparent how such a retrospective change can be justified.

The explanatory memorandum seeks to justify this policy change at paragraph 2.33 as being purportedly to avoid “loss duplication”. Presumably, this refers to the possibility of the joining entity having claimed a tax deduction pre-joining for the mark-to-market movement in the financial liability, and then the head company claiming a deduction for any actual outgoings when the liability is finally settled. However, in the case of a pre-TOFA joining time, there should not be any loss duplication as between the joining entity and the head company. The joining entity, by definition, could not have been subject to the TOFA rules and so would not have been able to utilise any of the accounting methods or the accruals method. The joining entity would not have been entitled to a pre-joining deduction for the mark to market value of the liability, under any tax method then available. Accordingly, there is no basis to create a retrospective permanent difference between taxpayers who have chosen to “ungrandfather” their pre-TOFA liabilities, and those taxpayers who have made a different choice.

Furthermore, the ungrandfathering election is simply a compliance measure designed in order to allow taxpayers not to have to apply two sets of tax provisions to their financial arrangements. As a compliance concession provided to taxpayers, it was never intended that the making of the ungrandfathering election would create significant tax distortions by treating taxpayers differently – i.e. eliminating tax deductions for those that made the ungrandfathering election but not for taxpayers that did not ungrandfather.

Finally, should the retrospectivity of the measures remain, there is a significant flow-on issue in relation to financial liabilities. This arises from the fact that if the deduction is denied (by virtue of resetting the tax cost of the liability at the accounting value of the liability assumed at the joining time) in relation to financial arrangements acquired as a result of pre-TOFA acquisitions, then the historic Allocable Cost Amount (ACA) calculation that was undertaken in relation to that acquisition will be incorrect – as the Step 2 amount should have been 100% of the liability rather than 70% as would have been the case (as at the time of acquisition, it would have been assumed that the liability would have been deductible). If this does occur then the provisions should clearly allow purchaser groups to amend their historic ACA calculations if they have the systems that allow them to do this (and monitor the ongoing consequences). This position should be clarified otherwise there will be ambiguity in relation to whether this is possible under Subdivision 705-E (even if purchaser groups have the systems to allow them to do this). If purchaser groups do not have the systems to allow them to amend the historic ACA calculations, or if they prefer not to, then they should be able to obtain an immediate capital loss in relation to the lost ACA. This could be provided under CGT event L6, but extended to cover both reset and retained cost base assets (CGT event L6 currently only covers reset cost base assets).

Second category – taxpayers that made post-TOFA acquisitions

A consolidated group that is subject to the TOFA rules may have acquired entities with financial arrangement liabilities since the time that Division 230 started to apply to the group. This time could have been as early as 1 July 2009 if an election to early adopt the TOFA rules was made. As noted in the example above, the purchaser group may have priced acquisitions on the basis that they would be entitled to deductions on the settlement of certain financial arrangement liabilities assumed from the joining entities. If the proposed changes apply retrospectively, this may mean that acquisitions since 1 July 2009 (almost 3 years ago) may have been incorrectly priced to the extent of the tax benefit of any deduction that was anticipated.

Again, it is our view that a commencement date for the final legislation should be 25 November 2011, so that taxpayers who relied on the tax legislation introduced by the Government, and made significant decisions and elections based on that law, are protected.

Our previous submission provides more comprehensive examples of the adverse consequences of the retrospective nature of the new measures.

Additional clarification required for accruals and realisation taxpayers

Additional clarification is required for accruals and realisation taxpayers in relation to item 3 of Schedule 2, to explain how they are to deal with the liability and the deemed payment received. Example 2.7 of the explanatory material explains how the gain is to be dealt with under the Subdivision 230-G balancing adjustment. However it then states that the negative liability "is used to work out the gain or loss and the spreading of that gain or loss on an on-going basis". This ongoing working out and spreading needs more clarification in the law or explanatory material, to avoid a fresh source of uncertainty for affected head companies.

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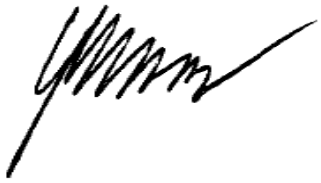
We would be pleased to discuss any aspect of this submission with you. If you have any queries please contact, at first instance, Karen Liew of the Institute of Chartered Accountants in Australia on 02 9290 5750.

Yours sincerely



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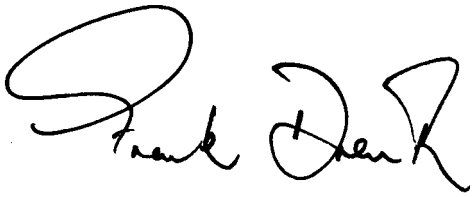

Frank Drenth
Executive Director
Corporate Tax Association

Paul Drum
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Attachment: Joint submission on the operation of the TOFA rules for consolidated groups dated 12 January 2012

12 January 2012

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Dear Christine

Operation of the TOFA rules for consolidated groups
Media Release No. 159 - Changes to the income tax law affecting consolidated groups

As you will be aware, on 25 November 2011, the then Assistant Treasurer announced a number of changes to the income tax law affecting consolidated groups. The changes contained in Attachment A of the 25 November 2011 media release number 159 ('the media release") were the subject of extensive consultation. Unfortunately the changes contained in Attachment B of the media release were not subject to any consultation.

The professional bodies that are signatories to this letter are of the view that significant consultation regarding the implementation of these proposals must be undertaken. In particular, extensive consultation is required regarding the retrospective nature of the proposals that will adversely affect taxpayers who relied on the existing tax legislation when they were making significant business investment decisions.

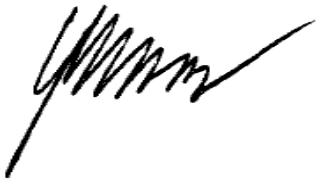
The attached submission discusses the following issues:

- Part A – the need for greater consultation;
- Part B – a summary of our understanding of the proposed changes in Attachment B; and
- Part C – examples demonstrating how the proposals will impact taxpayers inequitably (together with a discussion of some aspects of the proposals).

Although a number of issues are raised in the Attachment B media release this submission is primarily directed at the transitional balancing adjustment amendments set out in paragraphs 7 to 11 of Attachment B. This arises from the fact that these amendments largely reflect the retrospective nature of the proposals. Although this submission does indirectly discuss some issues relating to "liabilities" assumed when an entity joins a tax consolidated group (i.e. the changes set out in paragraphs 4 to 6 of Attachment B), this submission does not consider these issues in any detail and does not consider the appropriate way to deal with such liabilities under the income tax system. This will form the basis of a separate submission that we will provide in early 2012.

We would be pleased to discuss any aspect of this submission with you. If you have any queries please contact, at first instance, Susan Franks of the Institute of Chartered Accountants in Australia on 02 9290 5750.

Yours sincerely



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Part A – the need for extensive consultation

Introducing retrospective legislation that adversely affects taxpayers is generally undesirable as it disrupts the stability of our tax system. However, unexpectedly introducing retrospective legislation without appropriate prior consultation increases uncertainty for those taxpayers who are impacted by the measures.

The difficulties of introducing retrospective legislation were recognised by the former Assistant Treasurer in relation to the announcements contained in Attachment A of media release 159. To overcome these difficulties, the then Assistant Treasurer held extensive consultations which included:

a) Announcing publicly on 30 March 2011 that the Government was concerned about certain consolidations law issues and that the Board of Taxation would commence an urgent review into those matters.
b) A public review by the Board of Taxation involving a public issues paper and public invitation for submissions.
c) Board of Taxation discussions with a range of experts, and subsequent Board of Taxation report to the Government.
d) After the Board's report, an extensive consultation process commenced on 30 June 2011. The consultation process was led by the Government, and also included Treasury, the ATO and selected representatives from the business community and tax profession. A number of meetings were held in relation to the key issues and likely way forward for the Government.
e) Discussing successive drafts of Attachment A which contained a comprehensive analysis of the precise issues at stake, with section references, legislative history and treatment of transitional issues, as appropriate given the significant amendments with retrospective effect.
f) Protection of various assessments and amended assessments lodged by consolidated groups relying on the law in force.

In contrast, there has been no consultation in relation to Attachment B of media release 159. It is understood that the extent of consultation before the issue of Attachment B only extended to showing the proposed Attachment B measures in draft form on 24 November 2011, one day before their release on 25 November 2011, to the representatives involved in and focusing on the Attachment A issues.

Whilst the changes made by Attachment A (and the transitional rules in respect of these) remain the subject of much concern for businesses, the policy changes contained in Attachment B should at least be subject to a similar level of consultation to that given to those contained in Attachment A of media release 159.

On the face of Attachment B, the proposals apply retrospectively, without any regard to the fact that taxpayers will have made tax elective choices and decisions, with significant financial implications, and without any apparent regard for the need to achieve a degree of equity amongst taxpayers.

We are of the opinion that, proper implementation of Attachment B requires a commencement date of 25 November 2011 so that taxpayers which relied on the tax legislation introduced by the Government and made significant decisions, and elections, based on that law are protected. To be clear, we consider that taxpayers that had made elections (the TOFA "un-grandfathering election") based on the law prior to 25 November 2011 should not be subject to any adverse outcomes in relation to the calculation of their transitional balancing adjustment amounts as a result of the changes proposed by Attachment B – i.e. they should continue to be able to calculate their transitional balancing adjustment amounts on the basis of the law as it stood prior to 25 November 2011.

In the alternative, if the Government proceeds with making the Attachment B measures retrospective then, at the very least, taxpayers should be given the opportunity to reconsider TOFA transitional elections which were made prior to the announcement of Attachment B and on the basis of the law of Australia as it then stood (and which is now being retrospectively amended by Attachment B). We have included within Appendix C to this submission an example of how the retrospective nature of these amendments may impact taxpayers inequitably.

We believe that the Government must use the consultation process and the issues emerging from it to develop an appropriate package of measures in relation to Attachment B dealing with:

- date of commencement of the measures; and
- protection for taxpayers who relied on the law and made elections based on the law.

Part B – intended scope and operation of the measures

Although dealing with an extremely complicated area of the income tax law, Attachment B is extraordinarily brief. Indeed, it contains no references to legislative provisions and does not discuss/explain the context of the proposed changes or what the changes are intended to achieve. As such, we have set out below what we understand the measures set out in Attachment B apply to and also what we understand the Attachment B measures do. We have summarised these in a simple example (below) and we seek your confirmation that both our understanding and the example are correct.

We understand the Attachment B measures apply to:

1. financial arrangements (within the meaning of Division 230 ITAA 1997) held on or after the time Division 230 ITAA 1997 starts to apply;

2. by the head company of a tax consolidated group;

3. financial arrangements held as a consequence of either a formation event for the tax consolidated group or an entity joining the tax consolidated group after the commencement of Division 230 ITAA 1997 (in the case of a pre-TOFA acquisition the measures will only apply, via the calculation of a transitional balancing adjustment amount, to taxpayers that have elected to un-grandfather their existing financial arrangements at the time that Division 230 starts to apply to them and they hold financial arrangements previously acquired as a result of a pre-TOFA acquisition).

We seek your confirmation that our understanding is correct.

Furthermore, we understand that the measures:

1. deem the head company of the relevant tax consolidated group to have acquired/assumed financial arrangements (whether assets or liabilities) from the joining entity at the joining time;

2. deem financial arrangement liabilities subject to fair value, retranslation or financial reports tax timing methods to have been assumed by the head company at their accounting value at the joining time (that is, the head company is deemed to have received the accounting value as consideration);

3. deem financial arrangement liabilities which are not subject to fair value, retranslation or financial reports tax timing methods to have been assumed by the head company at their accounting value at the joining time;

4. allow the head company to use only the primary method (long-form method) for working out TOFA transitional balancing adjustments; and

5. in calculating their transitional balancing adjustment amounts, require the head company to apply the TOFA/consolidation interaction provisions (including, rules 1, 2 and 3 above) in relation to historic corporate acquisitions. For completeness, we note that although not stated in Attachment B we assume that the TOFA/consolidation interaction provisions are intended to be s.701-55(5A), s.701-55(5B), s.701-61 and s.715-375.

Although not stated in Attachment B we understand that the intent or "policy" behind rules 2 and 3 is to deny a consolidated group that assumes liabilities on acquisition of a company any deductions in relation to that assumed liability up to the amount of the accounting value of the liability at the time that the consolidated group acquired the company.

We seek your confirmation that our understanding is correct.

Although there may be disagreement between Treasury and industry in relation to the scope of these changes, we understand that at a minimum Treasury accepts that:

- some of these changes (particularly, rule 3 above) reflect a change in policy; and
- the position in relation to a number of the other changes was not clear prior to Attachment B.

In particular, we believe that it was clear (prior to the release of Attachment B) that taxpayers that had elected to un-grandfather their existing financial arrangements did not have to apply the TOFA/consolidation

interaction provisions in relation to historic corporate acquisitions (i.e. rule 5 above did not apply). This is considered in further detail in Part C below.

The above points are summarised below in an example and we seek your confirmation that you agree with this calculation.

Example

Facts

- Company B is an Australian resident company and a member of the Company A tax consolidated group;
- The shares in Company B are sold to Company C (an Australian resident company and head company of the Company C tax consolidated group) for $121 (net assets) either before or after the start of the TOFA law and, as a consequence, Company B joins the Company C tax consolidated group;
- For completeness, we assume that neither the Company A tax consolidated group nor the Company C tax consolidated group have chosen to apply any of the elective taxation methods under the TOFA law;
- At the acquisition time Company B has assets of $200 funded by borrowings of $100 and share capital of $100;
- The assets comprise only cash at bank denominated in Australian dollars (that is, cash of $200);
- The borrowing is denominated in foreign currency and the exchange rate has changed in such a way that the liability is now only worth $70 (that is, there is an unrealised FX gain of $30);
- Ignoring any interest income earned in respect of the assets, Company B therefore has an accounting profit of $30 and a tax expense (deferred tax liability) of $9 – that is, retained earnings of $21;
- Consequently, Company B's balance sheet is:

Assets	
Cash at bank	200
Liabilities	
Borrowings	70
Deferred tax liability	9
Net assets	**121**
Share capital	100
Retained earnings	21
Shareholders equity	**121**

Analysis

Tax position of the vendor (Exit ACA)
The position of the vendor, the Company A consolidated group, is as follows:

Exit ACA		
Step	**Amount**	**Legislative reference**
1	$200	S711-25
2	$Nil	
3	$Nil	
4	$109	S711-45(5)
Total old group ACA	**$91**	
Gain on disposal		
Sale proceeds	$121	
Capital gain	$30	

Please note that the above exit ACA calculation has been shown on the basis that the step 4 amount has been 'tax effected'. Attachment B is not stated to apply to the exit ACA calculation.

Entry ACA

Under the Attachment B measures:

- Company C (as head company of the tax consolidated group) will be deemed to have acquired the financial liability (the borrowing) at $70 (its accounting value) at the joining time.

- For TOFA purposes, the liability is therefore 'reset' to $70 so that, assuming no further movement in the exchange rate until repayment of the liability, no tax gain or loss is ultimately ever made on extinguishing the liability (refer section 230-25 ITAA 1997).

  In this regard we seek your confirmation that, if the Attachment B changes are introduced, further retrospective changes would be made so that the 'reset' of the liability occurs for all TOFA purposes including, in particular, the balancing adjustment provisions in Subdivision 230-G (as well as the interaction of TOFA and consolidation). The associated consequence of this is that the deferred tax balance (the deferred tax liability) should no longer be recognised.

- The entry ACA calculation in respect of Company B is as follows:

Step	**Amount**	**Legislative reference**
1	$121	S705-65 (note 1)
2	$ 70	S705-70 (1A)
For simplicity, ignore othe steps		
Total ACA	**$191**	
Retained cost base asset	$200	
Shortfall ACA (L3 gain)	$9	

Note 1: Purchase price currently reflects the deferred tax liability of $9 which, pursuant to the operation of Attachment B and subsection 705-70(1A) ITAA 1997, would otherwise not be a liability of the tax consolidated group. It is entirely possible that, following the announcement of Attachment B, the purchase price would be increased to reflect the fact that the liability would be ''reset' for tax purposes (with the effect that the acquiring group (in this example, the Company C tax consolidated group) would not be required to pay the $9 deferred tax in respect of the liability). This is one of the many issues requiring consideration.

Part C – Transitional balancing adjustment amounts in relation to un-grandfathered financial arrangements (plus various examples)

As reflected above, this submission relates specifically to the retrospective nature of the amendments which arise as a result of the proposal to apply certain TOFA/consolidation interaction provisions to the calculation of a taxpayers transitional balancing adjustment (**TBA**) amount (see paragraphs 7 to 11 of Attachment B).

This submission does not consider the appropriateness (or not) of applying the long-form method to the calculation of TBA amounts in relation to financial arrangements acquired as a result of a pre-TOFA acquisition. Although we are not convinced that permanent differences should arise (see paragraph 11 of Attachment B) provided that the Subdivision 230-G balancing adjustment provisions work correctly, we have not addressed the long-form v short-form TBA issues in this submission.

What we do consider to be a fundamental retrospective change in law is the proposed application of the "TOFA/consolidation" interaction provisions (see paragraph 8 of Attachment B) to the calculation of a taxpayer's TBA amount in relation to financial arrangements that it has acquired/assumed as a result of a historic corporate acquisition.

We consider that this proposal represents a retrospective change in law which will lead to inequitable consequences for those taxpayers that have elected to apply the TOFA provisions to their existing financial arrangements (i.e. those taxpayers that have elected to un-grandfather their existing financial arrangements).

In particular, we note that:

- taxpayers have already made elections to un-grandfather their existing TOFA financial arrangements – taxpayers made these decision in good faith based on the TOFA provisions as enacted. If taxpayers had known that the TOFA/consolidation interaction provisions applied when calculating their TBA amounts then they may not have made the decision to un-grandfather their existing TOFA financial arrangements; and

- although there are a number of consequences flowing from the application of the TOFA/consolidation interaction provisions to historic corporate acquisitions perhaps the most fundamental consequence is the denial of deductions in relation to financial arrangement liabilities assumed by a consolidated group when it acquired another entity (as a result of "resetting" the tax cost of the liability assumed to its accounting value at the time of acquisition). Such a retrospective change is inherently inequitable as the transaction will have been originally implemented on the basis that the deductions would be available to the purchasing group. To deny such deductions in relation to historic corporate acquisitions (potentially all the way back to 2002) cannot be justified from a policy perspective.

- In the Attachment A consolidation announcement, certain measures were implemented with effect prospectively from 31 March and various transitional measures apply to taxpayers which had lodged returns or amended returns or entered into transactions relying on the legislation. Attachment B is completely silent on consideration of these issues.

Although these issues are inherently complicated, we have attempted to illustrate our concerns through a simple example.

Example

Facts

- Company B is an Australian resident company and in 2006 was a member of the Company A tax consolidated group;

- Company B had the following assets/liabilities on 31 December 2006:

  - a deposit of $100 (denominated in Australian dollars) (the **Cash**); and
  - a derivative that was ($100) out-of-the-money (the **Derivative**).

- The Derivative was recognised in Company B's accounts with a fair value of ($100). A deferred tax asset of $30 was also recognised in Company B's accounts in relation to the Derivative.

  The financial statements of Company B were

Assets	
Deposit	100
Deferred tax asset	30
Liabilities	
Derivative	100
Net assets	**30**
Share capital	100
Retained earnings	(70)
Shareholders equity	**30**

- The shares in Company B were sold to Company C (an Australian resident company and head company of the Company C tax consolidated group) on 1 January 2007 for $30 (i.e. net assets). At this time Company B joined the Company C tax consolidated group.

- On 1 July 2010, the Company C tax consolidated group became subject to TOFA. At this time, Company C still held the Cash of $100 and the Derivative. For the purposes of this example, we have assumed that Derivative had not changed in value – i.e. it is still ($100) out-of-the-money on 1 July 2010 and at the time the Derivative is closed out.

- Company C elected to un-grandfather all of its existing financial arrangements (under Item 104(2) of the TOFA Act). As such, Company C is required to calculate a TBA amount in relation to all its un-grandfathered financial arrangements which will include the Cash of $100 and the Derivative. (Note: these facts are only relevant to Scenarios 1 and 3).

- Company C is subject to the default accruals and realisation provisions with Division 230 (i.e. Company C has not elected to apply any of the TOFA elective methods). For completeness, we note that no material differences should arise if Company C has elected to apply the elective methods – the only differences would be timing differences in relation to the recognition of the TOFA gains/losses in relation to the Derivative.

We have set out in the attached spreadsheet a number of scenarios in relation to this example being:

Scenario 1 Current law and un-grandfathering election made by Company C

- Scenario 1 is based on the existing provisions (i.e. without the Attachment B changes) and on the assumption that Company C elected to un-grandfather its existing financial arrangements.

- As reflected in Scenario 1, Company A will incur a capital loss of $70 and Company C will be entitled to a deduction for the $100 loss incurred when the Derivative is closed out.

Scenario 2 Current law and no un-grandfathering election made by Company C

- Scenario 1 is based on the existing provisions (i.e. without the Attachment B changes) and on the assumption that Company C has not elected to un-grandfather its existing financial arrangements.

- As reflected in Scenario 2, Company A will incur a capital loss of $70 and Company C will be entitled to a deduction for the $100 loss incurred when the Derivative is closed out.

Scenario 1 and 2 demonstrate that under the existing TOFA provisions (i.e. without applying the TOFA/Consolidation interaction provisions when calculating a taxpayers TBA) there is no difference between a taxpayer (here, Company C) that has elected to un-grandfather its existing financial arrangements and a taxpayer that has not elected to un-grandfather its existing financial arrangements.

Scenario 3 Attachment B applies and un-grandfathering election made by Company C

- Scenario 3 is based on the changes set out in Attachment B applying retrospectively (i.e. the TOFA/Consolidation interaction provisions applying when a taxpayer calculates its TBA amount) and on the assumption that Company C elected to un-grandfather its existing financial arrangements.

- As reflected in Scenario 3, Company A will incur a capital loss of $70.

- Furthermore, we assume that the "intent" of the Attachment B changes will be that Company C will ultimately be denied any deduction for the $100 loss that is incurred when the Derivative is closed out - as Company C will be deemed to have assumed the liability for its accounting value of ($100) at the time when Company C acquires Company B.

- We say "intent" as this will only occur if Treasury make further changes to the TOFA provisions beyond those set out in Attachment B. Attachment B merely states that the TOFA/Consolidation interaction provisions (relevantly, here s.715-375) will apply for the purposes of calculating a taxpayer's TBA. The calculation of a taxpayer's TBA amount does not include the Subdivision 230-G balancing adjustment provisions which will apply when the Derivative is closed out. In the absence of further changes in law, Company C should still be entitled to a deduction for the $100 loss incurred when the Derivative is closed out.

- Furthermore, in this scenario, the entry ACA Step 2 amount will be incorrect because, when the acquisition took place in 2007 it would have been assumed that the loss on the Derivative would be deductible to Company C - as such, the Step 2 amount would have been reduced to $70. As there does not appear to be any ability to adjust this amount retrospectively, Company C will also have lost $30 of ACA (as well as the $100 deduction).

Scenario 4 Attachment B applies and no un-grandfathering election made by Company C

- Scenario 4 is based on the changes set out in Attachment B applying retrospectively (i.e. the TOFA/Consolidation interaction provisions applying when a taxpayer calculates its TBA amount) and on the assumption that Company C has not elected to un-grandfather its existing financial arrangements.

- As reflected in Scenario 4, Company A will incur a capital loss of $70 and Company C will be entitled to a deduction for the $100 loss incurred when the Derivative is closed out.

A number of significant points are demonstrated by Scenarios 3 and 4 – these include:

- ***When Company C has elected to un-grandfather its existing financial arrangements, it is in a significantly worse position as a result of the changes introduced by Attachment B than it is under the current TOFA provisions. This is inequitable as Company C will have made the decision to un-grandfather its existing financial arrangements on the basis that the $100 loss that will be incurred when the Derivative is closed out would be deductible.***

- ***When Company C elects to un-grandfather its existing financial arrangements, it is in a significantly worse position than a taxpayer that has chosen not to un-grandfather its existing financial arrangements. Again, this is inequitable as why should Company C be denied the benefit of deductions (which it was always expecting to obtain) in relation to the loss incurred on***

close out of the Derivative solely as a result of electing to un-grandfather its existing financial arrangements (again, noting that Company C will have made the decision to un-grandfather its existing financial arrangements on the basis that the loss in relation to the Derivative would be deductible).

At their heart, these changes are retrospectively penalising taxpayers that have

(i) elected to un-grandfather their existing TOFA financial arrangements and
(ii) had historically acquired financial arrangements as a result of a corporate acquisition.

This is inequitable for a number of reasons, including:

- At the time of completing a pre-TOFA acquisition the purchaser (here, Company C) will have implemented the acquisition on the basis that certain liabilities that it assumed (e.g. an out-of-the-money derivative) would be deductible when the liability was ultimately discharged. The deductibility of such liabilities has been a feature of the income tax system since the consolidation provisions were introduced in 2002. It is not appropriate, in our view, to retrospectively deny such deductions in relation to corporate acquisitions which in many cases go as far as 2002.

- Even if there was any policy basis to deny such deductions, why should only a limited class of taxpayers (i.e. taxpayers that have un-grandfathered their TOFA financial arrangements) be denied the deductions? Furthermore, why should the changes only apply to a taxpayer that has un-grandfathered its existing financial arrangements with the changes having no consequences for a taxpayer that has not un-grandfathered its existing financial arrangements? In the example above, why should Company C be denied a deduction in relation to the $100 loss incurred on close out of the Derivative when it has un-grandfathered its financial arrangements (Scenario 3) but remain entitled to the $100 deduction if it had not un-grandfathered its financial arrangements?

- In 2010/11 when taxpayers were evaluating whether to un-grandfather their existing financial arrangements they did so in good faith on the basis of the TOFA provisions as they stood at that time – i.e. they based their decision on the income tax provisions at that time. In our view, it was clear that at this time the TOFA/Consolidation interaction provisions did not apply when calculating a taxpayers TBA. Taxpayers made irrevocable elections to un-grandfather their existing financial arrangements based on this position. Again, the basis upon which a retrospective policy change should be made here is not immediately apparent to us, especially after taking into account that taxpayer will have made irrevocable elections in relation to this.

- We understand that Treasury may argue that the TOFA/Consolidation interaction provisions were always clearly intended to apply when calculating a taxpayers TBA amount and that the change in Attachment B is simply clarifying this. We do not agree with such a proposition. In particular:

    a) in our view the clear reading of the TBA provisions is that the TOFA/consolidation interaction provisions did not apply when calculating a taxpayers TBA amount;

    b) at no stage within the Explanatory Memorandum to the TOFA Act is there any suggestion that the TOFA/Consolidation interaction provisions were intended to apply when calculating a taxpayers TBA amount (i.e. in relation to pre-TOFA corporate acquisitions). As this would have been a fundamental issue relevant to the calculation of a taxpayer's TBA amount, we cannot believe that if this was intended then this would not have been reflected in the Explanatory Memorandum (which is almost 500 pages long); and

    c) if the TOFA/Consolidation interaction provisions were intended to apply when calculating a taxpayers TBA (in relation to a pre-TOFA acquisition) then other changes would also need to be made to the TOFA provisions in order to make the provisions work. By way of example if the provisions did apply and the tax cost of a TOFA asset was reset under s.701-55(5A) then how would s.701-61 apply in the context of a pre-TOFA acquisition? Further, if the tax cost of either an asset or a liability was reset under the TOFA/Consolidation interaction provisions for the purposes of calculating a taxpayer's TBA amount then this would also need to flow through into the calculation of a taxpayer's balancing adjustment calculation (under Subdivision 230-G) when the asset or liability was ultimately terminated/closed out. Again, the fact that none of these issues were addressed within the TOFA provisions clearly indicates that the TOFA/Consolidation interaction provisions were never intended to apply when calculating a taxpayers TBA amount.

- If the TOFA/consolidation interaction provisions did retrospectively apply to the calculation of a taxpayers TBA amount then the effect of Attachment B would be to apply two retrospective changes in law to taxpayers that had (i) un-grandfathered their financial arrangements and (ii) held liabilities that they assumed as part of a pre-TOFA corporate acquisition. In other words, the amendments to the calculation of a TBA amount would involve one retrospective change in law and the amendments to assumed liabilities (also reflected in Attachment B) would involve a second retrospective change in law that would apply by virtue of the TBA provisions.

- Finally, even if fundamental changes were made to apply the TOFA/Consolidation provisions retrospectively through the calculation of a taxpayer's TBA amount there remains a fundamental flaw in relation to liabilities. This arises from the fact that if the deduction is denied (by virtue of resetting the tax cost of the liability at the accounting value of the liability assumed at the joining time) in relation to financial arrangements acquired as a result of pre-TOFA acquisitions then the historic ACA calculation that was undertaken in relation to that acquisition will be incorrect – as the Step 2 amount should have been 100% of the liability rather than 70% as would have been the case (as at the time of the acquisition it would have been assumed that the liability would have been deductible). As the ACA calculation may not be able to be revisited the consequence of the changes are not only to deny the purchaser group deductions in relation to the loss incurred but also to leave the purchaser without the appropriate amount of ACA. This is illustrated in Scenario 3 as Company C will not only be denied a deduction in relation to $100 loss incurred on close out of the Derivative but will also have only received a Step 2 ACA of $70 (in 2007) rather than the $100 which it would have received if the liability assumed was not deductible.

The above example shows the results in the case of a loss on a liability. We acknowledge that the reverse outcomes may arise in the case of a gain on a liability. For example, a favourable fluctuation in exchange rates on a borrowing denominated in a foreign currency.