BDO Kendalls

BDO Kendalls Tax Lawyers Pty Ltd
The Rialto, 525 Collins St
Melbourne VIC 3000
GPO Box 4736 Melbourne VIC 3001
Phone 61 3 8320 2222
Fax 61 3 8320 2200
tl.melbourne@bdo.com.au
www.bdo.com.au

ABN 94 118 725 554

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

By email: consolidation@treasury.gov.au

Dear Sir/Madam

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

Please find herein our submission in relation to the Exposure Draft dated 28 April 2009 regarding *Tax Laws Amendment (2009 Measures No 4) Bill 2009: Consolidation* ("**Exposure Draft**"). The Exposure Draft proposes amendments to Part 3-90 of the *Income Tax Assessment Act 1997*.

We provide our comments in relation to the following parts of the Exposure Draft:

- Part 1 - Use of the tax cost setting amount;
- Part 3 - Pre-CGT proportions;
- Part 4 - No double counting of amounts in the Allocable Cost Amount ("**ACA**");
- Part 7 - Modifications to tax cost setting rules when an entity leaves a consolidated group; and
- Part 8 - Accounting Principles.

All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

1. Part 1 – Use of the tax cost setting amount

We agree in principle with the policy underpinning the changes to section 701-55(6). This policy was expressed clearly in the former Assistant Treasurer's Press Release No.98 (1 December 2005) which states:

> *"Third, a modification will be made to ensure that the tax cost of a joining entity's assets determined under the tax cost setting rules is used by the head company of a consolidated group or MEC group for the purpose of applying all other provisions in the income tax law. **In addition, the head company will be taken to have incurred expenditure to acquire a joining entity's assets equal to their tax cost setting amount at the joining time**.*

Finally, rights to future income (such as work-in-progress amounts and unbilled revenue) held by a joining entity will be treated as retained cost base assets provided that those rights accrued to the head company. The tax cost setting amount will be equal to the terminating value of those rights. In addition, the head company will be taken to have incurred expenditure to acquire the rights at the joining time.

The deemed acquisition of assets at the joining time under these last two changes will not override the entry history rule ***other than in respect of a cost being incurred for the acquisition of the assets at the joining time****."* [Emphasis added]

We understand the aim of this proposed amendment is to ensure that section 701-55(6) operates as intended to ensure that the tax cost setting amount of an asset is appropriately recognised for income tax purposes. It is not a design feature of the law to ensure that there is a leakage of ACA. Key elements of the tax consolidation regime, such as the rules dealing with tax cost setting on exit, rely on the full extent of the entry ACA being appropriately allocated to assets or being allowed as a tax deduction.

In this respect, it is our view that considerable ambiguity still remains regarding the application of section 701-55(6), in particular in relation to the application of the "deeming" provision and the interaction with the "entry history rule".

1.1 Deeming provision

In accordance with the Assistant Treasurer's Press Release, the deeming provision is required to ensure that an expense is deemed to be incurred for the purposes of **applying** a provision..

Currently, the deeming provision only operates to determine the quantum of the tax deduction in the event that a provision ***is to apply***. The proposed section 701-55(6) states:

"If any provision of the Act that is not mentioned above ***is to apply*** *in relation to the asset by including an amount in assessable income, or by allowing an amount as a deduction...the expression means that the provision applies,* ***for the purposes of determining the amount****…".* [Emphasis added]

The amendments only apply for the purposes of determining the **quantum or amount**.

For example, certain provisions such as section 8-1 are not self-executing. That is, if no expense is incurred in a relevant income year, section 8-1 will not apply.

Section 8-1 will not otherwise operate in a year other than the year in which the expense is incurred.

Accordingly, the deeming provision needs to operate both to ensure that a particular provision, firstly applies; and secondly, to determine the quantum of assessable income or allowable deductions.

We recommend the relevant amendment be drafted as follows:

> *"If any provision of the Act that is not mentioned above is* ***capable of applying to an asset*** *by including an amount in assessable income, or by allowing an amount as a deduction...the expression means that the provision applies as if the cost, outgoing, expenditure or other amount had been incurred or paid to acquire the asset at the particular time for an amount equal to its tax cost setting amount...".* [Emphasis added]

1.2 Entry History Rule

It is unclear as to the meaning of "other purposes" in the note to the proposed section 701-55(6) in the context of the application of the entry history rule.

The Exposure Draft Explanatory Material ("**EM**") states:

> *"1.16 However, deemed acquisition does not override facts that may be relevant in determining:*
>
> - *Which provision of the income tax law is to apply in relation to the tax cost setting amount allocated to the asset; or*
>
> - *How a provision of the income tax law is to be applied to the tax cost setting amount allocated to the asset.*
>
> *1.17 These facts include, for example, the original acquisition date of an asset and whether the asset is held on revenue account or capital".*

Further clarification is required as to the scope of the entry history rule, in particular the interrelationship of the entry history rule and the provision sought to be applied to recognise the incurrence of the ACA allocated to the particular asset. The EM seems to suggest that the entry history rule is relevant in determining how a provision applies in recognising the ACA allocated to the asset.

For example, a taxpayer is entitled to a deduction for work in progress amounts (WIP) acquired pursuant to section 25-95. This provision applies to WIP amounts acquired after 23 September 1998. If WIP amounts were purchased prior to 23 September 1998, the taxpayer is not entitled to a deduction under section 25-95.

In the event that ACA was allocated to WIP amounts acquired pre 23 September 1998, the application of the entry history rule may mean that section 25-95 is not capable of application, as section 701-55(6) only applies to determine the "quantum" of a particular deduction / inclusion of assessable income and is not relevant for "other purposes". As the expense was incurred prior to 23 September

1998, the history relevant to the acquisition of that asset may preclude the application of section 25-95.

It is submitted that the correct and equitable treatment (as between taxpayers holding the same economic asset) would be for section 25-95 as currently drafted to apply to all assets of the same character (irrespective of when it was incurred). Otherwise taxpayers that have incurred expenditure prior to 23 September 1998 may "lose" ACA, on the basis that ACA allocated to this asset would not be recognised upon entry, and subsequently penalised again in the event that a subsidiary leaves the consolidated group holding this economic asset.

Accordingly, it is submitted that the entry history should not be relevant in determining the application of the section giving recognition to the ACA allocated to a particular asset. It is also submitted that the note to section 701-55(6) be deleted.

2. Part 3 - Pre-CGT proportions

The pre-CGT proportion mechanism should, in most cases, result in more appropriate outcomes than those that occurred under the cumbersome pre-CGT factor approach. However, we note some minor issues associated with the integrity rules set out in proposed section 711-70.

2.1 Interaction with Division 149

The integrity rules associated with the application of Division 149 may lead to anomalous outcomes when compared to those that apply where Division 149 happens to a group that has not consolidated.

Under the proposed integrity rule in section 711-70(1), the pre-CGT proportion will be deemed to be nil where a leaving entity held assets at the joining time and those assets stopped being pre-CGT assets while it was a member of the consolidated group due to the operation of Division 149. Thus, section 711-70(1) appropriately replicates the "freshening up" effect of Division 149 to ensure that the pre-CGT membership interests in a subsidiary member are ultimately taken to be post-CGT assets following a change in their majority underlying beneficial ownership.

However, Division 149 also adjusts the cost base of the relevant pre-CGT assets to their market value at the time of the change in majority underlying beneficial ownership. Although the underlying pre-CGT assets of the subsidiary member of a tax consolidated group would have their cost bases adjusted when Division 149 is triggered, proposed section 711-70 does not provide any corresponding adjustment to the market value for the *membership interests* in the exiting subsidiary.

This is likely to lead to an anomalous result (when compared to the outcome that occurs for non-consolidated groups) where, at the time of the change in majority underlying beneficial ownership, the market value of the membership interests in the leaving entity has been influenced by changes in the market value of its post-

CGT assets. Although Division 149 will operate to adjust the cost base of the relevant subsidiary's underlying pre-CGT assets (which will then be reflected in the cost base of the membership interests in the leaving entity as a result of step 1 of the exit ACA calculation under section 711-25), the change in market value of the membership interests in the leaving entity that is attributable to post-CGT assets will not be reflected in the cost base of those membership interests on exit.

As a general principle, we submit that the operation of Division 149 should be no more punitive to the head company of a consolidated group than it is to the parent company of a non-tax consolidated group. Accordingly, it is submitted that the integrity rule be amended to provide that where proposed section 711-70(1) applies to deem the pre-CGT proportion of the membership interests in a leaving entity to be nil, an appropriate adjustment should also be made to the cost base of the membership interests in the leaving entity to reflect the adjustment to the cost base of the membership interests that would have occurred had the group not been consolidated at the time of the change in majority underlying beneficial ownership.

2.2 CGT event K6 interaction – inconsistency between EM and proposed section 711-70(2)

Although the proposed amendments in sections 711-70(2) to (4) should ensure the appropriate interaction with CGT event K6, we note a minor inconsistency between the drafting of proposed section 711-70(2) and paragraph 1.70 of the EM.

Section 711-70(2) states that subsections (3) and (4) apply where an entity ceases to be a member of a consolidated group as a result of CGT event A1, C2, E1, E2 or E8 happening to the membership interests in the leaving entity. For example, if the interests in a subsidiary member are transferred to a third party (CGT event A1), sections 711-70(3) and (4) will apply because the subsidiary will exit the consolidated group as a result of CGT event A1 happening.

However, paragraph 1.70 of the EM states that:

> *"The integrity rule will apply if the leaving entity ceases to be a member of the old group and, **as a result**, one of the following CGT events happens to one or more of its membership interests…".* [Emphasis added]

The drafting of paragraph 1.70 is potentially confusing as CGT events A1, C2, E1, E2 and E8 will not happen ***as a result*** of a subsidiary member leaving a consolidated group – instead, it would be the CGT event happening that results in the subsidiary member leaving the consolidated group.

In order to ensure consistency between section 711-70(2) and the EM, it is suggested that paragraph 1.70 of the EM should instead be redrafted as follows:

> *"The integrity rule will apply if the leaving entity ceases to be a member of the old group as a result of one of the following CGT events happening to one or more of its membership interests...".*

3. Part 4 – No double counting of amounts in the ACA

We agree with the object of this amendment to remove duplications in the ACA calculation and provide clarity for the taxpayer. However, we note the following issues.

3.1 Meaning of "double counting"

It is clear that the proposed section 705-62 will apply where an economic attribute of the joining entity results in a double reduction (or double increase) in the ACA. For example, where a joining entity's prior year tax loss results in a reduction in step 1 and step 5, as outlined in Example 1.14 of the EM.

However, it is unclear whether the proposed section will apply to an economic attribute that results in an increase in ACA under one provision but a reduction in ACA under another provision. For example, see the discussion on liabilities reduced by future income tax deductions below.

Whilst the wording in proposed section 705-62(1) suggests that it would only apply in the first mentioned scenario (double reduction or increase), the use of the word "altering" in proposed section 705-62(2) suggests that it may also apply in the second scenario (reduction and increase).

We submit that the proposed section 705-62 should not apply where there is an increase and a reduction under two different provisions, as this does not give rise to "double counting", or duplication of ACA.

3.2 Liabilities reduced by future income tax deductions

In a press release dated 8 May 2007, the Treasurer announced an intention to modify the treatment of liabilities under the tax cost setting rules such that, if liabilities are reduced by future income tax deductions, the amount of the reduction cannot be added-back under another provision. It appeared likely that this would be achieved by eliminating an increase in the ACA step 2 amount under section 705-80 where a reduction in the ACA step 2 amount had been made under section 705-75(1).

Further clarification is needed as to whether the proposed section 705-62 is designed to achieve this purpose. We note that the EM for Part 4 of the Exposure Draft does not discuss this situation. On the basis that it is only designed to cover duplications that move in the same direction, in our view it should not eliminate an increase in ACA under section 705-80.

3.3 No similar provision for exit ACA calculation

We note that the Exposure Draft does not contain a similar provision for removing double counting in relation to the exit ACA calculation. The provision should be extended to remove any duplication or uncertainty in the exit ACA calculation for example in respect of any tax effect accounting adjustments which impact the tax provision and step 4 of the exit ACA.

3.4 The most appropriate alteration is to be made in light of the object of the Subdivision

The proposed section 705-62(3) provides that, where double counting has occurred in calculating the ACA, *"only the alteration that is most appropriate (in the light of the object of this Subdivision) is to be made".*

Paragraph 1.85 of the EM states that which alteration is most appropriate is a matter of judgement for the head company of the consolidated group. Further, example 1.14 of the EM indicates that where a loss has already been taken into account in determining step 1, a step 5 adjustment should not be made. Despite these statements, we submit that the EM provides only limited guidance as to the most appropriate alteration to be made and hence further clarification and/or guidance is required to assist taxpayers. For instance, there could be situations where both adjustments under the ACA calculation would equally accord with the objects of the subdivision.

4. Part 7 – Modifications to tax cost setting rules when an entity leaves a consolidated group

We agree with the object of this amendment to clarify the liabilities to be taken into account at the leaving time for the purposes of calculating step 4 of the exit ACA calculation and make the following comments.

4.1 Ensuring that liabilities held just before the leaving time are included in the old group's ACA

We agree that the proposed amendments to section 711-20(1) and section 711-45(1) to leaving liabilities will clarify that liabilities recognised at step 4 of the exit ACA will be those that exist "just before the leaving time" instead of those "that the leaving entity takes with it" or "is a liability of the leaving entity at the leaving time".

The scope of the proposed amendments is wide enough to include in step 4 of the exit ACA liabilities owed by a subsidiary member to entities outside the consolidated group that are capitalised into shares thus resulting in a member entity exiting the group.

Further, the proposed amendments are in line with the intention as outlined in paragraph 5.115 in the Explanatory Material to the *New Business Tax System (Consolidation) Bill (No.1) 2002*:

> *"Where a subsidiary member (the leaving entity) leaves a consolidated group (the old group) the head company recognises, **just before the time** the entity leaves, the membership interests in the leaving entity."* [Emphasis added]

4.2 Entry amount of a liability is different to its exit amount

We agree with the object of this amendment being the consistency of outcomes where the liability had been discharged prior to the leaving time therefore triggering CGT event L7. However, we note the following issues:

- Under the proposed amendments, CGT event L7 will be repealed with effect from 8 May 2007 to "reduce compliance costs" and the proposed amendments to section 711-45(8) are intended to have a "wider role than CGT event L7".
- As outlined in the EM, modifications to section 711-45(8) "will reduce compliance costs by limiting the circumstances in which it applies". However where the proposed amendments apply, it appears that the process of tracking and calculating accounting provision balances (i.e. employee leave) is likely to place a significant administrative burden on taxpayers given the proposed effective date of 1 July 2002.
- Given the EM at paragraph 1.203 acknowledges that such a process of:

> *"Tracking individual liabilities to determine whether the amount included at step 2 of the allocable cost amount for an individual liability exceeded the amount for which the liability was discharged places a significant compliance cost burden on affected groups".*

Bearing in mind the need to minimise compliance costs and the significant passing of time, we submit that this amendment should not have retrospective effect.

5. Part 8 – Accounting Principles

We agree with the object of this amendment, being to provide clarity for the taxpayer and improve the operation of the tax cost setting rules. However, we note the following issues:

5.1 Application where the entity did not prepare financial statements just before the joining (or leaving) time

Proposed sections 705-70(3) and 711-45(1A) provide a definition of "accounting principles for tax cost setting" for entry and exit cases respectively. These definitions refer to the "accounting principles" that would be used if the entity were to prepare financial statements just before the joining (or leaving) time.

A definition of "accounting principles" will be inserted into section 995-1(1) which effectively refers to Australian Accounting Standards Board ("**AASB**") accounting standards, or where no such standards apply, authoritative pronouncements of the AASB that apply in preparing financial statements.

As outlined in paragraph 1.139 of the EM, we note that where audited accounts are prepared just before the joining time, the accounting policies adopted in the preparation of those accounts will be considered to be the accounting principles for tax cost setting.

Paragraph 1.138 of the EM further provides that:

> *"…the joining entity's **accounting principles for tax cost setting** must be applied for the purposes of working out the allocable cost amount for the joining entity. These are the:*
>
> - *the accounting principles that the joining entity actually used to prepare its financial reports just before the joining time; or*
>
> - *if the joining entity did not prepare financial reports just before the joining time, the accounting principles that it **would** use if it were to prepare its financial reports just before the joining time."* [Emphasis added]

The application of the concept of "accounting principles for tax cost setting" is unclear in situations where the entity did not prepare financial reports just before the joining (or leaving) time, and either no accounting standard (or authoritative pronouncement) existed or the relevant accounting standard allowed alternative treatments at that time in relation to the measurement and recognition of certain assets and liabilities held by the joining (or leaving) entity.

This lack of clarity is especially likely to be present where a new asset or liability is held by the joining (or leaving) entity at the joining (or leaving) time which has not previously been recognised and measured in the entity's financial statements.

In this context, the use of the term "would" in the Exposure Draft presents uncertainties for taxpayers as taxpayers (or the courts) will be required to hypothesise the accounting principles the entity would have applied, rather than the accounting principles that could be applied by the entity to recognise and measure liabilities for tax cost setting purposes in the instances where no financial statements were prepared just before the joining time or new liabilities not previously reported are held by the entity at that time.

In most cases the appropriate accounting principles to be used would be quite clear. However, where accounting principles are non-existent or present alternative treatments, it would be quite difficult to determine the accounting principles to apply. Accordingly, further clarification is required as to the application of the concept of "accounting principles for tax cost setting" in the circumstances outlined above.

Moreover the interaction between these amendments and section 705-70(1A) is unclear. Further guidance is required on the application of this extremely difficult technical provision.

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6. Retrospectivity

We note that the bulk of the amendments are intended to apply on a retrospective basis (i.e. from 1 July 2002). Although this start date is appropriate for the majority of announcements that clarify existing provisions, retrospective application of law that affects substantive change prior to the announcement date may result in inequitable outcomes.

For example:

- The proposed pre-joining time roll-over over adjustments contained in section 705-93 may have significant impacts for certain entities that have “rolled-over” assets from entities that have elected to “stick”. As these provisions were only announced on 1 December 2005, the retrospective application of these provisions would be inequitable in the event that impacted groups were not provided an opportunity to re-exercise their election to “stick or spread”.

  We recommend that these changes be effective from 1 December 2005, the date of announcement.

- The negative effect of the existing pre-CGT rules may have dissuaded many pre-CGT groups from entering into tax consolidation. Although the new rules are intended operate retrospectively, the ability to revisit an earlier decision to consolidate has not been provided.

  We recommend that certain groups be provided with an opportunity to revisit elections to consolidate.

- The proposed changes to section 711-45(8) were not previously announced. Retrospective application of this provision (i.e. the requirement to track employee liabilities) may result in generating a retrospective liability for certain entities (along with penalties and interest).

  We recommend that the proposed amendments to section 711-45(8) apply prospectively from 8 May 2007 (the date that CGT event L7 is repealed).

We thank you for the opportunity to provide our comments in this regard.

Yours faithfully
BDO Kendalls Tax Lawyers Pty Ltd

Aldrin De Zilva
Legal Practitioner Director