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Mr A. Regan
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Email:anthony.regan@treasury.gov.au

Dear Tony,

Submission on exposure draft of Tax Laws Amendment (2009 Measures No. 4) Bill 2009

We refer to the exposure draft of the *Tax Laws Amendment (2009 Measures No. 4) Bill 2009* that was issued on 22 April 2009 and welcome the opportunity to provide comments on the exposure draft (ED). Our key submission points are set out in the attached appendix.

Please contact me on if you have any queries on any of the issues canvassed in the submission.

Yours sincerely

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Submission on Exposure Draft of Tax Laws Amendment (2009 Measures No. 4) Bill 2009

1 Use of the tax cost setting amount

Subject to our comments below, we support the proposed changes to subsection 701-55(6) contained in Part 1 of Schedule 1 of the ED and the proposed application date of 1 July 2002.

1.1 Scope of deeming

The provision states that it deems a cost, outgoing, expenditure or other similar amount to be incurred or paid to acquire the relevant asset. We understand, from recent discussions with Treasury, that the intent is that the provision only applies for the purpose of working out the amount that is to be included in assessable income or allowable as a deduction. This intention is apparent from paragraph 1.14 of the EM, which states that the provision does not affect the operation of the entry history rule in relation to an asset for other purposes. Furthermore, paragraphs 1.16 and 1.17 of the EM state that the deemed acquisition does not override facts such as the original acquisition date of an asset and whether it is held on revenue or capital account.

Notwithstanding the above, subsection 701-55(6) does deem a head company to 'acquire' an asset for its tax cost setting amount (TCSA), which may be read as overriding or changing the character of an asset as determined under the entry history rule. The continued application of the entry history rule will be critical as demonstrated in some of the examples contained in the EM. For example, in example 1.1, subsection 701-55(6) deems Head Co to have acquired the trade receivables for $20,000. The example states that when Head Co writes off the $2,000, it can claim a deduction under section 25-35, which implies, that Head Co has inherited the history of Company J in relation to the trade receivables even though Head Co is treated as having 'acquired' those receivables upon Company J joining the tax consolidated group. We note that this outcome is consistent with that in ATO ID 2004/3. However, the use of the word 'acquire' may potentially defeat the application of the entry history rule insofar as the character of the relevant asset is concerned (contrary, it is acknowledged, to the policy intent identified in the EM), and we recommend that Treasury confirm with the Australian Taxation Office (ATO) that they would read 'acquired' in the limited manner intended. If there is any doubt as to how broadly the use of the word 'acquire' in subsection 701-55(6) should be interpreted, Treasury should amend the provision perhaps by incorporating words to the effect that the deeming is only for certain purposes (as opposed to simply including those words in a note and in the EM).

1.2 Issues with examples

In addition to the issues potentially raised by example 1.1 on trade receivables, we have highlighted some other issues arising from the other examples below.

1.2.1 Consumable stores

Example 1.2 is about consumables stores. Company J is expressed to apply an incurred basis when claiming deductions for its consumables. However, the example states that Head Co would only be entitled to a deduction for the TCSA of the fuel in the year that it acquired Company J if it used the fuel in its transport business. It is not clear if this is implying that Head Co applies a usage basis to claiming deductions for consumables. If so, we query why a different basis should apply for Head Co as compared to Company J. As with example 1.1, some discussion on the entry history rule and how it interacts with subsection 701-55(6) would be useful.

1.2.2 Long-term construction contract

We recommend that example 1.3 on a long-term construction contract should be expanded to include discussion on how the setting of the tax cost for the construction contract interacts with the views of the ATO in IT 2450 on recognition of income from long term construction contracts. There are two acceptable methods set out in IT 2450 – the basic approach and the estimated profits basis. If the head company of a consolidated group acquires a joining entity that holds a construction contract, it is not clear if the head company can continue to apply the methods in IT 2450 and, if so, how the tax cost setting amount allocated to a construction contract is taken into account when applying those methods.

Under the estimated profits basis, for example, paragraph 26 of the ruling indicates the need to work out the notional taxable income expected to arise under a particular contract. The ruling goes on to highlight that the notional taxable income can change over the life of the contract. It is not clear from the example if the head company could take into account the TCSA in working out its notional taxable income. Under IT 2450, the amounts that would ordinarily be taken into account in working out notional taxable income would be actual construction costs. However, our understanding is that subsection 701-55(6) is not designed to treat the TCSA of the construction construct as a construction cost. We note that this is consistent with the outcome in example 1.9 on capital works, where the conclusion is that the TCSA for a building is not treated as undeducted construction expenditure for the purposes of Division 43.

As noted in example 1.18 of the EM, the construction contract is essentially a right to receive a payment in respect of work. Accordingly, we recommend that the EM include additional discussion on how the principles of IT 2450 would be applied (if they do, in fact, apply) in example 1.3 and how the construction contract would be characterised, i.e. as a construction cost or as right to receive a payment in respect of work.

1.2.3 Assets held on revenue account

This and other examples do not highlight that the application of subsection 701-55(6) does not preclude the application of any of the other tax cost setting provisions. For example, an asset may be a capital gains tax (CGT) asset as well as an asset to which subsection 701-55(6) applies, say, because it is held on revenue account. In this case, the asset's tax cost would be set under both subsections 701-55(5) and (6). However, on the disposal of the asset, the anti-overlap rule in section 118-20 would apply to reduce any capital gain by the amount of the gain that is included in assessable income under section 6-5.

We recommend that some of the examples be amended to clarify that subsection 701-55(6) does not operate to the exclusion of the other tax cost setting rules in the preceding subsections.

2 Group restructures

We support the proposed measures but submit that the application date should be 1 July 2002 rather than 27 October 2006. Our specific comments on the measures are set out below.

2.1 Cessation of group

When a group conversion takes place, proposed section 719-130 does not stipulate that there is neither a cessation of the old group nor a subsequent formation of the new group. It simply states that certain provisions – those set out in subsection 719-130(5) – that would otherwise have applied upon the group conversion do not apply unless the provision is expressed to apply.

In the ED, the only provisions of Part 3-90 that are expressed to apply despite section 719-130 are the pooling rules in Subdivision 719-K and any other provision whose application is necessary for the application of Subdivision 719-K. Subsection 719-130(4) also has the effect that the provisions in subsection 719-130(5) will continue to apply in a 'transfer-up' scenario.

This gives rise to various issues as set out below.

2.1.1 Losses

Notwithstanding that the ED only identifies a limited number of scenarios where the provision of Part 3-90 will continue to apply, we note that the commentary in the EM appears to go significantly further, especially in the context of losses. Paragraph 1.45 identifies various loss rules that will continue to apply where a special conversion event happens. The explanation given at paragraph 1.46 is:

> *Section 719-130 does not affect the operation of those provisions because they are not triggered by an on-going member joining a MEC group or leaving a consolidated group.*

We do not necessarily agree with this statement. Item 4 of the table in subsection 707-320(2) applies to adjust a group's available fraction for each bundle of transferred losses if there is an increase in the market value when the group is created because a subsidiary member of the consolidated group becomes an eligible tier-1 company of the MEC group (known as a transfer-up). The application of item 4 was considered by the ATO in TD 2004/D46. Although the ATO initially took the view that the available fractions could be adjusted under item 4, they subsequently withdrew the draft determination for the following reason (as stated in the withdrawal notice):

> *Item 4 applies to the head company of a continuing group. Subsequent to the release of TD 2005/D46, the Tax Office has formed the view that a special conversion event constitutes the cessation of a consolidated group and the coming into existence of a different group, namely a MEC group. Under that interpretative position, a special conversion event cannot fall within the ambit of item 4.*

Given the ATO's view that a consolidated group ceases upon the happening of a special conversion event, this must mean, contrary to the comments at paragraph 1.46, that the members of the consolidated leave that group and subsequently join the MEC group. Accordingly, this means that item 4 of subsection 707-320(2) would not appear to apply in a transfer-up scenario. We note that this issue was previously highlighted to Treasury as noted on the NTLG Consolidation subcommittee's issues register as at 9 March 2009 (issue 13.03a(i)). We recommend that Treasury liaise with the ATO in relation to any changes that need to be made to the ED to give effect to item 4 of subsection 707-320(2). More generally, we consider that, for clarity, the provisions identified by Treasury at paragraphs 1.45 and 1.47 as continuing to apply when a conversion event happens should be identified in the legislation (similar to what has been done with section 719-135).

2.1.2 CGT event L5

We note that section 719-130 does not expressly state that CGT event L5 will not apply upon the happening of a group conversion. Pursuant to subsection 104-520(1), that event happens if an entity ceases to be a subsidiary member of a consolidated group or a MEC group, and in working out the group's allocable cost amount for the entity, the amount remaining after applying step 4 of the table in section 711-20 is negative.

The first requirement of subsection 104-520(1) – that the entity ceases to be a subsidiary member – will be satisfied on a group conversion taking place notwithstanding section 719-130. It may be arguable that the second requirement of subsection 104-520(1) – the working out of the group's allocable cost amount for the entity – cannot be satisfied because the effect of subsection 719-130(5) is that there is no need to calculate the allocable cost amount for an entity when it exits the group. However, this does not necessarily mean that a calculation of the allocable cost amount could not be performed for the purposes of paragraph 104-520(1)(b). Accordingly, to avoid doubt, we recommend that Treasury consider amending subsection 719-130(5) to specifically exclude the application of CGT event L5. To avoid any uncertainty, we consider that application of the other CGT events that may happen on entry to, or exit from, a consolidated or MEC group - CGT events L1 – 4 and L6 – 8 – should also be specifically excluded.

2.2 Losses

The announcement of the Minister for Revenue and Assistant Treasurer on 27 October 2006 stated that when a group conversion occurs:

- the tax cost setting rules will not apply to the assets of the ongoing group members (and therefore certain capital gains and losses will not arise)
- tax losses of the ongoing group will not be tested and the capital losses that are apportioned over five years will not become immediately available
- the ongoing group's history will be transferred to the new group
- certain notifications currently required to be given to the Commissioner of Taxation will be removed.

We note that there is no guidance in the EM on how the loss rules in Subdivision 707-A and Subdivision 719-F will apply upon the happening of a conversion event. Paragraph 719-130(5)(b) is broad enough to capture the loss rules in those subdivisions. However, we recommend that the EM specifically discuss the treatment of losses (both group and transferred losses) that are transferred from an old group to a new group. Some examples highlighting the non-application of the transfer tests and whether available fractions need to be recalculated would also be useful.

2.3 Transfer up provision

Further guidance is required on the application of the exception in subsection 719-130(4) for transfer-up scenarios. The effect of the exception, amongst other things, is that exit calculations under Division 711 will still be required for a subsidiary member (the transferred up subsidiary) of a consolidated group that is transferred up such that it becomes an eligible tier-1 company and the consolidated group converts to a MEC group. We recommend that an example be given of how the exit calculation would be performed in practice. For example, assume a transferred up subsidiary wholly owns the shares in a number of other subsidiary members. While we would expect that the other subsidiary members would not themselves be required to perform exit calculations under Division 711 (as they do not fall within the exception in subsection 719-130(4)), it appears that they would practically need to perform those calculations in order to work out the tax cost of the membership interests in those subsidiary members that are held by the transferred up subsidiary.

2.4 Date of effect

As noted at paragraph 1.32 of the EM, upon a group conversion, significant tax consequences may inappropriately arise for members of the old group that become members of the new group. We also note that many taxpayers may have structured their group conversions to mitigate these consequences. For this reason, we consider that the proposed changes should have elective application from 1 July 2002.

We do, however, have some reservations about the start date of 27 October 2006 for the proposed exclusion for roll-up scenarios in subsection 719-130(4), the detail of which was not previously available. We understand that the intention of this exclusion is to ensure that the shares in the ET-1 have a cost base in the hands of the non-resident that acquires them. However, it will also be necessary to perform exit calculations under Division 711 for an entity that is transferred up such that it becomes an ET-1 of the new MEC group. Our view is that this measure should only apply from the date of the ED, namely 22 April 2009.

3 Pre-CGT proportions

We support with the proposed changes to the law to take into account pre-CGT membership interests of joining entities. However, we have some concerns with the proposed integrity rules.

If there is a change in the majority underlying ownership of the head company, subsection 711-70(1) will treat the pre-CGT proportion of the leaving entity as being nil. However, unlike section 149-35, there is no equivalent provision that will give a cost base to pre-CGT assets that become post-CGT assets as a result of a change in majority underlying ownership. We consider that there needs to be a similar provision that gives the pre-CGT shares a market value cost base.

We further note that the proposed integrity rules are to apply from 1 July 2002. Although the initial announcement of this measure stated that integrity rules may be introduced, Treasury did not previously provide any detail of those rules. We, therefore, consider that these rules should only apply from the date that the ED was issued, i.e. 22 April 2009.

4 No double counting of amounts in ACA

We agree with the proposed changes and application date of 1 July 2002. However, we consider that, for clarity, section 705-62 should be amended to prevent a particular amount from being taken into account multiple times (not just twice) in calculating the ACA. As noted at paragraph 1.79 of the EM, an adjustment can affect more than 2 steps of the ACA calculation.

5 Phasing out over-depreciation adjustments

We support the proposed phase out of the over-depreciation adjustment. As noted in the EM, the inter-company dividend rebate was removed on 1 July 2004. This means that the over-depreciation adjustment will, in any event, cease from 1 July 2009. For consolidated groups formed after that date, we recommend that Treasury consider allowing such groups to disregard the over-depreciation adjustment altogether.

6 Leaving time liabilities

We support the proposed amendments to subsection 711-45(8) but note that, although its application will be confined to specific liabilities, there may still be a compliance burden in tracking the extent to which those liabilities were taken into account in working out the ACA for a subsidiary member of the old group, which is likely to increase the longer the timeframe between the joining time and leaving time for subsidiary member. Treasury should consider confining the operation of the provision so that it ceases to operate after a certain period of time.

7 Inherited deductions

We support the proposed amendments. In relation to the proposed date of effect, we support the effective start date of 1 July 2002 for the amendment to exclude from step 7 deductions under section 43-15 for undeducted construction expenditure on assets acquired before 13 May 1997. However, the proposed amendment to section 711-35 was not previously announced and, therefore, we consider that this amendment should only have effect from 22 April 2009, especially given that it will have the effect of reducing the exit ACA worked out Division 711 by extending the existing treatment for acquired deductions to owned deductions.

8 Retained cost base assets

We support the proposed amendments and their application date of 1 July 2002.

9 Application of losses with a nil available fraction

We support this proposed amendment and the application date of 1 July 2002.

10 CGT event L7

We support the proposed repeal of CGT event L7 but recommend that the effective date of this amendment be 1 July 2002. As noted in the EM, tracking individual liabilities to determine whether an amount included at step 2 of the ACA for an individual liability exceeded the amount for which the liability was discharged places a significant compliance cost burden on affected groups. This potential compliance burden existed from the inception of the tax consolidation rules and we, therefore, consider that section 104-530 should be repealed from 1 July 2002.

If Treasury continues with the proposed repeal of CGT event L7 from 8 May 2007, we agree with the amendments to CGT event L7 to prevent double counting before that date.

11 Doubtful debts and CGT event L3

Subject to our comments below, we support the proposed amendment.

We consider that the date of effect should be 1 July 2002. This issue that proposed section 705-27 seeks to address may have affected taxpayers since the inception of the tax consolidation rules. Accordingly, we see no reason to confine its application of entities that join a consolidated or MEC group after 8 May 2007.

We understand that the purpose of the requirement in paragraph 705-27(1)(d) for debts that are intra-group assets is to avoid a double benefit arising. However, the provision operates on an all or nothing basis – as soon as any amount of deduction has been previously claimed in respect of the debt, it is not possible to reduce the tax cost setting amount. This may give rise to inequitable outcomes where the market value of the debt is less than its face value but only part of that difference has been claimed as a deduction. We recommend that the provision be amended to allow for such scenarios.

12 Loss multiplication rules for widely held companies

We agree with the proposed amendments and the proposed application date of 1 July 2002. However, we note that the amendments do not fully reflect the required changes noted by Treasury in its consultation paper on this issue. In particular, paragraphs 10 and 11 of that paper note that "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" and that "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 [certain conditions are satisfied]". It is unclear if Treasury proposes to introduce this amendment at a later stage or if a decision has been made not to proceed with it altogether. If it is the latter, we recommend that Treasury reconsider the decision not to introduce this amendment.

13 Amended assessments

We agree with the proposal to allow taxpayers 4 years from the date of the commencement of Schedule 1.