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Board of Taxation
C/-The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Sir/Madam

SUBJECT: SUBMISSION ON POST IMPLEMENTATION REVIEW OF CERTAIN ASPECT OF THE CONSOLIDATION TAX COST SETTING PROCESS

CPA Australia represents the diverse interests of more than 140,000 members in 114 countries throughout the world. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background, we provide this submission concerning the Discussion Paper issued by the Board of Taxation 's post-implementation review of certain aspects of the consolidation regime.

We have limited our comments to those questions for consultation that we consider will have the most significant implications for our membership base.

If you have any questions regarding the submission, please contact Mark Morris, Senior Tax Counsel, on (03) 9660 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully

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1. Liabilities held by a joining entity

1.1 Initial comments

Subject to some anomalous outcomes identified later in this submission, we agree with the Board's view that can be double recognition of deductible liabilities in non-formation cases. However, we are not convinced that amendments are required. Firstly, we note that the Board's preferred solution – to deem deductible liabilities to be assumed by the head company, at their accounting value, at the joining time – has already been adopted to some extent in the context of the taxation of financial arrangement (TOFA) rules[1]. In this regard, we note that the testing performed by the Australian Taxation Office (ATO) of the types of liabilities in respect of which double recognition is expected to arise identifies three such liabilities – out-of-the-money derivatives, foreign currency loans and deductible provisions.

We note that foreign currency loans would be financial arrangements under the TOFA rules. It is also expected that many derivatives are also likely to be financial arrangements that are subject to those rules. Accordingly, it is only provisions, which are unlikely to be financial arrangements, to which any additional amendments would apply. We query whether it is necessary to introduce amendments simply to deal with provisions, particularly given that the Board's preferred approach is expected to result in a significant compliance burden for taxpayers because of the need to track these liabilities after the joining time. Reference is made to the now repealed CGT event L7 and the practical difficulties involved with tracking liabilities. The explanatory memorandum to Tax Laws Amendment (2010 Measures No. 1) Bill 2010, which repealed CGT event L7 states (at paragraph 5.285):

> *In addition, the value of long standing liability provisions tends to be calculated on a pooled basis, rather than on an individual basis. 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 an unreasonable compliance cost burden on affected groups.*

This compliance burden will no doubt be more pronounced for small to medium enterprises (SMEs). Furthermore, given that many SMEs may not be subject to the TOFA rules because they do not exceed the relevant asset or turnover thresholds, acquiring consolidated groups that are SMEs will be required to track not just provisions but other liabilities such as out-of-the-money derivatives such as swaps, options or forwards, and unrealised gains or losses on foreign currency loans.

In summary, while we understand the Board's concerns on a theoretical level, we envisage that there would be significant practical compliance issues for taxpayers if the Board's preferred solution is introduced.

1.2 Formation vs acquisition scenarios

We do not consider that the double recognition of liabilities arises in formation scenarios.

Consider the following example:

- Sub Co is wholly owned by Head Co
- Head Co forms a consolidated group
- Sub Co's balance sheet at the formation time is:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Provision	100
Land	100	Retained earnings	(70)
DTA	30	Share capital	200
	230		230

[1] Section 715-375

Currently, the entry allocable cost amount (**ACA**) for Sub Co would be:

Step	Description	Amount
1	Cost of membership interests	200
2	Accounting liabilities	70[2]
		270

The notional ACA under section 705-80 would be as follows:

Step	Description	Amount
1	Cost of membership interests	200
2	Accounting liabilities	100
5	Owned losses	(100)
		200

Accordingly, the initial ACA of $270 would be reduced by $70 to give a final ACA of $200, which would be allocated to cash at bank ($100) and land ($100).

It would be inappropriate to treat Head Co as having assumed the provision for $100 at the joining time such that no deduction would arise on settlement of the provision. In this case, there has been no duplication of the unrealised loss on the provision.

However, we note that if Sub Co were sold by Head Co to another consolidated group (before settlement of the provision), duplication of the provision would arise. Consider if Sub Co was purchased by Purchaser Co for $130. The exit ACA would be:

Step	Description	Amount
1	Terminating value of assets	200
4	Accounting liabilities	-[3]
		200

Accordingly, Head Co would make a capital loss of $70 on the disposal of Sub Co. This would equal Head Co's economic loss.

For Purchaser Co, the entry ACA would be:

Step	Description	Amount
1	Cost of membership interests	130
2	Accounting liabilities	70[4]
		200

[2] Reduced under subsection 705-75(1) by $30
[3] Subsection 711-45(8)
[4] Reduced under subsection 705-75(1) by $30

The notional ACA under section 705-80 would be as follows:

Step	Description	Amount
1	Cost of membership interests	130
2	Accounting liabilities	100
6	Acquired losses	(30)
		200

The final ACA would be $200, which would be allocated to cash at bank ($100) and land ($100). However, if the company were wound up, there would be a tax loss of $100 on settlement of the provision. Furthermore, there would be an economic loss of $30 since Purchaser Co paid $130 to acquire Sub Co but would only receive $100 on winding up the company (after realising available assets and discharging the provision).

In summary, we agree that duplication can arise in acquisition cases but this does not appear to be the case under a formation case.

1.3 Compliance costs

As noted earlier, we anticipate that the Board's preferred solution will give rise to a significant compliance burden for taxpayers, in particular SMEs, who will be required to track deductible liabilities after the joining time.

In this regard, one option might be to introduce a rule that allows for the balance of deductible liabilities at the joining time to instead be included in assessable income over, say, a period of 5 years from the joining time. For example, an acquiring consolidated group might acquire a joining entity that has a provision of $100. Currently, the Board is proposing to treat the group as having assumed that provision for $100 at the joining time. As a result, if the provision is subsequently settled, for, say $120, any deduction would be limited to the excess (i.e. $20). Under our proposal, a deduction for $120 would be available on settlement of the provision. However, the balance of the provision of $100 at the joining time would be assessable over the 5 years from the joining time (i.e. $20 in each year). This proposal would remove the need to track the provision of $100 and any movements in it after the joining time.

Any such option would require further consultation. However, we submit that the Board should consult on such options to alleviate any compliance burden if it chooses to proceed with amendments to address the double recognition issue that it has identified.

2. Deferred tax liabilities

We agree that DTLs distort the entry and exit ACA. However, in some cases, removing DTLs from these calculations will not necessarily result in alignment between the tax and economic outcomes.

Consider the following example:

- Head Co incorporates Sub Co with share capital of $100
- Sub Co subsequently enters into two derivatives, the fair values of which subsequently increase and decrease by $100 respectively
- Sub Co is acquired by Purchaser Co for nil consideration
- Sub Co's balance sheet is:

Assets	$	Liabilities and equity	$
Derivative asset	100	Derivative liability	100
DTA	30	DTL	30
		Retained earnings	-
		Share capital	-

	130		130

Head Co's exit ACA would be:

Step	Description	Amount
1	Terminating value of assets	-
4	Accounting liabilities	(30)
		(30)

Accordingly, Head Co would make a capital loss of $30 under CGT event L5 on the disposal of Sub Co. This would not equal Head Co's economic loss of nil.

For Purchaser Co, the entry ACA would initially be:

Step	Description	Amount
1	Cost of membership interests	-
2	Accounting liabilities	100[5]
		100

However, applying subsection 705-70(1A), the DTL would be reduced from $30 to $6.92[6]. Accordingly, the step 2 amount would be reduced to $76.92.

The notional ACA under section 705-80 would be as follows:

Step	Description	Amount
1	Cost of membership interests	-
2	Accounting liabilities	106.92
6	Acquired losses	(30)
		76.92

Accordingly, the final ACA would be $76.92, which would be allocated to the derivative asset. If Sub Co were wound up, Purchaser Co would make no economic gain or loss. However, for tax purposes, it would make a loss of $100 on settlement of the derivative liability and a gain of $23.08[7] on settlement of the derivative asset.

If, on the other hand, the DTL were not taken into account in the entry or exit ACA process, the consideration given by Purchaser Co would be increased to $30.

Head Co's exit ACA would instead be:

Step	Description	Amount
1	Terminating value of assets	-
4	Accounting liabilities	-
		-

Accordingly, Head Co would make a capital gain of $30, which would equal Head Co's economic gain.

[5] Derivative liability of $100 less expected future deduction of $30 plus DTL of $30
[6] After 8 iterations

For Purchaser Co, the entry ACA would initially be:

Step	Description	Amount
1	Cost of membership interests	30
2	Accounting liabilities	70
		100

The notional ACA under section 705-80 would be as follows:

Step	Description	Amount
1	Cost of membership interests	30
2	Accounting liabilities	100
6	Acquired losses	(30)
		100

The final ACA would be $100, which would be allocated to the derivative asset. If Sub Co were wound up, it would make an economic loss of $30 since it acquired Sub Co for that amount but would receive no cash on the wind up. However, it would make a tax loss of $100 consisting on settlement of the derivative liability. Accordingly, removing the effect of DTLs from the exit and entry ACA calculations does not result in alignment of the economic and tax outcomes.

We also note that if the Board's proposed rule to deem deductible liabilities to be assumed by the head company, at their accounting value, at the joining time were introduced, it would appear that alignment between tax and economic outcomes would still not arise in the above scenario. That is, the consideration given by Purchaser Co would be nil if the DTA and DTL were both ignored.

Head Co's exit ACA would still be nil, resulting in Head Co making no capital gain or loss on the disposal of Sub Co. This would equal the economic outcome.

For Purchaser Co, the entry ACA would initially be:

Step	Description	Amount
1	Cost of membership interests	-
2	Accounting liabilities	100
		100

The notional ACA under section 705-80 would be as follows:

Step	Description	Amount
1	Cost of membership interests	-
2	Accounting liabilities	100
6	Acquired losses	(30)
		70

[7] Proceeds of $100 less tax cost of $76.92

The final ACA would be $70, which would be allocated to the derivative asset. If Sub Co were wound up, it would make no economic gain or loss since it acquired Sub Co for no consideration and would receive no cash on the wind up. However, it would make a tax gain of $30 on settlement of the derivative asset.

3. Adjustments to the value of liabilities

We are not aware of any liabilities other than DTLs to which subsection 705-70(1A) applies. We agree that this provision could be repealed if the effect of DTLs is removed from the exit and ACA calculations.

In relation to the proposed removal of section 705-80, we agree that this provision does not have any practical effect in full acquisition scenarios. Continuing with the derivative asset and liability example above, it is useful to consider the outcomes for Purchaser Co where section 705-80 is ignored:

For Purchaser Co, the entry ACA would be:

Step	Description	Amount
1	Cost of membership interests	-
2	Accounting liabilities	100
		100

Currently, the notional ACA under section 705-80, as worked out earlier, would be $70, resulting in a final ACA of $70. As highlighted earlier, this gives rise to a mismatch between the tax and economic outcomes.

If section 705-80 were ignored, ACA of $100 would be allocated to the derivative asset. If Sub Co were wound up, it would make no economic gain or loss since it acquired Sub Co for no consideration and would receive no cash on the wind up. Furthermore, it would make no tax gain or loss on settlement of the derivative asset (since it would not have a tax cost of $100), and there would be no tax gain or loss on settlement of the derivative liability.

4. CGT issues

41. Issues with roll-overs

We agree with the CGT roll-over interaction issues identified by the Board. To determine if the introduction of the systemic rules is appropriate, we have sought to apply those rules to the examples set out in the Board's report. For convenience, we have briefly summarised those rules below:

Rule	Description
1	Differentiate between an acquisition and a restructure • Restructure rule in section 124-784 applies • Deemed restructure if roll-over under Subdivisions 122-A, 122-B, 124-G, 124-H or 126-B
2	Determine the cost base of membership interests • Restructure under rule 1 – underlying asset approach • Not a restructure – approach under specific roll-over provision
3	Interposition of new holding company • Restructure under rule 1 – old consolidated group continues to exist with new holding company treated as head company • Not a restructure – although not explicitly stated in the Board's report, it appears that the old consolidated group would cease to exist
4	Retaining existing tax costs • Restructure under rule 1 – retain existing tax costs of joining entity's assets • Not a restructure – although not explicitly stated in the Board's report, it appears that

	the old consolidated group would cease to exist
5	Other interaction issues • Determining the time at which the underlying tax asset approach is applied (that is the completion time) • Switching off the single entity rule so that the underlying tax assets of the joining entity can be seen for the purpose of the underlying tax asset approach

In relation to Example 7.1 of the Board's report, these rules would apply as follows:

Rule	Description
1	Differentiate between an acquisition and a restructure • There would be a deemed restructure as the individuals utilise Subdivision 124-H roll-over
2	Determine the cost base of membership interests • The cost base of Hold Co's units in Trust A would be $1,000
3	Interposition of new holding company • Not relevant
4	Retaining existing tax costs • Both Trust A and Company A will become members of Hold Co's consolidated group

It is not clear how these rules will apply where chains of multiple entities are rolled over as is the case under Example 7.2. If rule 2 applies to set the cost base of Hold Co's units in Trust A at $1,000, this would be allocated to the shares in Company A upon formation of the consolidated group. The entry ACA would be exactly the same as that worked out in the Board's report (i.e. $3,000).

If rule 4 instead of rule 2 applied, then Company A retain the current tax costs of cash at bank ($5,000) and the depreciable assets ($10,000). While this would be an appropriate outcome, as mentioned earlier, clarification is required of when rule 4 would apply.

In this example, clarification is required of the interaction between rules 2 and 4. If rule 4 applies, it would not appear necessary to apply rule 2. The cost base of membership interests under rule 2 would be relevant to step 1 of the entry ACA calculation. However, if rule 4 applies, it would appear unnecessary to perform an entry ACA calculation.

In Example 7.1, if rule 2 applied, the entry ACA would be as follows:

Step	Description	Amount
1	Cost of membership interests	13,000
2	Accounting liabilities	2,000
3	Owned profits	-
		15,000

This amount would be allocated to cash ($5,000) and the depreciable assets ($10,000).

If, instead, rule 4 applied, it would not be necessary to perform an entry ACA calculation. However, the same outcome would arise. That is, the tax costs of cash and the depreciable assets would be $5,000 and $10,000 respectively.

It may be that the Board was contemplating a scenario where Company A was rolled over to Hold Co but Hold Co had not yet formed a consolidated group.

In that case, rule 4 would not apply as there is no existing consolidated group. If Hold Co subsequently decided to form a consolidated group, rule 2 would then be applied to determine Hold Co's cost base of its membership interests in Company A.

Having regard to the above, clarification is required by the Board of how rules 2 and 4 are intended to interact.

Turning to Example 7.2, the proposed rules are expected to apply as follows:

Rule	Description
1	Differentiate between an acquisition and a restructure • There would be a deemed restructure as the trust utilises Subdivision 122-A roll-over when it transfers Company A to Hold Co
2	Determine the cost base of membership interests • The cost base of Hold Co's membership interests in Company A would be $13,000 being the total cost bases of the assets of $15,000 less then loan of $2,000
3	Interposition of new holding company • Not relevant
4	Retaining existing tax costs • Hold Co would retain the existing tax costs of Company A's assets

Example 7.4 considers the cessation of a consolidated group when a new holding company is interposed on top of an existing consolidated group. The only roll-over where the group can continue to exist is that under Subdivision 124-G. This issue would be addressed by rule 3.

4.2 MEC groups

We also note that the focus of the Board has been on consolidated groups. It is noted that similar issues can arise with MEC groups. For example, an MEC group may consist of a single eligible tier-1 (**ET-1**) company. The membership interests in an ET-1 would be held by a foreign company either directly or indirectly through other foreign companies, partnerships or trusts. Depending on the ownership profile of the ET-1, if a new Australian resident holding company is interposed between the foreign resident shareholders and the existing ET-1 company, different roll-overs may be available, which will give rise to the same anomalies identified by the Board in relation to consolidated groups. It is assumed that the membership interests in the existing ET-1 company constitute indirect Australian real property interests as defined in section 855-25.

Similarly, if a MEC group consists of 2 or more ET-1 companies, interposition of a new Australian resident company would usually require the new company to be incorporated and the existing ET-1 companies transferred to that company. While Subdivision 126-B roll-over would be available if the membership interests in the ET-1 companies are indirect Australian real property interests, exit ACA calculations would still be required for the subsidiary members of the MEC group.

4.3 Liabilities

In relation to the proposed underlying asset approach, we note that section 124-784B requires liabilities in respect of assets to be subtracted in working out the first element of the cost base of membership interests acquired in the original entity. The term 'liabilities' is not defined although subsection 124-784B(4) states that a liability that is not in respect of a specific asset is taken to be a liability in respect of all the assets of the entity.

At the NTLG Losses & CGT subcommittee meeting on 7 June 2006, the ATO provided the following guidance on whether a DTL would be a liability in respect of an asset for the purposes of Subdivision 124-G:

> *Subdivision 124-G deals with liabilities in respect of assets. We consider that it is appropriate to give the term its legal meaning. It extends to a legally enforceable debt that is due for payment and to a presently existing obligation to pay either a sum certain or an ascertainable sum. It does not extend to contingent liabilities, future obligations or expectancies. As is noted in the question, the*

consolidation and other regimes specifically refer to deferred tax liabilities, and we consider that these legislative references to the revised accounting standards extend the meaning of the word 'liabilities' beyond its ordinary meaning for CGT purposes (i.e. a legal liability).

This approach is consistent with the approach adopted in respect of the meaning of liabilities for the purposes of the small business CGT concessions. In ATO ID 2004/206 we said:

The term 'liabilities' as used in sub-section 152-20(1) of the ITAA 1997 to determine the net value of the CGT assets of an entity, has its legal meaning. Amounts that are within the accounting meaning of the term 'liabilities' but not within its legal meaning, are therefore not within the scope of the term as used in sub-section 152-20(1) of the ITAA 1997.

The ATO refers to ATO ID 2004/206, which has since been withdrawn and replaced by TD 2007/14. Paragraph 18 of that determination states:

In the context of subsection 152-20(1), 'liabilities' extend to legally enforceable debts due for payment and to presently existing obligations to pay either a sum certain or ascertainable sums. The term does not extend to contingent liabilities, future obligations or expectancies.

Having regard to the above, it appears that some liabilities that are recognised under the accounting standards would not be liabilities for the purposes of the roll-over rules, in particular the underlying asset approach contained in section 124-784B. Consider the following example:

- Sub Co is owned by Trust A, which previously incorporated Sub Co with share capital of $200
- Trust A rolls Sub Co over to Parent Co utilising roll-over relief under Subdivision 122-A
- Parent Co is not the head company of a consolidated group
- Sub Co has the following balance sheet at the time of the roll-over:

Currently, if Parent Co later formed a consolidated group, and Sub Co’s position in the balance sheet is unchanged, the entry ACA would be as follows:

Assets	**$**	**Liabilities and equity**	**$**
Cash at bank	100	Share capital	200
Land	100	Provision	100
DTA	30	Retained earnings	(70)
	230		230

The entry ACA would be as follows:

Step	**Description**	**Initial**	**Notional**
1	Cost of membership interests	200	200
2	Accounting liabilities	100	100
2	Reduction for future deduction	(30)	
6	Acquired losses		(30)
		270	270

The final ACA would be $270, which would be allocated to cash at bank ($100) and land ($170).

If rule 2 applied, under the underlying asset approach, the tax cost of Parent Co’s membership interests in Sub Co would be $200. That is, the provision, based on TD 2007/14, would not be taken into account, which would still result in a step 1 amount of $200 (based on the cost base of Trust A’s shares in Sub Co).

While the correct outcome arises under the above example, it is useful to revisit the current treatment of DTLs in the context of the above. If a DTL were recognised in the balance sheet of Sub Co, it is noted that it would still increase the step 2 amount currently but, if an underlying asset approach were adopted, it would not reduce the amount taken into account at step 1. Accordingly, the above example and the non-recognition of DTLs as liabilities for the purposes of the underlying asset approach is another reason in favour of removing DTLs from entry and exit ACA calculations going forward.